David Hertzell
Law Commission
Steel House
11 Tothill Street
London SW1H 9LJ

22nd January 2014

Dear David,

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 consultation paper (No 215) 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] and the Law Commission's initial paper[2].

[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

[2]CFA UK response to "Fiduciary Duties of Investment intermediaries: Initial Questions"
https://www.cfauk.org/assets/2725/CFA_UK_Fiduciary_Duty_2013_SENT.pdf

Overview

"Our provisional view is that the law of fiduciary duties as such should not be reformed by statute. ***Fiduciary duties are difficult to define and inherently flexible………*** *The difficulties of using the word fiduciary would multiply if one were to attempt statutory reform. Any attempt to change fiduciary duties through legislation would result in new uncertainties and could have unintended consequences, especially for trusts."* (Law Commission[3])

There is much to welcome in how the Law Commission has developed its consultation paper and the helpful manner by which it has been set out. CFA UK welcomes the provisional view that further statutory reform is not required given the uncertainties that would arise from such change. Equally important is the recognition that the law can only go so far and that trustees and investments professionals must ensure that they fulfil their responsibilities.

CFA UK also agrees that where fiduciary duty does apply is at the trustee level; although investment intermediaries are unable to live up to the fiduciary standard their duty of care should be of a fiduciary quality. Just as important is that investment professionals duty of care is the same high standard regardless of the classification of the client. In addition to their regulatory obligations, CFA UK members abide by the CFA Institute's Code of Ethics and Standards of Practice[4]. The Code and Standards requires members to exercise their responsibilities to clients with the fiduciary qualities of loyalty, prudence and care. While we can understand the emphasis placed on pension trustees, our response has a broader context because our members act for a variety of client types ranging from private individuals to institutional clients.

CFA UK agrees with the commission's view that there has been too much emphasis on 'buyer beware'. This has to be balanced with 'seller beware'. This would address the imbalance in favour of the client.

We also welcome the Law Commission's recognition that those that have a fiduciary duty, such as trustees look at the entire portfolio and not a single investment or asset class in isolation. Furthermore, we concur with the commission's conclusion that many of the issues related to investment intermediaries raised by the Kay Review would be better addressed by the financial

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[3] "Fiduciary Duties of Investment Intermediaries"; consultation paper no 215
http://lawcommission.justice.gov.uk/consultations/fiduciary_duties.htm
[4] Standards of Practice Handbook, Tenth Edition (effective 1 July 2010)
http://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2010.n2.1.aspx

services regulator. CFA UK has commented in the past that we need a more effective regulatory regime where the onus is on supervision and enforcement rather than new rules and guidance. This view is supported by several Parliamentary reports[5] and the comments by Lord Turner[6] that have highlighted the lack of effective regulation in the years leading up to the financial crisis of 2008. As we are learning on a regular basis, firms that acted inappropriately prior to the crisis are only being exposed since the crisis broke. Where the client's interests are not protected, then it is imperative that the governance mechanisms to protect the beneficiary's interests are robust enough to hold those responsible to account.

While the focus on investment intermediaries is welcome there is also a noticeable absence of focus on the sell-side (universal, retail and investment banks and brokerages that provide services to the investment intermediaries). Without taking into account the role played by the sell-side, any assessment would be incomplete. In addition, the notable absence of the sell-side also needs to be addressed to provide a balanced approach to the investment chain.

The sell-side plays an important role in how the capital markets operate and interact with the investment chain. Hence, the sell-side has a key role to play in the area of market integrity, which is important to all financial market participants. The sell-side provides a variety of functions that range from forming expectations, price formation, providing liquidity and supply a variety of products and services used by investors to manage risks and liabilities. For example, pension schemes with liability driven mandates rely on the major banks to provide the means by which such mandates can be implemented. Given recent evidence has shown that some major banks have been associated with activity that has lowered trust and undermined market integrity; these institutions should be part of this and any other consultation related to the investment chain.

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[5] Parliamentary Commission on Banking Standards http://www.parliament.uk/bankingstandards

Parliamentary Commission on Banking Standards: 'An accident waiting to happen: The failure of HBOS'

http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/an-accident-waiting-to-happen-the-failure-of-hbos/

[6] 'Lord Turner admits FSA failures in financial crisis', Amanda Lee, Pensions Age, 15/10/2012

http://www.pensionsage.com/pa/lord-turner-admits-fsa-failures-in-financial-crisis.php

Some banks also provide investment services to a variety of clients either via their retail branch advisers or their private banking divisions. Key to these relationships is the nature of the services being provided. In the case of execution only business the duty of the bank will be less than if it is providing advisory services. Where advisory services are provided these are within the regulatory scope and face enforcement actions if the bank's conduct is found to be inappropriate[7].

We concur with the commission that the relevant laws can only go so far. Beyond legislation, actions depend on the behaviour of those with a fiduciary duty, investment profession, its industry and the regulator. It is vital that the commission appreciate how an investment mandate works in practice and the checks and balances that exist in this process. We use the term trustee loosely to cover a diverse array of beneficiaries (individuals or organisations for example charities and endowments) and those that represent their interests. We start by restating our view with regard to fiduciary duty; we then focus on the importance of effective regulation and later set out key elements of the investment process.

[7]FCA fines Lloyds Banking Group firms a total of £28,038,800 for serious sales incentive failings: Published: 11/12/2013
http://www.fca.org.uk/news/press-releases/fca-fines-lloyds-banking-group-firms-for-serious-sales-incentive-failings

Fiduciary Duty

As we stated in our previous response to the commission our members are unable to meet the fiduciary standard as specified below. To ensure our members appreciate why this is the case we reiterate the key elements of 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, it would not be possible for them – as agents – to meet all of the four criteria listed above. Our members abide by the CFA Institute's Code and Standards which ensures that CFA UK Members act for the benefit of their clients and place their clients' interests before their own, even though the fiduciary standard cannot be met.

While point 4 above can be met by investment professionals, the other three points cannot. 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.

Effective regulation

"Our new regulatory approach will be proactive and preventative, aiming to head off problems in advance." (Howard Davies, FSA Chairman, 2000[8])

"The crisis was not a bolt from the blue – it arose from poor supervision, bad rules and structures, ………… and the errors made by regulators, economists, central bankers and policymakers, as well as bankers themselves………A lot of apparently very clever people got it very wrong, and the ordinary citizen suffered. We have to do better in future."
(Lord Adair Turner, FSA Chairman 2012[9])

Meeting the fiduciary standard is not a panacea. As the commission has demonstrated, trustees can act against the interests of the beneficiaries. Similarly, investment intermediaries can also be held to account subject to the relationship they have with the client. What matters is trust. The key issue is when the beneficiaries' interests are not protected, those responsible for failing to place clients' interests first should be held to account. The financial services regulator does have a variety of powers available to hold firms to account.

