Daniel Churcher
Law Commission
Steel House
11 Tothill Street
London SW1H 9LJ

5th July 2013

Dear Daniel,

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) is keen to share its views, ideas and observations on the Law Commission's initial paper related to the 'Fiduciary Duties of Investment Intermediaries'. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC).

The PSMPC identifies and monitors key regulatory and best practice developments likely to affect CFA UK members. The PSMPC has been an active contributor to the Kay Review[1]. The PSMPC is keen to present some of the strengths and limitations of the Review that will have a material bearing on the Law Commission's initial and consultation papers.

<u>Context and scope</u>

Before considering the answers to the questions raised, it is crucial for the Commission to gain a practitioner perspective of the issues raised by the Kay Review and the subject of fiduciary duty. We note that one of the key limitations of the Kay Review with regard to the investor was the focus on equity at the exclusion of all other asset classes. In the evidence we provided to the Kay

[1] The Kay Review of UK Equity Markets
https://www.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf
CFA UK response Kay Review Final Report
https://www.cfauk.org/assets/2829/Kay_Review_recommendationsSENT.pdf

Review we highlighted that investors invest in more than one asset class and care about the return from the total portfolio rather than just constituents. The Law Commission should not make the same error by looking at one asset class in isolation, in this case equity. The commission's third term of reference suggests that relevant stakeholders in the equity investment chain should be consulted. The word 'equity' should have been omitted. The expression of fiduciary duties relates equally to all asset classes.

It is important for the commission to note (as we commented in our various responses to the Kay Review) that the investment chain can be quite involved. Participants in asset markets are diverse (each having their own objectives, views on return generation, and holding periods) and the evolution of capital markets has encouraged the development of a diverse set of intermediaries.

Where trustees are involved, their fiduciary responsibility to put their beneficiaries interests' first is clear. Where agents provide investment services, the duty of care is very high, but not set at the level of a fiduciary standard. This should not compromise the ability of the investment professional to act in the client's interests, despite the conflicts of interest they may face. In our view, when firms fail to manage conflicts and place their interests ahead of their clients, it is due to ineffective governance within these firms combined with inadequate supervision and enforcement of the existing regulations rather than a failure of those regulations. As we understand the term fiduciary, we do not believe that the imposition of a fiduciary standard on UK regulated firms is practical.

Scope and regulatory requirements for UK regulated firms

'Kay criticised FCA rules as failing "materially below the standards necessary to establish" trust, confidence and respect.'

(Law Commission Initial paper 'Fiduciary Duties of Investment Intermediaries' 2013)

According to the Law Commission's 1992 report, to meet the fiduciary standard one must meet the following four conditions -

1) *The "no conflict rule"* – a fiduciary must not place themselves in a position where their own interest conflicts with the beneficiary.

2) The "no profit rule" – a fiduciary must not profit from their position at the expense of the beneficiary.

3) The "undivided loyalty rule" – a fiduciary owes undivided loyalty to their beneficiary, and therefore must not place themselves in a position where their duty towards one beneficiary conflicts with a duty they owe to another beneficiary.

4) The "duty of confidentiality" a fiduciary must use information obtained in confidence from a beneficiary for the benefit of the beneficiary and must not use it for their own advantage or for the benefit of any other person.

While all investment professionals have a duty of care to their clients[2], it would not be possible for them – as agents – to meet the four criteria listed above. Investment firms face conflicts on a daily basis. They are paid by their clients so profit from their position and act on behalf of more than one client so cannot meet an undivided loyalty rule (consider the simple case of heterogeneous assets that must be allocated to a single client portfolio). It is only those that represent a single beneficiary that can and should meet the fiduciary standard.

