# Mis-selling of personal pension plans: A legal perspective

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**Philip Ryley**

is a solicitor and Head of the Pensions and Financial Services Unit at Ringrose Wharton, Bristol. He specialises in contentious issues within the financial services and pensions sectors and is regarded as an authority on the pensions mis-selling litigation. He manages a team of solicitors who act for life companies, networks, independent financial advisers and investors.

Philip has the financial planning certificate and is a member of the Chartered Insurance Institute, the Institute of Financial Planning and the Life Insurance Association. He is also a member of the Association of Pension Lawyers and sits on the Pensions Litigation Committee. He regularly comments in both the national press and the financial press on financial services and regulatory issues.

**John Virgo**

was called to Bar in 1983 and has developed a specialist practice in professional negligence litigation. A major part of this work has centred on financial services disputes, both litigious and regulatory. He acts both for the industry and investors, which preserves a sense of balance when advising on such issues. Recent reported decisions include *Cocking v. Prudential* at 1996 Occupational Pension Law Reports 35 and *Hale & Hale v. Guildarch Ltd & Ors* at 1999 Professional Negligence Law Reports 44. He is co-author of 'Surveyors' Liability, Law and Practice'[1], 'Liability of Financial Advisors'[2], and 'Lawyers' Liability, Law and Practice'.[3]

**Abstract** This paper is based on a talk given by Philip Ryley and John Virgo to the Association of Pension Lawyers at their Annual Conference in Bournemouth in November 1998. The authors provide an outline on the pension mis-selling saga and indentify some of the key legal issues that have arisen out of the Pensions Review and the litigation.

**Keywords:** *pensions mis-selling; pensions review; opt-out; transfer; why litigate?*

**Philip Ryley**
(Ringrose Wharton, 5 Queen Square, Bristol BS1 4JQ.

Tel: 0117 9226233; Fax: 0117 9226983; E-mail: mail@ringrosewharton.co.uk)

**John Virgo**
(Guildhall Chambers, 22–24 Broad Street, Bristol BS1 2HG and 5 Stone Buildings, Lincoln's Inn, London

E-mail: john.virgo@guildhallchamb)

## Introduction

The mis-selling of personal pension plans was described by the Trades Union Congress in its publication 'Justice Delayed' as 'one of the greatest financial scandals of all time'. It was an unprecedented example of mass mis-selling of financial products which has resulted in substantial professional negligence litigation. Approximately 1.5–2m people have been affected. The compensation bill to the industry has been estimated by some sources to top £4bn with the total cost likely to exceed £11bn. Several hundred court actions have been issued involving most of the major life companies and many independent financial advisers. The cost of the industry's Pensions Review and the level of compensation paid will undoubtedly mean that with-profits policy holders and shareholders of those life companies will also suffer losses. Many independent financial advisers have gone, and will go, out of business. The cost of indemnity insurance for advisers will increase as a result of the substantial increase in claims. On top of all this, the Treasury directed the regulators to discipline heavily and fine those companies and firms that fell behind in the Review process. The adverse publicity that has followed could have a damaging effect on public confidence for years to come.

## What is pensions mis-selling?

Personal pension plans were introduced on 1st January, 1989 but were backdated to 1st July, 1988. This new product was launched as part of a government campaign to extend individual pension choice as well as replacing the old self-employed retirement annuities. Legislation also allowed employees to contract out of the State Earnings Related Pension Scheme (SERPS). Since millions of employees and self-employed individuals did not have access to occupational pension schemes, the introduction of personal pension plans was an attractive proposition and today over 5m employees have such plans. Unfortunately, the success of the personal pension plan has been marred by the mis-selling that occurred between 1988 and 1994.

The personal pension plan was invariably promoted as being a portable and flexible product which relied upon the investment performance of its underlying funds. However, while there was considerable publicity during the late 1980s exploiting the advantages of the personal pension plan, there was little publicity comparing that product with the benefits that employees were entitled to under existing final salary occupational pension schemes.

In a nutshell, approximately 2m people (eligible for pensionable employment) may have been wrongly advised by life companies and financial advisers to opt-out, not join or transfer benefits from existing occupational pension schemes in favour of personal pension plans. Most advisers involved in these transactions failed to give the investors investment business advice which was compliant with their obligations under the Financial Services Act 1986. As a result, the investors lost favourable defined benefits available in occupational pension schemes and ended up investing in an investment performance-related product which provided little security and no guaranteed benefits.

In order to fully appreciate the extent of this bad advice, it is necessary to compare the advantages and disadvantages of final salary occupational pension schemes with personal pension plans, with particular reference to stability, security and predictability.

## Final salary schemes

- The Investor receives a 'defined benefit' employee's pension linked to the value of his or her final salary at retirement and linked to the number of years service within the scheme.
- Most schemes are contracted out of SERPS.
- Employers contribute to the scheme (eg, usually 4 to 6 per cent of pensionable salary).
- Some schemes provide early retirement options.
- Lump sum tax-free cash can be taken from the company pension scheme to the maximum of one and a half times final salary after 40 years' service. If an investor takes tax-free cash (and this is common) the pension will be reduced.
- Most schemes would increase pensions in payment by 3 to 5 per cent per annum. Some schemes guarantee these increases while others offer discretionary reviews. Public sector pensions are automatically increased in line with the retail price index, as are public sector deferred pensions.

— Most final salary schemes provide family protection benefits, such as death-in-service benefits of up to four times annual salary, widow's and dependant's pensions and death in retirement benefit. Some schemes also provide long-term disability pensions and private medical insurance as part of the benefits.