Where the rules are breached, the FCA has a wide range of disciplinary, civil and criminal enforcement powers. These include powers to:

(1) withdraw authorisation;

(2) prohibit an individual from operating in all or some regulated financial activities;

(3) publicly censure firms and individuals;

(4) impose financial penalties;

(5) seek injunctions, including asset-freezing injunctions;

(6) seek restitution orders; and

(7) prosecute firms and individuals.

By using these powers appropriately, the regulator has the means to make an example of the offending firm(s) and send strong signals to other firms. These signals will simultaneously

[8] http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/009.shtml

[9] "Lord Turner admits FSA failures in financial crisis", Amanda Leek, Pensions Age 15/10/2012 http://www.pensionsage.com/pa/lord-turner-admits-fsa-failures-in-financial-crisis.php

reassure consumers that the regulator will not tolerate behaviour in which client's interests are placed second. While the record of the regulator prior to the crisis has been poor, we hope that the severity of the scandals now being unearthed will prompt the regulator to take stronger action. One U.S regulator has gone as far as issuing a cease and desist proceedings[10] to one global institution over the breach of regulations.

It was useful for the commission to set out clearly the manner by which the courts would view the relationship between the beneficiary (or their representative) and the investment professional. As we understand it the courts are reluctant to intervene even though they have the power to do so. Our members will find it valuable to learn that the courts are influenced by three interdependent considerations –

1) Respect for commercial relationships
2) Regulatory decision-making; and
3) Contract terms.

This reaffirms the view shared with the commission that it is in these three areas that require further attention rather than by reform of statute. Chapter 11 in the consultation provides useful examples where the categorisation of the client becomes crucial in determining the recourse available against a financial organisation.

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[10] The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against JPMorgan Chase & Co.("JPMorgan") http://www.sec.gov/litigation/admin/2013/34-70458.pdf

Trustees

The pensions legislation[11] *requires that investment powers are to be exercised 'to ensure the security, quality, liquidity and profitability of the portfolio as a whole', without 'excessive reliance on any particular asset, issuer or group of undertaking'.* (Law Commission)

Trustees must act in accordance to the powers that are granted to them by the trust instrument. Within these powers, trustees are afforded discretion when carrying out their duties. This flexibility is set out as follows -

(1) Trustees must not "fetter their discretion" by, for example, applying a pre-existing moral or political judgment;

(2) Trustees must consider the relevant circumstances; and

(3) Trustees must obtain proper advice.

Other considerations may also be needed to be taken into account although these would have to be consistent with the trust instrument and the beneficiary's interests. Trustees have the latitude to take into account other factors and interests for example environmental, social and governance (ESG) factors.

In fulfilling their duties, trustees should have the relevant knowledge and skill to ensure that any investment mandate aligns with the objectives of the beneficiaries. This applies not only to pensions schemes but also other similar constructs such as endowments, charities and foundations. However, there is flexibility available given the differences that exist between these types of entities.

The trustees should be best placed to hold their investment professionals to account as they have the power to terminate the contract. Taking investment advice and delegating the management of the portfolio does not absolve the trustees of their responsibilities to the beneficiaries. Lack of knowledge or understanding should not be an excuse for trustees not to provide robust challenge. In fact there are training courses and similar types of learning opportunities to enable trustees to

[11] Occupational Pension Scheme (Investment) Regulations 2005 SI 2005 No 3378

improve their knowledge about investments. CFA Institute has published 'A Primer for Investment Trustees'[12] which is publicly available and may be helpful as a source of information and insight to trustees.

Portfolio governance, preferences and type of mandate

"I think we should follow a simple rule: If we can take the worst, take the risk."

*(*Dr Joyce Brothers)

Any investment mandate should be formalised in a Statement of Investment Principles or Investment Policy Statement (IPS)[13]. Figure 1 sets out the variety of factors that need to be considered when designing an appropriate IPS. We recommend that the commission should review the IPS of different types of beneficiaries[14] to see how the contents align with the interests of the beneficiary. Figure 2 provides a potted example of an IPS which may be helpful. The IPS should set out the parameters for the managing the assets on behalf of the beneficiaries for example risk appetite, capacity for loss and other factors pertinent to the governance of the portfolio. In addition the IPS can also include preferences that can determine how the portfolio is constructed. Examples of preferences could include –

1) Medical charities often exclude investments in businesses that sell products linked to cancer.
2) Investing in companies with strong environmental credentials.
3) Excluding companies that are involved with gambling or alcohol production.
4) Trustees may prefer to avoid strategies where there is an extensive use of derivatives.

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[12] 'A Primer for Investment Trustees, Research Foundation Publications January 2011, Vol. 2011, No. 1
http://www.cfapubs.org/toc/rf/2011/2011/1

[13] CFA Institute's IPS July 2013
http://www.cfainstitute.org/about/governance/Documents/reserves_investment_policy.pdf

[14] Wellcome Trust Investment Policy, April 2013
http://www.wellcome.ac.uk/stellent/groups/corporatesite/@msh_publishing_group/documents/web_document/wtx062542.pdf