The challenge for trustees in meeting a fiduciary standard in the UK is the need to have the skills and expertise to fulfil their duties in the interest of the end beneficiary. The approach to UK pension fund trusteeship, including member nominated trustees, means that pension funds may be well placed to serve members interests from a motivational point of view, but may be poorly positioned to uphold their fiduciary responsibilities because of a lack of appropriate financial education and experience. The Trustees Act 2000 helps to mitigate that risk because of its requirement for trustees to take investment advice from a suitably qualified person, which largely mitigates the risks posed from their own knowledge gaps. The example given of 'investing in the wrong fund' would have been avoided if expert support had been provided on the design of a carefully drafted Investment Policy Statement[3].

We accept that investment professionals can fall short of their duty of care. In the case of the Madoff scandal, it became clear that many investment intermediaries and advisers did not undertake adequate due diligence; resulting in significant client losses.

We suggest that when assessing the fiduciary criteria of the investment chain it would be better to distinguish between those that need to meet a fiduciary standard and those that have a duty of care that has a fiduciary quality. The new UK regulator, the Financial Conduct Authority (FCA)[4],

---

[2] As described in the society's position paper on stewardship http://www.cfauk.info/integrity/
[3] Elements of an Investment Policy Statement for Institutional Investors
Codes, Standards, and Position Papers May 2010, Vol. 2010, No. 13
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n13.1

Elements of an Investment Policy Statement for Individual Investors
Codes, Standards, and Position Papers, Elements of an Investment Policy Statement for Individual Investors (May 2010): 1-9.
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n12.1

[4] Journey to the FCA
http://www.fca.org.uk/your-fca/documents/fsa-journey-to-the-fca

recognises that duty of care is paramount regardless of the status of the client and that *caveat emptor* is no longer a defence.

In relation to point 1.5 in the commission's document listing its initial questions, we disagree with Professor Kay's criticism of the FCA rules. The regulatory failure was not a consequence of insufficient regulatory scope, but was the result of the inadequate exercise of existing regulatory powers. Those powers remain – and have been extended – and are backed by widespread voluntary adoption of ethical codes and standards of professional conduct such as our own[5].

The UK regulatory framework makes clear the duties and responsibilities for regulated firms and individuals in the financial sector. The Principles for Businesses[6], the Conduct of Business[7] rules the Approved Persons Regime[8] (which may be replaced in future) and the 'Fit and Proper'[9] tests set out what is required. Client interests are paramount. In addition, to these responsibilities our members abide by a Code of Ethics and Standards of Professional Conduct (see Appendix for a summary) that requires them to place client interests first and to respect the integrity of the capital markets. This, like our suggestion to you, requires our members to act in accordance with a duty of care with a fiduciary quality, rather than meeting the strict definition of the fiduciary standard.

Do Fiduciary Duties over-emphasis financial returns?

Those that have a fiduciary duty should always act solely in the interest of the beneficiaries. Those fiduciaries that are responsible for the investment assets of the beneficiaries should ensure that they are generating the types of returns that meet the criteria, preferences, risk profiles and capacity of loss of the beneficiaries. However financial returns are not the only criteria to consider.

We believe that a fiduciary should consider the overall wellbeing of its beneficiaries. For example a trustee of a UK pension fund is right to consider the trade-off between demanding additional cash funding to improve the liquidity of the pension fund versus putting an undue strain on the sponsoring employer and endangering the jobs of those beneficiaries. Beneficiaries will differ in the way they want trust assets managed; some may have strong preferences (e.g beneficiaries working within medical charities not wishing for the trust to investing in tobacco companies or a

[5] See appendix
[6] http://fshandbook.info/FS/html/FCA/PRIN/2/1
[7] http://fshandbook.info/FS/html/FCA/COBS/2

[8] http://fshandbook.info/FS/html/FCA/APER/1
[9] http://fshandbook.info/FS/html/FCA/FIT/2

defined contribution member being unwilling to save unless offered a Socially Responsible Investment option). We believe that it is reasonable for a fiduciary to consider whether it is appropriate to invest in assets that contrast with the beliefs and preferences of their beneficiaries. However, the risk of relative underperformance as a consequence of restricting the investable universe should be acknowledged and addressed by the trustees.