## Personal pension plans

— Only available to investors not participating in an employers' scheme or the self-employed.
— Employers will rarely contribute to a personal pension plan, especially if a final salary occupational pension scheme is available.
— The personal pension plan is portable in that contributions can be made irrespective of the employee changing from one employer to another.
— The personal plan is an investment product based upon investment performance and the value of the fund could therefore go up or down. The personal pension plan is therefore not inflation proof and its end value is determined by market forces.
— Upon reaching retirement, the investor will have to purchase an annuity and again this will be based on the annuity rates at the relevant time which are determined by market forces.
— The annuity which can be bought at any age between 50 and 75 is liable to income tax.
— The investor will pay front-loaded commission and charges throughout the term of the personal pension plan which will be substantial with some plans.

With a personal pension plan, the size of benefits ultimately payable is dependant upon:

— the amount that is paid in by way of contributions
— the way the investment fund performs
— the level of commission and charges payable by the investor
— the cost of annuities at retirement
— annuity rates prevailing at date of retirement.

A final salary scheme provides benefits that are linked to the final pensionable salary subject to any major catastrophe, the pension is stable, suitable and predictable for most qualifying investors. With a final salary scheme, the size of benefits ultimately payable is dependant on:

— the final salary at retirement (eg, some schemes base the pension calculation on the scheme member's gross or basic salary during the last three years before retirement);
— the number of years service; and
— the fractionary increase as defined by the scheme ie, most schemes provide a pension that builds up at a rate of 1/60th of final salary for each year of service.

## Who was affected?

The mis-selling of personal pension plans arose simply because many working people, including teachers, nurses, civil servants and council employees, were persuaded to leave or not join their final salary occupational pension schemes or in many cases to transfer the deferred benefits from those schemes in favour of personal pension plans. The mis-selling therefore took three forms:

— opt-out
— transfer
— non-joiner.

An *opt-out* case is when an active

member of an occupational pension scheme is advised to withdraw from it, in favour of a personal pension plan, while continuing in the employment which gave rise to his or her membership. A *transfer* case is when an active or non-active member of an occupational pension scheme is advised to transfer the accumulated fund from the occupational pension scheme into a personal pension plan or Section 32 Buy Out Bond. A *non-joiner* case is when an individual, who is eligible to join an occupational pension scheme, is advised not to do so and usually then advised to invest in a personal pension plan.

## How did it occur?

Bearing in mind that hundreds of thousands of investors were mis-sold personal pension plans, it is not unreasonable to conclude that self-regulation of the industry failed to protect investors from what was then recognised to be unacceptable practice. LAUTRO stated in its 'Enforcement Bulletin No. 16' 1992:

> 'the starting point for a company representative considering the situation of a member of a defined benefit occupational pension scheme . . . should be to assume that it would not constitute the best advice to recommend opting-out into a personal pension. . .'

In fact, all of the retail regulators issued guidance to their respective members in relation to the transfer of deferred benefits of final salary pension schemes. The guidance was issued by FIMBRA and LAUTRO during July 1992, by SIB in August 1992 and IMRO during March 1993. Unfortunately, this guidance was issued too late for the majority of transactions.

There is little doubt that the majority of personal pension plans that were mis-sold between 1988 and 1994 arose as a result of either negligent advice on the part of careless advisers or non-compliant advice on the part of commission-motivated advisers. Many investors were persuaded to leave or not join their occupational pension schemes as a result of advisers failing to provide advice in a materially compliant way. The regulators of that time laid down the standards that were expected of those providing investment business advice. The regulators acquired their authority from the Financial Services Act 1986. The rules that were drawn up by the regulators under the Financial Services Act can be viewed as a series of layers. There was thus a common theme established within the industry: at their broadest, three core obligations were imposed upon a financial adviser:

— to know one's client
— make suitable recommendations and
— provide best advice.

A typical mis-selling case would include one or more breaches of the duties to know one's client, provide suitable recommendations and give best advice and the more common examples were as follows:

— Failing properly to assess the investor's personal circumstances and financial position, often involving incomplete or inaccurate completion of the 'Fact Find';
— Failing to identify existing or potential pension entitlements within the relevant occupational pension scheme, including contingent benefits such as death and early retirement benefits and spouse's pension;
— Failing to explain the guaranteed nature of the benefits under the relevant occupational pension scheme,

including the fact that it was the employer who took the risk of under-performance of the relevant fund and the impact of the final salary entitlement in relation to inflation risks;

— Failing to explain the fact that both employer and employee made contributions in the case of most occupational pension schemes where as, under a personal pension plan only one party, namely the investor, would be contributing to that pension arrangement;
— Failing to explain that in a personal pension plan, the risk of under-performance of the underlying investment fund and the risk of fluctuations in annuity rates would be upon the investor;
— Failing to advise as to the incidence of charges and commission in the personal pension plan. In many cases, the front-loaded charges and commission would swallow up a large proportion (often up to one third or even one half) of the contributions made in the first few years. Early cancellation of the personal pension plan could result in a zero transfer value;
— Failing to advise about the availability of additional voluntary contributions (AVCs) and free-standing additional voluntary contributions (FSAVCs) as an appropriate means of topping up any existing deficiency in the investors pension entitlement within an occupational pension scheme.

The bottom line for most investors was that they were not adequately informed that, by moving from occupational pension scheme provision to personal pension plan provision, they were losing a guaranteed pension and were in effect investing on the open market and exposing themselves to risk.

## What were the losses?

Most investors who were mis-sold a personal pension plan have not yet retired and therefore their actual loss has not yet crystallised. Most of these investors have suffered what is caused 'a prospective loss at retirement'.

An individual investor can work out what he or she would have been entitled to had he or she remained in or joined the occupational pension scheme as opposed to taking out a personal pension plan. Taking into account assumptions of salary increase and mortality it is possible to estimate what the individual investor would be entitled to at normal retirement age. Similarly, an individual investor can ascertain current fund value and transfer value of the personal pension plan and again applying various assumptions, it is possible for the investor to calculate on a conservative basis what the value of the pension fund will be at normal retirement date and what level of annuity that fund will buy at that time. Any shortfall will then be discounted back to today's value. The latter calculation is complex and has to take into account a considerable number of factors. The calculation will vary depending on whether or not the claim relates to an opt-out, transfer or non-joiner. The shortfall will form the basis of the loss to the investor.