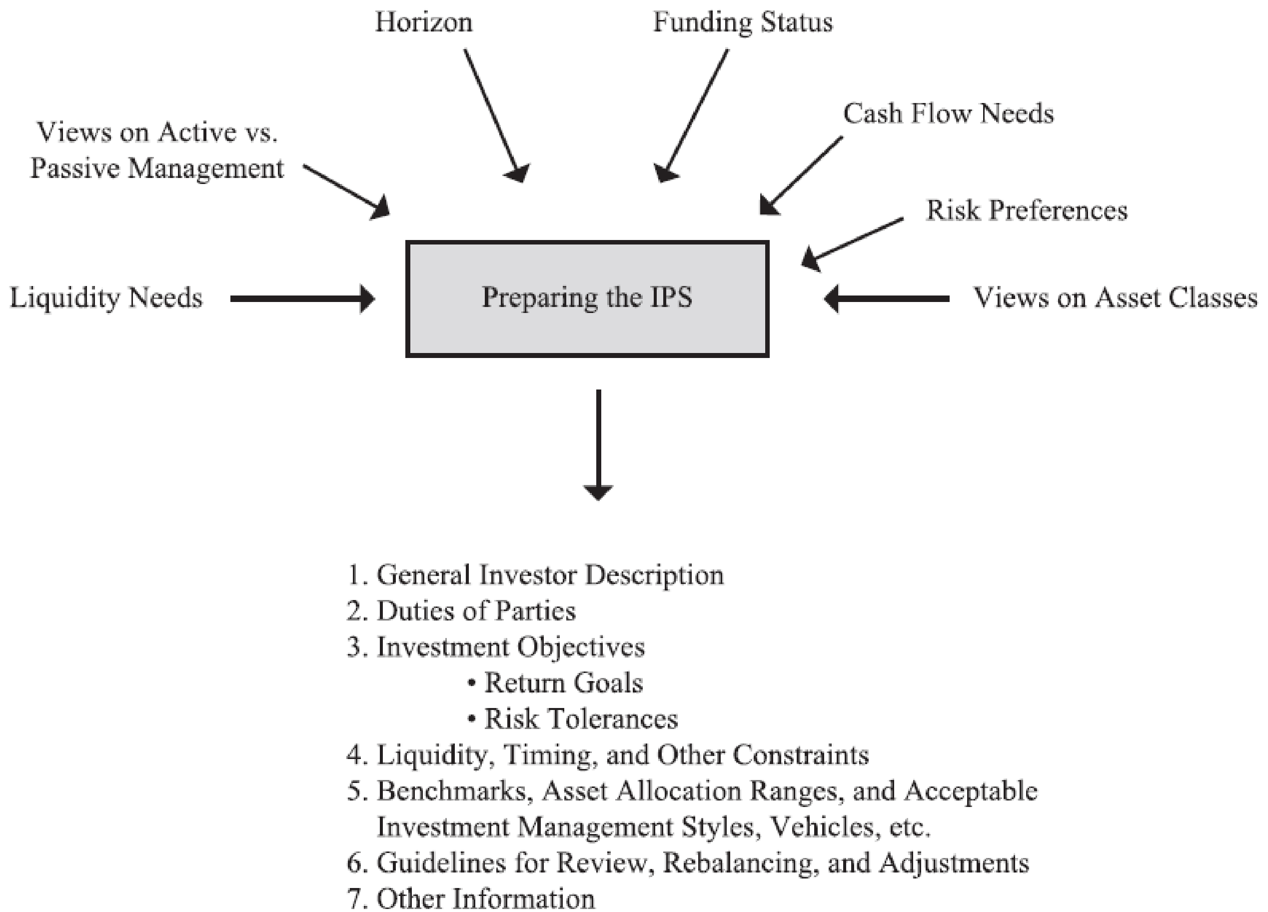
Other trustees may have a more flexible approach to where the portfolio is invested. The key here is that the portfolio should be aligned with the beneficiaries' interests or the mission of the organisation.

For trustees of defined benefit pension schemes it is vital that the liability profile is central to any investment mandate. Equally crucial is that even if some schemes have similar liability profiles, each scheme could take a different approach in managing them to align with the beneficiaries' preferences and the considerations of the employer. While herding is not unknown, schemes with similar liabilities may well take different approaches in how they manage these liabilities. Trustees should work in collaboration with their investment professionals so that the trustees can ensure that their requirements are being met and that where they are not, there is sufficient challenge to make sure investment professionals adhere to these requirements. Similarly, the investment professionals should be able to convey why the approach being proposed is suitable to match the liability profile of the scheme.

It is also important that the trustees appreciate the different types of mandate they can enter into, an issue not recognised in the consultation. For example, the trustees can have a discretionary mandate where the decisions are made for them without the need to be consulted. Alternatively, the trustees could have an advisory mandate that allows the trustees to be consulted before actions are taken on the portfolio. Both approaches have costs and benefits and it is crucial that whichever is chosen, the trustees make sure that the portfolio aligns with the preferences of the asset owner.

Related to the beneficiary's requirements is their choice of whether or not to participate in the lending of the securities (equity and bonds) they hold in the portfolio. Retail clients have less of a choice then institutional ones. Those that can exercise a choice may choose to forgo the fees by not taking part in securities lending, while others may choose to generate additional returns (income) from this practice. Those that are exposed to securities lending should be made aware of the risks and benefits of the practice. The consultation is correct that securities lending is not without risk. However, those that do provide stock lending for equities and repurchase agreements for bonds should have in place robust processes to minimise the risks in case of default by the borrower (i.e ensuring that these arrangements are collateralised according to reasonable parameters and that the collateralisation practices adhere to the applicable laws, standards or guidelines). Of course this service does require resources and so the lending fee rebated back to the asset owner will be net of reasonable costs.

Figure 1 – Preparing the IPS[15]



[15] Manager Selection, Research Foundation Publications, December 2013, Vol. 2013, No. 4, CFA Institute pubications

http://www.cfapubs.org/toc/rf/2013/2013/4

Figure 2[16] Sample extracts from an IPS

Sample Text from University of California Retirement Plan	
Section	Text
Objectives	
2. Investment Policy	"Capital Market . . . Asset Class . . . Manager Value-Added Risk" "[Manager] risk is an implementation risk and is the responsibility of the Treasurer (and indirectly the investment managers)." "select managers with experience and expertise . . . benchmark and range of probable outcomes"
4. Performance Objectives	"Return should exceed the Consumer Price Index on a consistent basis over time." "Return should match or exceed the total Retirement Fund weighted benchmark return." "Leverage may be used in Private Equity, Real Estate, and Absolute Return strategies."
5. Asset Class and Manager Guidelines	"All individual manager guidelines will be consistent with broad asset class guidelines and this Policy."
Appendix	"several risk measures which focus on surplus risk . . . [and] ratio of plan assets to liabilities" "Active risk or 'tracking error'"
Constraints	
2. Investment Policy	"implement procedures to provide efficient management of liquidity"
5. Asset Class and Manager Guidelines	"The purchase of securities issued by tobacco companies is prohibited in separately managed accounts." "The use of derivative securities or contracts to create economic leverage in the portfolio is prohibited."
Appendix	US Equity: Russell 3000 Tobacco Free Index
Rebalancing	
Appendix	"monitor monthly . . . rebalance assets . . . in a timely and cost effective manner when actual weights are outside the prescribed ranges" "may utilize derivative contracts (in accordance with Appendix 4) to rebalance the portfolio"
Schedule for Reviews	
5. Asset Class and Manager Guidelines	"Managers are required to submit periodic reports to the Treasurer summarizing investment activity and strategy." "Managers are required to reconcile investment returns with the custodian each month."