QUESTIONS FOR DISCUSSION

The Law Commission should take note to distinguish where the fiduciary standard lies and where the duty of care having a fiduciary quality is owed. We encourage the commission to focus its thinking on the investable portfolio in aggregate rather than on a portion allocated to equities. Beneficiaries and those that act on their behalf, care about the performance of the entire portfolio, not just the part invested in equities.

Who is subject to fiduciary duties?

Do you believe that you are subject to fiduciary duties? Does this cause problems in practice?

The fiduciary duty lies with those directly responsible to the ultimate beneficiary; for example, the trustees of a pension fund, charity or similar organisation. Where those trustees delegate their management of the portfolio to investment professionals, the latter have a duty of care to act in a manner that has a fiduciary quality. However, as those investment professionals may have other clients, they cannot offer undivided loyalty. Equally, while they should make every effort to avoid conflicts of interest where they can (and to mitigate those where they cannot be avoided), the 'no conflict' rule is not attainable. Investment professionals must act in the best interests of their client and where investment professionals sub delegate the selection and construction of portfolios to other regulated professionals there is duty to ensure that the portfolios are being managed in a manner aligned with the ultimate beneficiary's risk profile, capacity for loss, preferences and circumstances.

Are fiduciary duties a moral code?

Do you perceive fiduciary duties to be a form of moral code? Is it helpful to think about fiduciary duties in this way?

A fiduciary duty is a legal obligation to act in the best interest of another party. This responsibility may be perceived as a moral and ethical responsibility, but it is its backing in law that makes it powerful and effective.

What can fiduciary investors take into account?

We are particularly interested in exploring how far pension trustees and others wish to take into account:

(1) Environmental, social and governance factors relevant to a company's long-term financial performance, which might not have an immediate financial impact;

(2) Beneficiaries' interests other than the maximisation of financial return, such as their future quality of life or whether they might lose their jobs if a voting right was exercised on a takeover bid; and

(3) The ethical views of the beneficiaries and generally prevailing ethical standards.

How is the law perceived, and it does it act as a barrier to ethical investment?

The aim should be to meet the client's **risk-adjusted return** requirements subject to any constraints or additional objectives that the client wishes and which are permitted by a relevant regulator. We believe that there is little evidence that pension trustees wish to take greater account of ESG factors, except where these factors are considered likely to have a financial implication.

Do fiduciary standards encourage 'lemming behaviour'?

The Kay review was told that fiduciary duties could lead to "herding or even 'lemming' behaviour'". Investment intermediaries may attempt to protect themselves against criticism by doing the same as everyone else. As Lord Myners 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". This may make investment intermediaries overly cautious. Alternatively, it could encourage very risky behaviour if that was the approach of other investors.

Do fiduciary duties place too much emphasis on prevailing investment norms?

This question is confused. Fiduciary standards apply to trustees. In the context of the commission review, their role is to ensure the appropriate investment of the trust's assets in the ultimate interests of their beneficiaries. They will take account of actuarial estimations, the regulatory environment in which they operate and the economic outlook. It should not be surprising that different sets of trustees (with responsibility for similar sets of liabilities and operating in similar environments) may come to similar conclusions as each other as to how best their assets might be invested.

Lord Myners's criticism of herding in the investment profession related to the tendency of investment managers to 'hug the benchmark'. This is a behavioural flaw based around limiting personal career risk. It is not related to the expression of a fiduciary duty.

Those that have a fiduciary duty should follow a patient and disciplined approach to the investment program for their beneficiaries rather than be tempted to action owing to short term changes (usually negative) in their portfolios. Investment fads come and go and those that have fiduciary duty should not succumb to them not matter how tempting they may be.

Do fiduciary duties encourage too much diversification?

The current case law and statutory rules require fiduciaries to act "prudently" by seeking to diversify their portfolios. Yet Kay identified fragmented shareholding as a major factor in discouraging the effective engagement between shareholders and companies.

Does the law encourage too much diversification?