So far as the litigation is concerned the types of loss are as follows:

— Loss of guaranteed defined benefits
— Loss of contingent benefits: (a) death benefits and (b) early retirement on grounds of ill health and redundancy;
— Excess contributions: (a) paid into personal pension plan and (b) loss of ability to make contributions into an additional voluntary contributions scheme;
— Distress, anxiety and inconvenience.

In most cases, investors who were persuaded to leave or not join their occupational pension schemes, have been able to rejoin those schemes and have been able to buy back all of the lost years, including all contingent benefits by paying a reinstatement figure. Since reinstatement is possible and the reinstatement figure will put the investor back in the same position as if he or she had never received the bad advice in the first place, the principal loss in that type of case is the difference between the reinstatement cost figure and the transfer value in the personal pension plan. Where the investor has paid more into the personal pension plan than the occupational pension scheme, there is an argument on behalf of investors that that portion of the fund should be paid into an AVC arrangement or, alternatively, the excess contributions should be returned to the investor with interest at the statutory rate.

However, the Inland Revenue has stated in PSO Update 21 that compensation for excess contributions paid as a cash lump sum would in general be inappropriate because it is normally not possible to convert pension rights into a cash lump sum before retirement. The general recommendation from the PSO is that compensation should be paid into a pension vehicle securing the investors' benefits or, in the case of an investor who is retired, the vehicle under which the annuity/pension is being paid. The litigation has enabled investors to recover any excess contributions as cash damages.

In transfer cases (where the investor is no longer in the same employment) and in opt-out cases and non-joiner cases (where full reinstatement is not possible), the investors cannot rely upon being fully reinstated into their occupational pension schemes and their losses are determined by prospective loss at retirement referred to above. The quantification of those losses require the application of actuarial assumptions and will ultimately lead to the investors topping up their personal pension plans to mirror (so far as is possible) the benefits that would have been achieved had they been serving in their occupational pension schemes. The level of this top-up, based on actuarial assumptions, is crucial to whether or not the investors receive a full redress. The investor is, in effect, looking to the negligent adviser to pay a lump sum into his personal pension plan which will be sufficient to produce the same pension and the same lump sum at normal retirement age. In addition, the investor will also want to secure sufficient compensation to cover the loss of any contingent benefits eg, early retirement on grounds of ill health or redundancy. In *Well v. Wells*,[4] the House of Lords ruled that the courts should consider calculating lump sum payments representing damages for future loss on the basis that the award would be invested in index-linked government securities and no longer a mixed bag of equities and gilts. This judgment does not rest well with the discount rates applied by the regulators in the Pensions Review, which adopt far more optimistic yields. The Wells decision has not yet been considered by a court in the pensions mis-selling litigation but some investors are arguing that revised actuarial assumptions to those applied by the Review should be considered as being appropriate in their cases. If a court was to apply the Wells decision to a pensions mis-selling case, such a judgment could have a dramatic effect on the Pensions Review.

## How was it discovered?

The Securities & Investments Board (SIB), now the Financial Services Authority (FSA) and the Self-Regulating

Organisations (SROs) undertook a systematic survey of a sample of recorded advice on pension transfers in 1993. This study was designed to examine the extent of compliance with regulators' requirements in the sale of lump sum pension transfers. The study was designed to cover a representative sample of firms undertaking pension transfer business in the constituencies of FIMBRA, LAUTRO and IMRO. The officers of the SROs reviewed 735 client files, and graded the files into one of four categories. Neither clients nor advisers were interviewed as part of the review.

The SIB commissioned KPMG accountants in August 1993 to summarise the results of the review of the 735 client files undertaken by the SROs. The survey, which related only to transfers, revealed that more than 90 per cent of the files failed to have evidence of substantial compliance. The more surprising fact is that nearly 40 per cent of the files were actually categorised as suspect and unsatisfactory. A suspect file was defined as:

> '... a file which contains material evidence of actions that is at first sight either suspicious or misleading such as evidence of an apparently perverse recommendation, positive evidence of mis-selling, or of playing on emotive issues, categorisation of the client as "execution only" or a comparison that does not match the profile of the Ceding Scheme benefits without evidence of explanation...'

As a result of this report, on 8th December, 1993 the SIB announced the formation of a Regulators' Steering Group to examine whether and to what extent inadequate advice had left people, who had transferred paid-up pension rights or opted-out of live membership from an occupational pension scheme potentially worse off at retirement and how those transactions could be remedied. An Advisory Committee, Working Party and Consumer Panel were also established to advise the SIB, which shortly thereafter published standards for future transfer and opt-out business in March 1994.

As a result of the information gathering by the regulators between July 1992 and May 1994, the SIB issued guidance on high priority cases in May 1994.

The KPMG report to the SIB identified substantial material non-compliance. The findings of that report formed the beginning of what is now commonly referred to as the 'Pensions Review'.

In May 1994 the SIB issued guidance on high priority cases and in October 1994 the SIB published 'Pension Transfers and Opt-Outs — Review of Past Business Part 1'; 'Statement of Policy and Part 2', 'Specification of Standards and Procedures'. This guidance issued to the SROs and recognised professional bodies (RPBs) under Section 206 of the Financial Services Act 1986 was to be the model for all to follow.