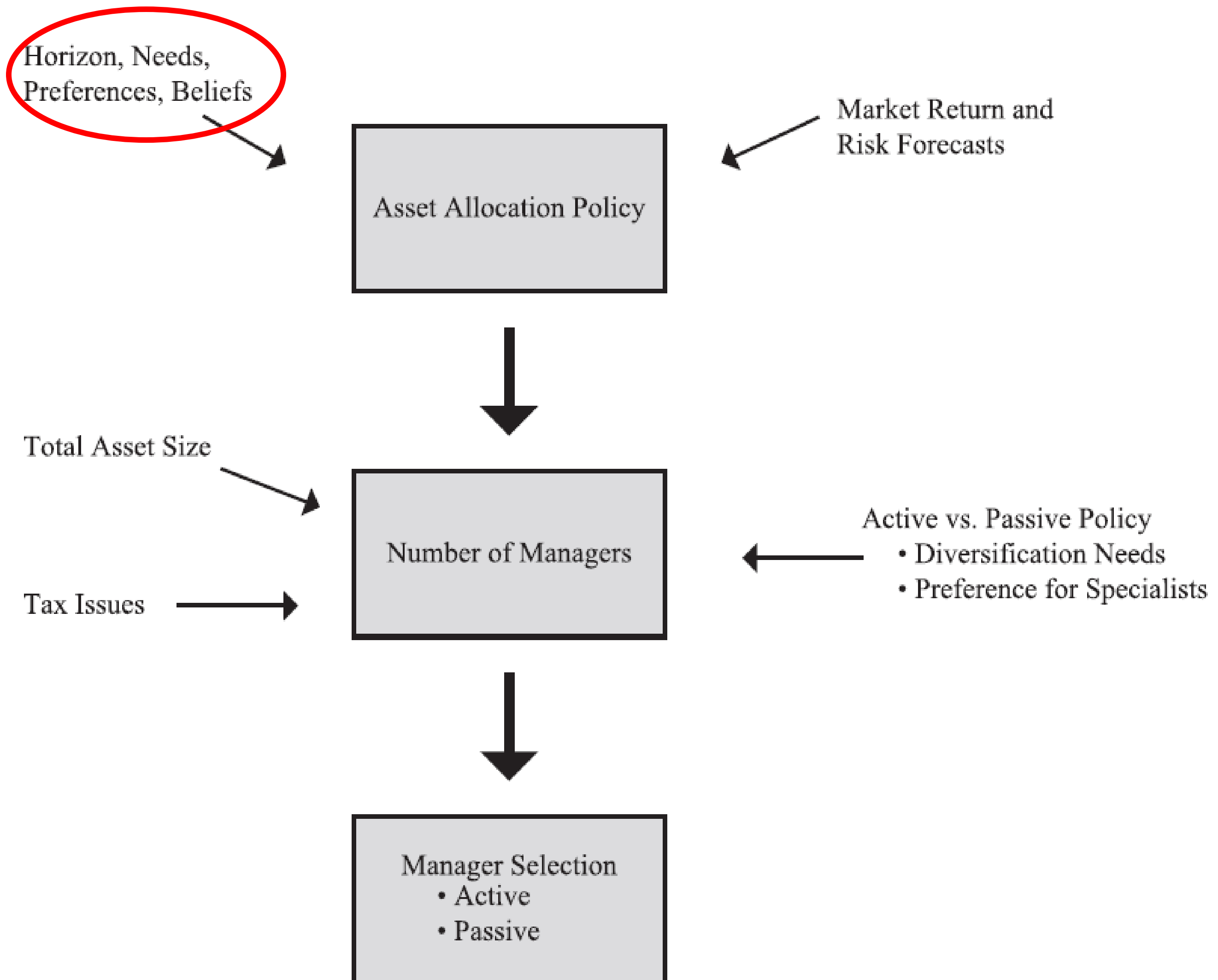
Source: May 2006 University of California Retirement Plan Investment Policy Statement.

[16] Ibid

Portfolio implementation, construction, risk adjusted returns; beneficiary interests come first

After the IPS has been completed the next stage is implementation which in itself creates a host of decisions which can be presented in Figure 3.

Figure 3[17] – Implementation process



[17]Ibid

It is welcome that the commission appreciates the need to consider the total portfolio not just one asset class. The Law Commission makes much of the terms 'over-diversification' and 'excessive diversification'. These concepts miss the point. The aim of any portfolio is to ensure that the risk adjusted returns are maximised subject to the beneficiaries' risk appetite, capacity for losses and preferences. Diversification is key to this because it allows the portfolio to reduce the risk in the hope that the expected return will rise.

Diversification involves spreading the portfolio over a wide array of assets. Figure 4 provides a list of these assets. While not all asset classes are needed in every portfolio, it is essential that any asset that is added to or taken away from the portfolio provides risk-adjusted benefits. There will be some assets in the portfolio that fall in value but it is hoped that other assets in the portfolio more than offset this decline by rising in value. Figure 5 provides an insight into some of the key elements to be considered when choosing the appropriate investments.

Figure 4[18]– Sample of asset classes that may be used to populate a portfolio

Public Markets	Illiquid Markets
Domestic equities	Private equity
Overseas equities	Venture capital
Commodity futures	Direct commodities
Real estate trusts	Direct real estate
Hedge funds	Timber
Domestic fixed income	Private debt financing
Overseas fixed income	

[18] Ibid

Figure 5[19] – Characteristics of public and non-publicly traded securities

	Publicly Traded Securities	Non-Publicly Traded Securities
Instruments	Equities, fixed income, commodity futures, REITs, high yield	Private equity, direct real estate, direct commodities, distressed
Portfolio construction	Diversified	Concentrated
Portfolio transparency	High	Low
Liquidity	High	Low
Funding	Quick implementation	Commitment implemented over time
Information sources	Much, publicly available	Much, privately collected
Fund accessibility	Commonly open	Commonly limited
Asset accessibility	Open	Limited
Asset ownership	Passive	Active
Leverage	Uncommon	Financial leverage common
Fees	Lower	Higher, performance based

Figure 6[20]– Access to investments can vary according to client type

Investor	Availability	Accessibility	Fees
Large institutional	Premium managers	Regular, portfolio managers	Lowest
Small institutional	Other institutional managers, funds of funds	Regular, portfolio managers and/ or relationship staff	Lower
High net worth	Small managers, consolidators, mutual funds	Infrequent, relationship staff	Higher
Individual	Mutual funds, insurance products	Only published information	Highest

Figure 6 demonstrates that how the client type can influence the access to investment opportunities which in turn can influence how the portfolio is populated.