In short, no. It is disappointing that the concept of diversification is confused with the issue of fragmented shareholding and engagement. When a portfolio is constructed **to meet the beneficiary's needs**, it is designed to achieve the most appropriate risk adjusted return. To do so requires populating a portfolio with different assets, e.g equities, bonds, cash etc to align with the risk profile and return requirements of the beneficiary.

Each constituent of the portfolio contributes to the return of the portfolio but also helps manage the risk of the portfolio. Diversification enables one to have a portfolio that contains a broad array of assets so that if some assets decline in value others may compensate by going up in value. From the beneficiary's perspective the portfolio is either diversified or under-diversified. Fragmented shareholdings (and the reduction in shareholder influence that may result) may be a consequence of diversification but it is one worth bearing.

Do fiduciary duties discourage stewardship?

It has been suggested that any time spent by shareholders in guiding companies to make good decisions suffers from the "tragedy of the commons". In other words, there are clear collective benefits from such work, but no one shareholder benefits enough to justify the cost of the work. This leads to the question of whether stewardship activities are compatible with fiduciary duties, if the benefit to the investor does not justify the cost. Do you perceive any tension between fiduciary duties and time spent on stewardship?

CFA UK believes that investment managers' primary responsibility is to act as stewards of the assets entrusted to them by clients, not as stewards of corporate assets.

However, we take your question to relate to the issue of corporate engagement. Fiduciary responsibility requires the beneficiaries' interests to be put ahead of broader societal interests. This means that if the costs of corporate engagement exceed the potential benefits from it to the beneficiary, then a fiduciary should not engage in such activities.

For an investment manager acting as a steward of its client interests, it may be possible that their primary responsibility is met through active engagement with investee companies, but it is also possible that it is not. Engagement with companies is intended to improve value creation within that company, but investment managers' responsibility is to generate the risk-adjusted returns that their clients expect. Sale of an asset may better serve this purpose as the costs of engagement may outweigh benefits.

Rather than requiring fiduciaries individually to act counter to their duties, a better way to tackle this issue would be to seek to reduce the cost of engagement through collective action. This approach is being developed elsewhere as a response to a separate recommendation of the Kay Review.

Are some permitted market practices incompatible with fiduciary duties?

The Kay report identifies some areas in which financial market rules permit practices which are incompatible with fiduciary duties. One example is that income from stock lending is not always disclosed and rebated to the ultimate investor. Is this a problem? And are there other conflicts of which we should be aware?

No comment.

Exclusion clauses

We are interested in the extent to which financial intermediaries use exclusion clauses to modify their duties to their clients. When are such clauses appropriate and when inappropriate?

No comment

Delegation

In an increasingly specialist financial services landscape fiduciaries often delegate their investment powers. The Trustee Act 2000 and Pensions Act 1995 explicitly recognise the desirability of this by protecting trustees from liability so long as they have taken all reasonable steps to confirm that their agents have the necessary skills and are carrying out their work competently. However, delegation may create confusion as to who is ultimately responsible for fulfilling fiduciary obligations.

Do you delegate your investment duties or fulfil delegated duties? If so, to what extent do you believe fiduciary duties apply to you?

The CFA UK represents members who work for pension schemes and charities who may delegate some part of their investment duties, but most of our members work for investment management or investment consulting firms fulfilling delegated duties. As we have outlined above, we believe that there is a duty of care sharing qualities of a fiduciary standard on all those fulfilling delegated investment roles.

We trust that these comments are useful and would be pleased to discuss them in person.

Yours,

Natalie WinterFrost, CFA FIA
Chair Professional Standards & Market Practices Committee,
CFA Society of the UK

Will Goodhart
Chief executive
CFA Society of the UK

Sheetal Radia, CFA FRSA
Policy Adviser
CFA Society of the UK

About CFA UK and CFA Institute

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.

Appendix

CFA Institute

CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity of and uphold the rules governing capital markets.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:
   a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients. Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Members and Candidates in the CFA Program. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.