The 'Pension Transfers and Opt-Outs Review of Past Business' identified priority groups of investors who were given target dates of the review of their transactions (see Appendix 2 for priority timetable). The 'Statement of Policy' provided:

> 'SIB is satisfied from all the information it has that some of the business was done in a materially non-compliant way, and that some of the investors concerned will be found to have suffered loss as a result of unsuitable advice... This review of past business is expected to take firms at least two years to complete substantially, and will call for a major administrative effort on their part... The question whether a firm was in breach of its duties must be judged without the

> wisdom of hindsight, by reference to the relevant regulatory requirements *in force at the time of the transaction*. The relevant rules are those on suitability, 'know your customer', understanding of risk, adequate information and misleading statements... The aim of the redress programme is to offer recompense to investors who have been disadvantaged as a result of bad advice and to put them into the position they would now be in if they had not suffered actionable loss as a result of a compliance fault. It is highly desirable that, where possible, reinstatement is allowed in the occupational scheme concerned, at a fair cost. In other cases, the appropriate form of remedy will normally be supplementation of the personal pension entitlements ('top-up').'

It is quite clear from the 'Statement of Policy' that the SIB envisaged a life industry review of all pension mis-selling cases which would be carried out effectively and the full cooperation of the industry. The 'Statement of Policy' further indicated:

> 'An aim of the review programme is to provide proper redress (where it is due) without recourse to the courts. Entitlement to redress will depend on there being a loss (whether actual or prospective) which is caused by a firms' material contravention of an applicable regulatory requirement. Past transactions must be judged against the regulatory requirements applicable when the advice was given and against the assumptions which were reasonably made at the time, there should be no retrospective imposition of later, more exacting, requirements. In this way it is intended that neither the investment firm nor the personal pension policyholder should be given any reason to litigate to achieve a more favourable outcome'

The Personal Investment Authority (PIA) was recognised as an SRO on 18th July, 1994 and took over the responsibilities of FIMBRA and LAUTRO, including Pensions Review. FIMBRA was previously responsible for regulating independent financial advisers and LAUTRO was responsible for regulating the vast majority of life companies.

Following consultation with its members, the PIA Board subsequently implemented the Pensions Review through an amendment to its rules and the issue of further elaborate guidance.

In February 1995 the PIA published 'Pension Transfer and Opt-Outs Review of Past Business — Statement of PIA's Policy'. This was soon followed by more exacting guidance in April 1995 when the PIA issued 'Guidance on Pension Opt-Outs and Non-Joiners' and in July 1995 issued 'Guidance on Pension Transfers'. Further, in August 1995 the PIA issued further 'Guidance on Redress Assessment'. All of this guidance (PIA Guidance) presented the life industry with a phenomenal obligation and responsibility which would require considerable resourcing and logistical muscle.

## The pensions review — an outline

The SIB created the template for the Pensions Review when it published 'Pension Transfers and Opt-Outs — Review of Past Business. The PIA published its own guidance in February 1995 which was very much based on the 'Specification of Standards and Procedure' published by SIB a few months earlier. The PIA as the dominant SRO was charged with the task of ensuring that the Pensions Review was actually carried out by its members.

The topic of the Pensions Review is in itself a major area of discussion. The comments in this paper are confined to those issues which have become relevant to the litigation. Copies of all of the documents referred to in this paper can be obtained from the FSA and the PIA.

The PIA Guidance adopted the timetable and priority categorisation set by the SIB and stated that the PIA members should aim for completion of the required 'substantial majority' of the first priority cases by 31st December, 1995. The PIA further stated that PIA members should still aim for completion of all first priority reviews by the target date of 31st December, 1996. With the benefit of hindsight, it would now appear that this timetable was unrealistic for several reasons which will be discussed later.

The PIA Guidance set out that all members 'who advised on or arranged for personal pension plans, section 32 contracts or section 226 contracts' between the 29th April, 1988 ('A day') and 30th June, 1994 should review those transactions in accordance with the Guidance. A number of firms were also expected to review transactions sold through their appointed representatives ie, sold at the time when the representative firm was an appointed representative of the member. Where an appointed representative had been previously authorised in its own right, the appointed representative under the Guidance was responsible for carrying out the Review, but the member firm was responsible for ensuring that the Review was promptly and properly undertaken by the appointed representative. In the case of 'departed firms' (ie, those out of business), the PIA set up the PIA Pensions Unit to be responsible, for investigating the transaction, if necessary passing the matter on to the Investors Compensation Scheme for compensation.

The PIA Guidance was split into two parts. The first part set out guidance on specific matters such as who was responsible for carrying out the Review, awards for distress or inconvenience, contributory negligence, PIA monitoring of the review programme, credit for work already done, limitation and other matters. The second part was aimed to provide members with practical assistance in implementing the Review and was divided into various sub-sections with process maps to illustrate the process involved.

The PIA Guidance varied depending on whether or not the transaction involved opt-outs, non-joiners or transfers. Phase 1 dealt with the priority cases and the timetable for priority cases slipped from the 31st December, 1995 to 31st December, 1997. In fact Phase 1 still remains outstanding, although the industry was directed by the FSA to complete Phase 1 in full by December 1998.

The Review process was split into five steps:

(1) identifying priority cases
(2) gathering information
(3) compliance assessments
(4) loss assessment
(5) assessment of cause of loss.

The PIA adopted the SIB proposition that wherever possible reinstatement in the occupational pension scheme was the 'optimal form of redress' for opt-out/non-joiners where the investor remained in the relevant employment. However, the PIA has allowed member firms to avoid reinstating an investor if the reinstatement cost quoted by the occupational pension scheme is 'unreasonable'. In those circumstances the member firm could offer the investor a top-up of the personal pension plan.

In July 1995 the PIA issued its 'Guidance on Pension Transfers' and introduced the 'Financial Viability Test' which created a more streamlined approach to the review of transfer cases. The Financial Viability Test provided member firms with an option of adopting an alternative approach to the full process of information gathering and compliance assessment. This alternative approach was aimed at speeding up the Review.