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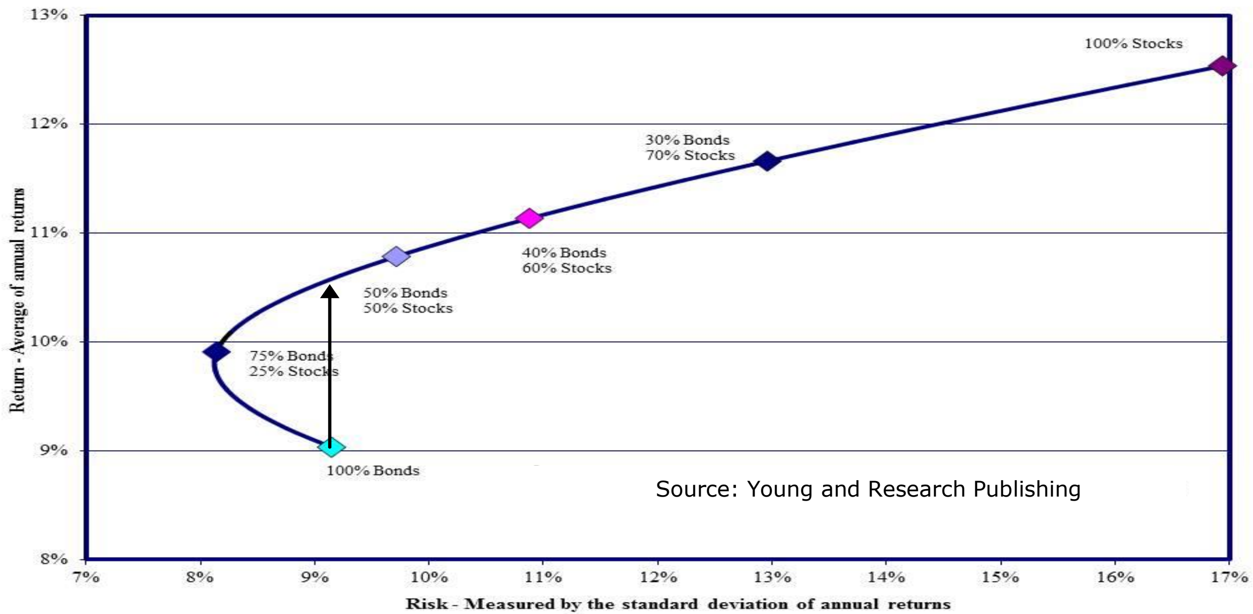
[19] Ibid – REITs are Real Estate Investment Trusts
[20] Ibid

Chart 1[21] – Efficient Frontier



Based on the beneficiary's requirements a portfolio can be diversified or concentrated. It may be preferable for the commission to adopt this terminology. Chart 1 presents an efficient frontier along which various portfolios are plotted. For the sake of simplicity, the portfolios only use two asset classes, bonds and equities.

The majority of the portfolios along the frontier are diversified. What this means is that these portfolios maximise the return for a given level of risk, or minimise the risk for a given level of return. Any portfolio that plots below this line is deemed undiversified. For example, the 100% bonds portfolio is concentrated because one could reduce the weighting to bonds say to 60% and increase the weighting to equities from 0% to 40%; thereby move along the frontier to attain a higher level of return for the same level of risk provided by the 100% bonds portfolio.

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[21] http://www.youngresearch.com/authors/ejsmith/risk-and-reward-an-efficient-frontier/

In practice, while a diversified portfolio may be preferable, it may not always be appropriate or aligned with the beneficiary's interests. For instance, the trustees may deem it necessary to keep the entire portfolio invested in bonds for good reasons despite the chance to earn a higher return via a different approach. The reasons could include, a mature liability profile for a defined benefit scheme, the beneficiary having a very low capacity for losses, an aversion to investing in any asset class apart from bonds, and ensuring the portfolio has sufficient assets to meet a series of liabilities. Just as a patient has the right to refuse a beneficial treatment advised by their doctor (informed refusal) so the beneficiary has the right to have a portfolio that matches their preferences. The trustee and their advisers have to respect the wishes of the beneficiary.

Investment horizons and goals

The Kay Review Final Report and the Law Commission emphasise the need to have a long-term investment horizon. However, no definition of 'long-term' has been put forward and one can understand why. The 'long-term' means different things to different beneficiaries. An individual saving for their pension may have an investment horizon of 40 years; a charity may have an investment horizon of 100 years; while universities may have multi-century horizons. So which is the right definition of 'long-term'?. There isn't one.

Following on from the previous section of this response, it is important to note that there is no optimal investment horizon. The investment horizon(s) must be linked to the beneficiary's goals. It is preferable to promote the view that the investment horizon should be appropriate to the beneficiary. Since beneficiaries differ in their requirements they may often have several investment horizons each with an associated goal. These goals may need to meet short, medium and long-term time horizons.

Consideration should be given to goals-based metrics[22] which are adopted by the most forward thinking private sector schemes. The metrics used to measure success are defined for the short, medium and long term goals. Having a goals-based approach can ensure that each scheme has the ultimate beneficiary and stakeholders in mind; all those involved have a set of clear consistent

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[22] Client Goal–Based Performance Analysis, Stephen Campisi, CFA; CFA Institute Conference Proceedings QuarterlyMarch 2011, Vol. 28, No. 1: 32–41 http://www.cfapubs.org/doi/abs/10.2469/cp.v28.n1.1

objectives that can be continued regardless of changes in decision-making personnel. This means that the portfolio has to be constructed to take into account these goals and the diversity of time horizons. These portfolios may not always be preferable but will align with the beneficiaries' interests.

Asset allocation and manager selection

Once the portfolio strategy has been agreed the next stage is to decide how the assets should be allocated and which managers should be chosen. This process should take into account the preferences of the trustees or those that act in the best interests of the ultimate beneficiary. How those preferences are formulated is determined by the beneficiary. The key is that the beneficiary or their representatives collaborate with their investment professionals so that the portfolio that results aligns with the beneficiary's preferences.

The diversity of investment approaches available to investors should provide sufficient choice to meet a variety of investor preferences outside of purely risk and return. The merits of each selection should be taken into the context of the entire portfolio rather than a single investment. It may be that the beneficiaries prefer an approach that emphasises environmental, social and governance (ESG) factors. Others may favour an approach that is based on religious doctrine such as Sharia Law. Each set of preferences comes with its own costs and benefits which have to be relayed to the representatives of the beneficiaries. For example, the exclusion of interest paying investments from a Sharia portfolio could have seen a portfolio exposed when the financial crisis hit because the portfolio may not have contained the defensive assets of government bonds.

Similarly, the level of stewardship and who undertakes this can be expressed by the beneficiary or the trustee in the IPS. For example, the allocation to equities could be wholly taken up by investments in activist funds (funds which take material stakes in companies with a view to influencing operational and strategic changes) some of which can be less liquid than standard equity funds (which can be liquidated in a matter of days).