In November 1996, the PIA issued further substantive guidance when it published 'Simplifying the Pensions Review: Part 1 Statement of Policy and Part 2 Guidance and Model Specification and Schedules to Part 2'. In January 1997 the PIA published 'Simplifying the Pensions Review: Amending Guidance', in a further attempt to speed up the Pensions Review process. When the Pensions Review was announced, the SIB said that it would consider experience and information gained from the early stages of the Pensions Review to assess whether further categories of business should be reviewed on an industrywide basis. Following consultation, the FSA and PIA jointly published 'Pension Transfers and Out-Opts Review Phase 2' and issued model guidance to all SROs and RPBs in August 1998. Phase 2 covers all those transactions that do not fall within the priority categories in previous guidance and incorporates a 'direct invitation' approach to investors to encourage investors to assist with the Pensions Review. Firms were required to have completed mailing of Phase 2 investors by 31st March, 1999 with the assistance of a publicity campaign with a media spend of £10m. The nationwide publicity campaign appeared on TV, radio and in the press between January and April 1999 and the underlining message was 'if you care about small sums why not bigger ones?'. To maximise the effectiveness of the mailings, the envelopes addressed to consumers were marked with 'R.U. Owed?' which ties in with the question posed to consumers at the end of the advertisements: 'Mis-sold a pension? — They O.U.'. Needless to say, this type of media coverage has been criticised heavily by the trade associations representing the life industry.

In February 1999, the FSA and PIA published 'Simplification of the Pension Review — Loss Assessment Calculations for Transfers'. This consultation paper proposed a simplified approach to calculations for transfers and is expected to lead to a speedier resolution of the Pensions Review and significant savings in administrative costs. Again, the approach taken by the regulators is very much that of a blanket approach. Individual investors may be concerned with the adequacy of this approach in connection with top-up offers. Further guidance was issued by the FSA in July 1999 introducing an optional compliance test for transfer cases.

Throughout the Pensions Review documentation, references are made to the PIA Ombudsman Bureau as being the appropriate forum for the handling of any dispute arising from the Pensions Review. For example, the PIA reminds its members in the 'Statement of Policy' that an investor is entitled to lodge a complaint with the PIA Ombudsman Bureau which would have a discretion to disapply statutory limitation periods.

## Why should investors litigate?

The SIB in its 'Statement of Policy' stated that:

> 'A fundamental principle is that redress will be due only where the investor can reasonably be said to have suffered loss and the loss is caused by a material breach of the rules on the part of the firm'.

However, the SIB went on to say that:

> '… it is intended that neither the investment firm nor the personal pension policyholder

> should be given any reason to litigate to achieve a more favourable outcome'.

The PIA Guidance issued in April 1995 stated that it was:

> '… aimed to provide a fair and monitorable basis for this review which will assist Members and investors in avoiding the delay, and the cost, of resort to the courts of law.'

While the Pensions Review was a genuine attempt by the regulators to put their industry in order and to ensure compensation was offered to investors who had suffered losses, litigation was inevitable.

The litigation has revealed a number of fundamental flaws which go right to the heart of the SIB/PIA Review. Some of the reasons for litigation were addressed in the decision of *Cocking v. The Prudential Assurance Company Limited*.[5]

## Conflict of interest

What prompted the litigation to begin with was the inherent conflict of interest involved in the companies responsible for the original negligent advice deciding whether they had been guilty of inappropriate sales. Many investors such as teachers, nurses and local government employees, with the backing of their trade unions, became concerned with the apparent risks of such a conflict.

The potential for conflict of interest is evident throughout the Pensions Review and because the Pensions Review applies a blanket approach to remedying what is a massive problem, there is always scope (with even the most exacting regulation) for abuse to arise. For example, the SIB's 'Specification of Standards and Procedures' provides:

> 'Where the investor's account of events conflicts with a firm's own records or leaves doubt, firms should assess the reliability of the investor's account fairly and with good faith. Any conflict of accounts should be clearly documented'.

Similarly, the PIA's 'Guidance on Pensions Opt-Outs and Non-Joiners' states:

> 'The seller may be asked for his or her recollection but, in this case, equal heed should be paid to what the investor believes was said. Where there is any conflict between these two accounts or any other doubt regarding oral disclosure, you must attempt to decide between them fairly, disinterestedly and in good faith and taking into account all relevant factors'.

His Honour Judge Raymond Jack QC said in his judgment in *Cocking v. The Prudential Assurance Company Limited* [supra]:

> 'There will be a need to interview an investor if a conflict emerges or perhaps for clarification. The investor is of course a claimant and is also a potential litigant against the company. It is an unusual situation and could be a source of unease'.

The Pensions Review allows a member firm to consider contributory negligence on the part of the investor. The Pensions Review also provides that the member firm should decide on whether or not advice was given in a materially non-compliant way. If the advice was given in a materially non-compliant way, the same member firm carries out any loss assessment and concludes what is the appropriate form of redress ie, reinstatement or top-up. While it is accepted that the regulators are responsible for monitoring the Pensions Review and ensuring that it is adequately performed, there is nevertheless scope for the member firm to interpret the Pensions Review and the Guidance thereunder according to its own interests which may not necessarily be the same interests as those of the investor. The investor is not independently represented and hence there is scope for the investor being short-changed in compensation or possibly not compensated at all. Bearing in mind that the monitoring system put in place by the regulators provides for sample monitoring, it is impossible for the regulators to guarantee that each and every investor will be adequately compensated. Needless to say, individual investors are not interested in sample monitoring but want to be guaranteed that their own pension provision is protected and if necessary, totally compensated. For example, even if 0.05 per cent of investors within the Pensions Review process do not receive full compensation, although this would appear to be a very small percentage, it actually amounts to up to 10,000 investors.

## Delay

Although the regulators were charged with ensuring that the Pensions Review was carried out promptly, it soon became evident that those life companies and independent financial advisers were failing to or unable to implement the Pensions Review and in particular, in connection with the priority cases. The industry vehemently argued that the timetable set by the regulators was unrealistic and that there were considerable resource difficulties with meeting the target dates. The delays in the carrying out of Phase 1 of the Pensions Review have been well documented and many life companies and networks of financial advisers have been fined substantially for those delays. As at 27th January, 1999, the PIA levied 248 fines relating to the Pensions Review and the total exceeded £5.7m. Fines have been in the region of £100,000 to £600,000 and Treasury Ministers have been quick to 'name and shame' various companies with a view to forcing those companies and others to carry out the Pensions Review. Both the Treasury and the regulators have not hesitated to lay the blame firmly with the life industry and have chosen to ignore their own historic failings in investor protection. Some in the industry may have good reason to feel aggrieved for being held solely responsible.

The delay in the Pensions Review being carried out potentially left a number of investors at risk of not being fully reinstated at all. For example, prior to reinstatement, an investor may find himself or herself changing from one employment to another, being made redundant or retiring early on grounds of ill health. As soon as one of those events occurs, the investor ceases to be eligible for reinstatement and must therefore rely upon the secondary form of redress which is a top-up of the personal pension plan. Many investors have died since the Pensions Review was first implemented but prior to being reinstated. The estates of those deceased investors will not receive redress of reinstatement but will be offered the death benefits available under the employer's scheme. The cost to the adviser will be substantially reduced and the delay will have awarded the adviser with a significant saving. In most cases, delay is a financial advantage to the company and can be a financial disadvantage to the investor, particularly if the delay means a loss of early retirement benefits.

## Costs of an independent investigation

To the objective bystander, it may well appear a peculiar feature of the Pensions Review that the company which negligently mis-sold its product should be charged with the task of assessing its own competence in making the initial sale. Not only does the company have to decide whether or not it has been materially non-compliant, but it is also required to decide on the form of redress and the level of compensation. Not only does this infringe the basic legal principle of *non-index in sua causa* but where the investigator has, as here, a financial interest in the outcome of the Pensions Review, the law presumes bias against him (*R v. Gough*).[6]

The industry may well complain at the arbitrary and blanket criticism implied by this presumption, but its protest is not served by an almost universal refusal to meet the cost of any third-party appraisal of any offer of redress made in an individual case.

While the Pensions Review requires a member company to advise an investor of the wisdom of obtaining independent advice before accepting any offer of settlement made, the company concerned is not obliged to meet this cost.

The appropriateness of the principle of independent advice cannot seriously be disputed and it is clear that unless an investor's claim is settled against the backdrop of litigation, this cost will be borne by the victim rather than the perpetrator of the negligent advice but such costs and expenses are legally recoverable is clear (*Cocking v. The Prudential Assurance Company Limited* [supra]).

## Excess contributions

The adviser who negligently persuaded an investor to opt-out of a beneficial occupational pension scheme in favour of an unsuitable personal pension plan will usually have advised that his or her company's product offered a better deal for less cost.

To many innocent investors the idea of paying less than they had been contributing to an occupational pension scheme with a prospect of a better retirement package proved irresistible. When redress is offered through the Pensions Review, however, the member company is entitled to insist that the investor give credit for any savings and contributions during the opt-out period.

Although the redress offered by the Pensions Review is meant to mirror compensation which would be ordered by the courts, the stance taken by the Pensions Review on this topic is at odds with the principles by reference to which a court in these circumstances assesses compensation.

There is little doubt in the above scenario that common law principles of assessment would not require credit for such savings to be given.

Conversely, an investor may have found that the personal pension plan has ended up costing more than he or she had been contributing to the occupational pension scheme. The Pensions Review in this instance directs that any such excess contributions should be paid into an AVC or FSAVC scheme. The Pensions Review resists payment of cash lump sums when there is no doubt that if dealt with by litigation this wasted expenditure would be returned to the investor as an award of damages with interest. The Pensions Review approach therefore represents another departure from common law principles for the assessment of compensation.

## Advice given prior to 29th April, 1988

The Pensions Review specifically excludes those cases where advice was given prior to 29th April, 1988, otherwise known as 'A day'. By 29th April, 1988, a large number of investors would have been advised to opt-out or transfer ahead of the legalisation coming into force. Investors advised many months before 29th April, 1988 would be included in the Pensions Review if the Pensions Review had included all personal pension plans *completed* after 29th April, 1988 rather than basing the review population on those investors *advised* after 29th April, 1988. Bearing in mind there was considerable publicity about personal pension plans prior to their implementation, it is not unreasonable to assume that many investors would have been sought out and advised by financial advisers long before the actual transfer or opt-out took place.

Life companies and independent financial advisers had spent many months lining up individuals to effect transfers and opt-outs just as soon as the relevant legalisation came into force. Some analogy can be made with the 1st August car registrations and the enormous backlog of sales orders that exist prior to that date, although no actual sale takes place until that particular date. Some sources have estimated that several thousand people may have been excluded from the Pensions Review as a result. Problems will not arise if the financial advisers agree to review the transactions on a voluntary basis and compensate those investors.

## Top-up v. reinstatement

It is accepted by all parties concerned with the Pensions Review that reinstatement is the optimal and appropriate form of redress. Where reinstatement is not possible or where the company argues that the reinstatement cost figure is unreasonably high, the investor will be offered a top-up of the personal pension plan. A top-up is a secondary form of redress and leaves the investor exposed to a risk of being under compensated.

Where a disadvantaged investor can secure reinstatement at a price to an occupational pension scheme, the court would be likely, if satisfied liability for a mis-sale was established, to order the Defendant company to pay as damages the price required for reinstatement (vide by analogy *Ruxley Electronics v. Forsyth*).[7]

Under the Pensions Review, however, the member company is not obliged to make such an offer if it believes that the ceding scheme trustees are demanding an unreasonably high price for readmission with full continuity of service. In this event, the company may offer to top-up the existing personal pension plan by an amount which it assesses will make equivalent provision at retirement to that lost as a result of the opt-out.