Engagement also carries other costs of which the asset owner needs to be aware. The investor needs to be sure that the costs of engagement will be worthwhile and accept that any benefits will be shared by all shareholders. Hence, with little certainty about the success of engaging and the free-rider issue associated with it, the preference may be to sell a holding where there are ESG concerns rather than undertake engagement which has a low probability of success.

Engagement is likely to be more effective where there are formal contractual obligations and this is most relevant for lenders and those that have invested in the debt of a company. Lenders of

capital have the potential to call upon the terms and conditions of these contracts should they believe that there are breaches. The strength of these creditors has been demonstrated in high profile examples that range from Woolworths to the Co-op bank. In the latter case, the debt holders agreed to exchange their debt for equity in the troubled organization.

By being able to act efficiently, the asset owner can reduce the opportunity cost to the portfolio of remaining in an investment that gives cause for concern. When considering factors outside of risk and return, the main focus should be opportunity cost, the return foregone elsewhere where the portfolio is not invested.

Portfolio turnover and risk management

Table 1[23] – Rebalancing criteria

Asset Class	Long-Term Policy Weight (%)	Rebalancing Range (%)
U.S. equity	30	25–35
Non-U.S. developed-market equity	20	15–25
Emerging-market equity	10	5–15
U.S. fixed income	20	15–25
U.S. inflation-linked bonds	10	5–15
U.S. real estate	5	0–10
Alternative investments	5	0–10
Cash	0	0–5
Total	100	

The portfolio of assets should align with the policy asset mix and this should be stated in the IPS. In addition, there should also be an indication when the portfolio should be rebalanced. Table 1 above sets out example target weights for each asset class in a portfolio and when to rebalance. For example, if the allocation to US equities rises to 45% due to strong markets then it would be good risk management practice to sell down the excess allocation and redistribute to the other asset classes subject to the required weights. In doing so this approach ensures that –

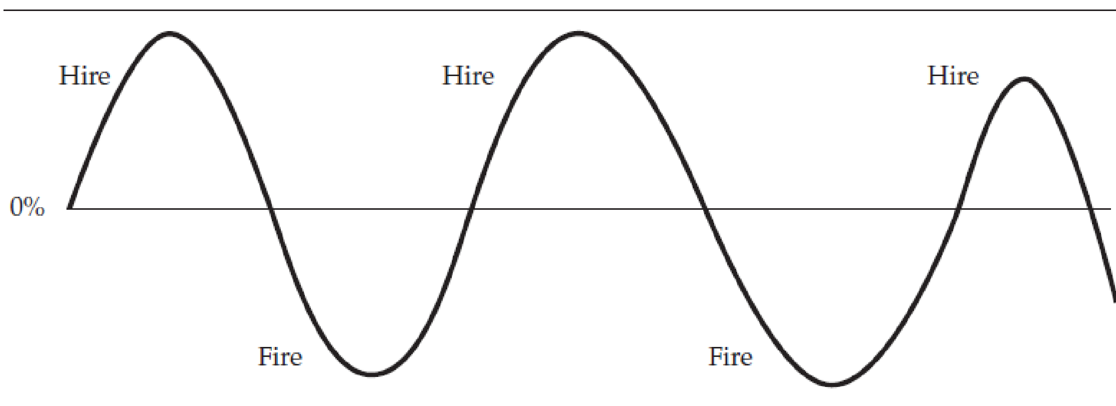
1) The portfolio is aligned with the beneficiary's risk tolerance and references

[23] Ibid ('A Primer for Investment Trustees')

2) The costs and turnover of the portfolio are controlled
3) The risk is managed appropriately

Disciplined portfolio rebalancing ensures that costs and risks are controlled. Rebalancing also demonstrates why turnover in a portfolio can arise for reasons that are consistent with the beneficiary's preferences. Not all turnover should be seen as short-term or against the interests of the beneficiary. For example, some asset managers may use high turnover strategies to generate returns over the long-term. In general, regardless of the approach being used, it is essential that the trustees and their advisors can be reassured that the asset managers are delivering value to the entire portfolio. On occasion, it may be preferable to retain an underperforming manager because of the diversification benefits provided to the portfolio. Risk-adjusted returns (net of fees) are more important than returns by themselves.

Figure 7[24] – The wrong side of the active performance cycle



We cite evidence in our response to the Kay Review[25] that private sector trustees have a tendency to chase returns and invest in funds that have done well in the past. Often this desire to "do something" works against the portfolio and the beneficiary's interests. Similarly, trustees should ensure that those responsible for managing the assets adopt a disciplined approach to turning over the portfolio. The trustees have a responsibility to monitor the level of turnover to ensure

[24] Ibid
[25] CFA UK response to the Kay Review of UK Equity Markets
https://www.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf

that it is appropriate. Otherwise trustees can enter a value destroying cycle of ‘buying high and selling low’ (Figure 7).

Portfolio evaluation, attribution and appraisal

“Nothing will work unless you do.”

(Maya Angelou)

It is vital that the beneficiary (or their representative) evaluate the portfolio to assess the success of the investment program. The evaluation also incorporates how the performance was achieved (appraisal). The importance of the evaluation cannot be overstated enough because it provides the following –

1) “Quality control check”

2) Feedback control mechanism that helps identify the strengths and weaknesses of the investment program. A successful program can be shown to be appropriate and effective.

3) Reinforces the hierarchy of accountability, responsibility and authority of the governance structure.

The attribution and appraisal processes determine how the portfolio generated its returns and identifies how each manager performed. This process also helps the trustee to determine the value provided by their managers. The information provided to the trustees by investment professionals must be presented in a manner that takes into account the understanding and expertise of those trustees.

Questions

Question 1 Do consultees agree that Chapter 10 represents a correct statement of the current law? (14.6)

We concur with this statement and how it applies.

Question 2 Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests? (14.11)

Yes

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

Yes

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

No comment

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

This is something for legal experts to determine.

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

Yes. The key here is if trustees have sufficient knowledge and understanding of the law and how it applies to them. As we cite in the body of this response there is sufficient latitude for trustees to implement a diversity of strategies as long as they align with the interests of the beneficiaries or with the mission of the organisation they represent.

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 remain concerned by the use of the phrase 'short-termism' as its definition is unclear. We have stated that portfolio turnover is an accepted part of risk management. However, trustees should be vigilant to limit excessive portfolio turnover. Similarly, trustees should resist the temptation to chase returns and so sell underperforming assets and invest in those that have done well in the recent past without taking the impact on the total portfolio into account. The focus should always be on the entire portfolio rather than focussing too much on one investment or asset class. A robust IPS should ensure that portfolio turnover is kept at reasonable levels and that there are appropriate guidelines that determine when transactions need to take place to ensure the portfolio is aligned with the IPS.