Some will argue that this is not satisfactory. First, it ties the investor to the very company which mis-sold the pension. Secondly, the ultimate value of the topped-up pension will inevitably depend on market performance until retirement and carry with it inherent risks which would not have existed if the investor had remained entitled to full benefits in his employer's final salary scheme. Thirdly, the presumptions as to the future performance allowed to be adopted by the specification are not conservatively stacked in the investor's favour and depend on optimistic growth rates being achieved. This conflicts with the approach of the House of Lords in *Wells v. Wells* [supra].

Further, although an investor may be told that reinstatement is possible, it has emerged in a number of cases that this does not always involve the purchase of all lost years together with guaranteed continuity of service. For example, some schemes may agree to the purchase of added years but will not reinstate the continuity of service enabling full contingent benefits to be reclaimed. This can result in significant losses of contingent benefits, such as early retirement, ill health provision and/or redundancy provision. Issues of this kind require independent verification.

Full reinstatement means that the investor will be put in the position he or she would have been had he or she not been given the bad advice in the first place. The investor will be able to buy back the lost years in the occupational pension scheme and maintain continuity of service thus ensuring that all contingent benefits are reclaimed. Once the investor is fully reinstated and compensated for any excess contributions and distress and anxiety, the investor can be satisfied that he or she has achieved full redress. The investor will have to surrender the personal pension plan and give credit for the pension fund to assist with the purchase of the lost years.

A top-up means that the investor will retain the personal pension plan but the company will top-up the fund to an appropriate level to compensate for any loss at retirement. The top-up calculation is based upon basic information and actuarial assumptions dealing with, among other things, future investment returns, future rates of inflation, annuity rates and discount rates. Unfortunately, the Pensions Review is a blanket approach to remedy a massive problem. The regulators have always argued that they have been determined to produce something that is fair and pragmatic and workable both as to the procedures and as to outcome. The problem with the Pensions Review attempting to be 'fair' is that it is trying to be fair to both the investor and the industry and this ultimately results in applying assumptions which compromise both parties.

As a blanket approach, it is difficult to criticise a system which is designed to be fair, pragmatic and workable. On the other hand, why should one investor be fully reinstated into his/her occupational pension scheme while another investor receives a top-up of the personal pension plan which does not guarantee the same protection. The regulators undoubtedly did not intend to discriminate between investors who can be reinstated and investors who cannot be reinstated but unfortunately this discrimination does arise. The regulators could have avoided this discrimination by insisting that companies offer a form of indemnity to investors (who cannot be reinstated) on the basis that upon the retiring event (which may be normal retirement age, redundancy, early retirement, death etc.) the company would fully indemnify the investor against that loss. Needless to say, there are practical difficulties with such a proposal. For example, the company may go out of business or it may be difficult for it to maintain adequate funds or keep in touch with the investor. These numerous practical difficulties do not excuse the discrimination of the Pensions Review.

Another method of reducing the discriminatioin in the Pensions Review is to revisit the actuarial assumptions used in calculating the top-up figure. Instead of being fair to both parties, the actuarial assumptions could build in a level of protection which would substantially increase the likelihood of the investor receiving the same pension and lump sum as if he or she remained in the occupational pension scheme. The life industry has argued against a revision of the actuarial assumptions on the basis that investors should not receive more than is due to them. This argument could be overcome by providing for the capping of the benefits upon the retiring event. Any excess could be reclaimed by the company at the time of the retiring event.

Bearing in mind it is extremely unlikely that the Pensions Review will be substantially changed, there is no doubt that investors who are reliant upon top-ups need to be independently represented and to have any offers of top-up independently checked. A principal cause of concern with offers of top-up is that, while the companies invite the investors to consider having the offers independently checked, the companies will not pay for the cost of that independent checking. This causes major concern simply because most investors will not be able to check offers themselves and may not be minded to commission their own representatives to verify them. Again, because of the blanket approach to the Pensions Review, mistakes can be made and the litigation has identified cases involving offers of significant under-compensation. Most investors would not become aware of errors until retirement when it would probably be too late to rectify matters.

## Contributory negligence and failure to mitigate

When left to the company to decide whether and if so what compensation to offer, the Pensions Review allows for any offer to be reduced if the member company believes the investor may have been guilty of contributory negligence in opting-out or transferring out of the employer's scheme in favour of the recommended personal pension plan.

The classic example is the investor who, having been taken in by the salesman's claims regarding the personal pension, does not later read through the literature containing product warnings and advice on the risks.

The argument in support of failing to mitigate loss has been used by member companies in connection with investors being slow in rejoining their occupational pension schemes. The PIA Guidance states:

> 'Where either contributory negligence or a failure to mitigate loss become apparent, firms may make appropriately reduced offers of compensation. The amount of and reason for any such reduction should first be explained to the investor who should then have the opportunity to comment on the reduction. An investor should also be informed of his right of recourse to the complaints system. Members must carefully document these cases keeping relevant notes explaining why a reduced offer has been made'.

It is anticipated that the courts would be reluctant to reduce damages on these grounds. The investors have in reality done no more than act in accordance with the very advice they were given (vide by analogy *Gran Gelato v. Richcliff (Group) Limited*).[8]

## Compliance assessment and causation

A full compliance assessment under the Pensions Review required three questions to be answered:

— Was there a material compliance fault?
— Is there an actual or prospective loss?
— If so, is the loss the result of that fault?