Question 8 Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances? (14.28)

The discretion available to trustees should be sufficient to consider ESG issues if the trustees choose to do so. Using a broader constituency of all beneficiaries and their representatives, the preferences that can be expressed should reflect those of the ultimate beneficiary (or consistent with the mission of the organisation concerned) where it is possible to do so. The extent to which this is possible may vary between types of beneficiary. However, as we cite above the trust instrument or its equivalent, should determine the extent to which the portfolio takes into account the beneficiary's preferences and the manner by which these can be used to select suitable investments.

Question 9 Does the law encourage excessive diversification? (14.32)

The commission appears to have misunderstood the concept of diversification. Either the portfolio is appropriately diversified or it is not. Excessive/over-diversification is a misleading term. As we cite above, the starting point should be a diversified portfolio which is then modified to incorporate the preferences of the ultimate beneficiaries. For example, there are some charities and endowments that have large concentrated holdings in a small number of companies. Often there is a constraint on selling these assets and so this has to be incorporated into the how the portfolio is constructed. Hence, these portfolios would be concentrated (or not sufficiently diversified)

because of the large allocation to a few securities and so not ideal. However, the portfolio remains appropriate because it represents the wishes of the settlor and may form part of the trust instrument.

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

We would suggest that the there is scope for trustees to achieve the preferred portfolio to maximise the risk adjusted return. However, there is sufficient discretion to ensure the portfolio is appropriate to the requirements of the trust instrument. This may at times result in a portfolio that does not aim to maximise the risk adjusted return, which is an acceptable outcome.

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

The use of liability driven mandates on the surface may appear to indicate undue risks are being taken especially in light of the recent financial crisis. However, the important point to consider is how these mandates are constructed and that any liability driven mandate is spread across a variety of suitable counterparties.

It would be the responsibility of both the trustees and their advisers to ensure that the mandates in place are robust and to stress test these on a regular basis.

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)

Yes, the prevailing law allows the appropriate focus and sufficient flexibility.

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

No comment

FIDUCIARY-TYPE DUTIES IN CONTRACT-BASED PENSION SCHE

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 would agree that there should be a mechanism in place that ensures that whatever the type of pension scheme is in place it is set up to be in the best interests of the members. This becomes more important given the material differences between contract based and trust based schemes[26]. It is especially important that those in contract based schemes are getting value for money and not exploited by being a captive audience[27].

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)

Providers should undertake an annual review of the investment strategies. This becomes essential given that the relationship is between employee and provider and often the employee may lack the skills and expertise to assess the value of the provider's offering.

The review would ensure that these strategies continue to operate in the manner originally specified and remain a relevant part of the provider's pension offering. It is essential that any review is impartial, especially as many contract based schemes offer the provider's own funds. Providers should be open to replace their own funds with external funds if these external funds deliver value to the end investor.

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[26] Money Purchase Pension Schemes: Comparison of Trust Based (OPS) with Contract Based (PP), 16 April 2013, Freshfields, Brickhaus, Deringer
http://www.freshfields.com/en/knowledge/Money_Purchase_Pension_Schemes_Comparison_of_Trust_Based_(OPS)_with_Contract_Based_(PP)/?LanguageId=2057

[27] Pension charges cap shelved, Josephine Cumbo, Financial Times, January 17, 2014
http://www.ft.com/cms/s/0/90229f78-7f80-11e3-94d2-00144feabdc0.html#axzz2r2FuHToG

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

In the first instance it may be preferable to start with a set of standards or a code that sets out the responsibilities of the Independent Governance Committee (IGC). Formalising the IGC's duties in law should be a final step; although the IGC's decisions could be legally binding if they act in the best interests of the beneficiaries. By having a common set of standards the IGC can act with a fiduciary quality rather than meeting the fiduciary standard. As appealing as the IGC is, it is essential that it can demonstrate its independence of the provider, otherwise we have a governance mechanism that is ineffective and against the interests of the employees [28]. Perhaps the regulator can undertake some effort to ensure that providers appoint independent members to their IGCs.

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)

This seems a sensible suggestion although IGC members should be liable if they acted in a manner that was against the spirit of their remit.

[28] http://touchstoneblog.org.uk/2013/09/office-of-fair-trading-report-falls-short-on-pensions-governance

FIDUCIARY DUTIES IN THE REST OF THE INVESTMENT CHAIN

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

We agree. The law can only go so far. As we state in the body of our response the rest is down to the regulatory and contractual requirements between clients and their investment professionals.

Question 19 Should rights to sue for breach of statutory duty under section 138D of the Financial Markets and Services Act 2000 be extended? (14.67)

Our understanding of section 138D is that it allows people to recover losses by showing that their loss was caused by a breach of an FCA or PRA rule (ie they don't have to rely on that breach as evidence of negligence) so it will presumably be a useful avenue of recourse where it is available. Generally, this approach is only available to private persons (ie individuals and non-corporate persons). That said, in certain circumstances it may be that non-private persons can bring a claim, including where the person that is seeking to bring the action is acting in a fiduciary or representative capacity on behalf of a private person.

The main aim should be consistency[29] of approach so that where rules are breached or mis-selling has taken place there is a form of recourse

However, we are mindful about how the relationship is contractually defined, as explained in chapter 11 of the consultation and how crucial the contract is for the courts. For example, one of the cases set out in chapter 11 highlight the risks clients take when they are not fully aware of the terms under which they are classified and the manner by which they interact with the provider of investment services. Perhaps in this case the regulator could have had scope to act, something it has done with regard to the miss-selling of interest rate swaps to small and medium sized businesses[30].

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[29] 'MPs demand powers to extend interest rate swap misselling redress', Money Marketing , 17 December 2013, By Tessa Norman
http://www.moneymarketing.co.uk/news-and-analysis/regulation/mps-demand-powers-to-extend-interest-rate-swap-misselling-redress/2004444.article

[30] Banks face ban from selling interest rate swaps, Harry Wilson, Banking correspondent,The Telegraph 28 Jun 2012
http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9363553/Banks-face-ban-from-selling-interest-rate-swaps.html

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

As we cite above, if investment consultants are members of CFA UK then they would be obliged to adhere to our Code and Standards which are clear about how they should conduct themselves in placing their clients interests first. Even CFA UK members undertake activity that does not fall within the remit of the UK regulations; these members would still be bound to act in the interests of their clients. When consultants do provide advice that comes within the scope of the regulations, then consultants have to act in accordance with these requirements. Before a review is requested it may be valuable for the regulator to provide some insight as to how the activity of investment consultants is divided between the perimeter guidance[31] and regulated advice. Perhaps the FCA could provide clarity on the regulatory status of consultants and the services they provide; especially when it comes to generic advice and where this advice results in a recommendation.

While the market appears to be concentrated in the field of pensions, the quality of suppliers should be the over-riding concern. Perhaps the market can only sustain a small number of providers? If there are concerns these should be raised accordingly. All too often the reliance on perceived wisdom or anecdotal evidence does not provide sufficient basis for a review. Of equal importance is the ability of the clients of the consultants to have sufficient recourse in their contracts. As the consultation cites very clearly the courts will often follow what has been agreed in the contract between the principal and the agent.

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

No comment

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[31] FCA – Perimeter Guidance Manual
http://fshandbook.info/FS/html/FCA/PERG/8/29
http://fshandbook.info/FS/html/FCA/PERG/8/28
http://fshandbook.info/FS/html/FCA/PERG/8/31

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

No. Securities lending (bonds and equities) plays a vital role in facilitating the ability to express a negative opinion about a security and so provides useful information to the market. This is supported by a study from the Federal Reserve Bank of New York[32], which found that restrictions to short selling reduces liquidity and increases costs to investors. Given the unfavourable reward to risk ratio for short selling any attempt to further limit this activity would further undermine market integrity.

It would be useful for the commission to appreciate the process involved with securities lending in the following flowchart. The key element in this process is the collateral available to the lender, which often exceeds the amount of the securities loaned to the borrower.

The choice available to clients with regard to participating in securities lending often depends on how the client is classified. The institutional client has the choice whether or not participate in securities lending. Retail clients in pooled funds may have no choice in whether or not the fund they invest in lends its securities. However, retail funds that do engage in securities lending make this clear in their relevant documentation and the terms by which the lending takes place[33]. Retail clients that invest in funds that undertake securities lending should read the relevant materials (if they are selecting investments themselves). Investment advisers, where applicable, should provide information about securities lending and its implications to their clients.

Institutional clients that wish to lend their securities to improve returns should ensure that the firms that do this on their behalf have systems and controls in place to ensure that the risks associated with this activity are managed appropriately. The risk of default will always be present given the failures of Worldspreads, MF Global and Lehman Brothers. The beneficial owner of the security being lent does undertake a risk of default by the borrower, although this is mitigated by the collateral pledged for the loan. Large custodians and others that have well developed securities lending businesses can ensure that the terms of the loan match the risks associated with the borrower. If the collateral pledged during the term of the loan falls below the required

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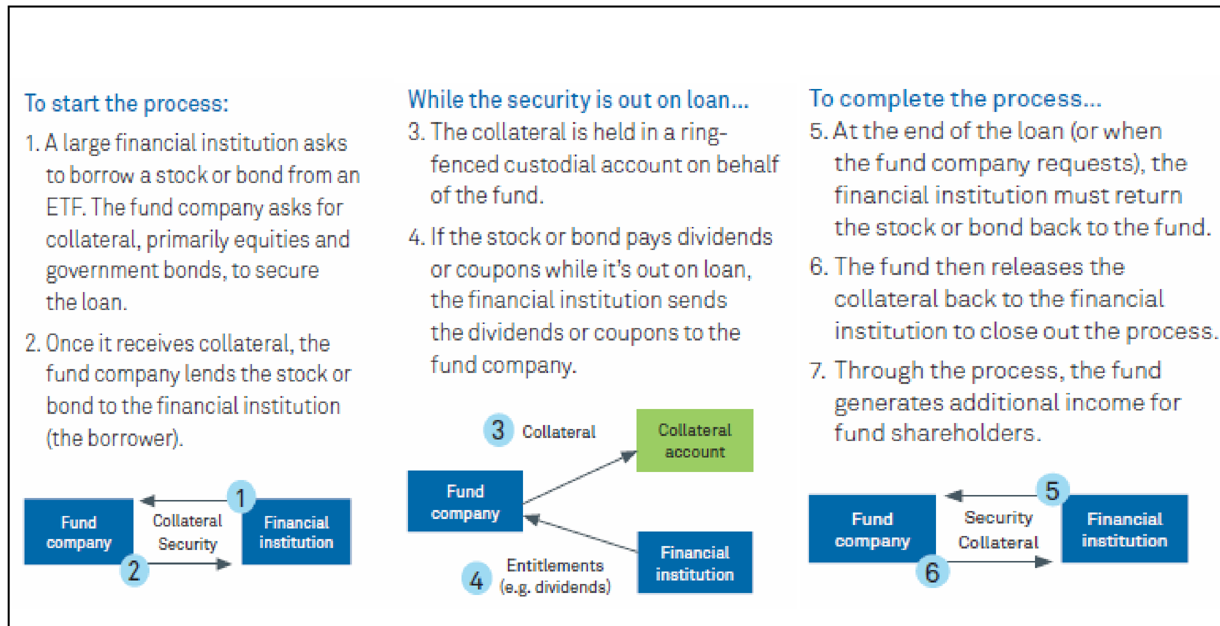
[32] Federal reserve Bank of New York Staff report no. 518, "Market Declines: Is Banning Short Selling the Solution?" September 2011

[33] iShares FTSE 100 UCITS ETF (Acc) Key Investor Information Document http://uk.ishares.com/en/rc/stream/pdf/false/publish/repository/documents/kiid/kiid-ir-ishvii-ishares-ftse-100-ucits-etf-acc-gb-ie00b53hp851-en.pdf

value, the lender (or their representative) can demand more collateral to be pledged. The lender can also determine the period when the loan should be repaid. The term of the loan can vary from being called at anytime to being callable across specified periods; for example, one month.

Flowchart- how securities lending works in practice



Source: iShares Securities Lending Brochure[34] (ETF is an Exchange Traded Fund)

Trustees should take responsibility to obtain the appropriate assurance that the processes to undertake securities lending are strong enough and can protect the clients' assets. The issue of protecting client assets remains a cause for concern especially as in recent years firms have paid financial penalties for falling short of the regulator's standards. More important than conducting a review would be the assurance from the regulator that it is vigilant in the area of client assets and securities lending. Equally essential is that the regulator demonstrates it has learned the lessons from Lehman and MF Global. Further reassurance is needed from the legal framework so that in the event of a default, assets are returned to clients as quickly as possible.

[34] http://uk.ishares.com/en/rc/stream/pdf/false/publish/repository/documents/en/downloads/brochure_securities_lending_guide_indiv.pdf

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

Yours,

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