The SIB's Statement of Policy provided:

> 'A precondition for redress is that the investor (or, if he of she is dead, a spouse or dependant) can be said to have suffered actionable loss as a result of the firm's material compliance fault. Actionable loss arises when, after a policyholder's death or retirement, the personal pension fund is not large enough to purchase benefits equivalent to those the occupational scheme would have provided or if, at the time of the review, the investor is exposed to a probable prospective shortfall'.

The Pensions Review allowed firms to

choose between either carrying out a compliance assessment first or a loss assessment first. The SIB stated that the order of undertaking the loss assessment and the compliance assessment was irrelevant to the end result and firms should be allowed to adopt whatever sequence best suits them. Whichever assessment is undertaken first, a 'pass' renders the rest of the process unnecessary. This option available to firms is particularly relevant to transfer cases and the investor is at risk if he/she is allowing a compliance assessment to be carried out by the perpetrator of the negligent advice without any independent representation and checking.

Another area of concern to investors relates to non-joiners where a firm may conclude that an investor decided not to join an occupational pension scheme for a variety of reasons unconnected with any advice he or she was given to take out a personal pension. Even though the advice may be found to be materially non-compliant (save for an incomplete Fact Find) the firm can consider whether or not any advice given had any material effect on the investor's decision to remain out of the employer's scheme. The PIA's Statement of Policy provides:

> 'PIA takes the view that because an investor *may* have had personal reasons for not joining his occupational scheme that is not a valid reason for excluding such cases from the scope of pro-active review. The points which have been made by respondents seem more relevant to the question of causation — once a member has determined that its advice in a particular case was non-compliant it then needs to address the question of whether or not the investor would have acted differently if its advice had been compliant. In looking at causation a firm might reasonably conclude in the light of known facts in individual cases that the investor would not have acted differently because he had his own reasons for not joining the occupational scheme'.

Investors are potentially put at risk in such cases if they are not independently represented or at least independently advised on what options are open to them. There is a clear danger that a large number of investors who are refused compensation on this ground may not challenge the refusal and as a result will receive no compensation to which they may be entitled.

## Joint liability

A further area which the Pensions Review does not adequately address is a problem of whether the first negligent member company responsible for opting an investor out of a company scheme continues to be liable for losses after the date when a second adviser takes over and sells a further inappropriate product.

Does this sort of churning break the initial chain of causation? The writers' experience is that most life companies contend that it does and that the first company's liability is effectively capped by the involvement of a subsequent adviser.

It is believed, however, that this argument will almost certainly not succeed in the industry's favour before the court.

## Guarantees

Faced with the delays in completing the Pensions Review and some pressure from the regulators, a number of life companies are now offering a form of guarantee to the investor by way of redress. One may be forgiven for thinking that what is proposed is a type of indemnity against losses sustained by the investor as a result of acting on the negligent advice of the financial representative. Nothing could in fact be further from the truth. Such guarantees simply commit the life company concerned to offering (later rather than sooner) the compensation directed to be offered by the Pensions Review. Such guarantees are no more than a guarantee that the investor will get what the regulators have decided he or she should get rather than be assured of a complete indemnity in respect of all losses flowing from the original mis-sale. If, for example reinstatement proves impossible, the life company will, on the investor's retirement, top-up the personal pension plan fund to the level of the benefit in the occupational pension scheme. The investor will then need to use this fund to purchase an annuity, which is unlikely to provide the same size of lump sum and other retirement benefits as would have been achieved under the occupational scheme.

## Conclusion

The mis-selling of pensions litigation commenced in the latter part of 1994 and is still proceeding. However, despite over four years of litigation there has been no trial. Over 500 writs have been issued and despite the novel arguments that have been pursued in the litigation, particularly with reference to the adequacy of the Pensions Review, the likelihood of a full trial would appear to be minimal. The Financial Services Act 1986 has been the principal piece of legislation in financial services for over ten years and yet there have been few reported judgments which deliberate on Section 62 of the Act (providing for a statutory cause of action) in the context of a direct action by an investor over the mis-selling of a personal pension plan.

Despite the limitation difficulties that face most investors, there will undoubtedly be further claims arising from mis-selling. In addition, the PIA Ombudsman Bureau (and its proposed successor, the FSA Ombudsman Scheme) will continue to receive complaints. It is debatable as to whether or not the Bureau will deviate from the requirements applied by the Pensions Review.

The Financial Services and Markets Bill is now under debate in Parliament and a new dawn in regulatory control is about to break. The Financial Services and Markets Bill will carry the equivalent of section 62 but what is of greater interest is the clear intention of the FSA to make individuals personally responsible for their acts and omissions. The FSA has recently published its consultation paper outlining the principles and codes of practice for 'approved persons'. This anxiously-awaited document extends personal responsibility to a wider scope of individuals connected to financial services. The Financial Services and Markets Bill proposes to regulate defined areas of investment activity by ensuring that they are conducted by persons fit and proper to carry out such work. The Government has made it clear that, in appropriate circumstances, the FSA should be able to take disciplinary action in the form of fines and public censure, against employees guilty of mis-conduct.

In addition, the FSA will be able to withdraw approval for employment in cases where it believes that an employee is not fit and proper to be employed in the regulated function. The FSA's ability to disqualify particular individuals from employment in the industry or from specified sectors is also likely to be retained under the new legislation and furthermore extended to all the sectors covered by that legislation.

The FSA is also applying emphasis to training and competence in an attempt to ensure that those who give investment business advice are adequately qualified and competent to do so. The FSA will have extensive and far-reaching powers and the reduction in self-regulation (while not necessarily attractive to the industry) should result in a more effective mission statement of investor protection and less likelihood of future mass mis-selling of financial products.

## References

1 Jordans, February 1998.
2 Oxford University Press, expected publication date April 2000.
3 Palladian, expected publication date April 2000.
4 [1998] 3 WLR329.
5 [1996] OPLR35.
6 [1993] AC 646 (HL).
7 [1996] 1 AC 344.
8 [1992] 1 AER 865.