Legal issues for defined contribution schemes when selecting investments

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Abstract This paper is based on a presentation given at the IBC 'Pensions Communication' Conference on 29th April, 2003. It examines the legal issues for trustees of defined contribution occupational pension schemes when selecting a range of investment funds, including default funds and life-style options. The position of employers when selecting personal pensions or stakeholder pensions is contrasted. The paper also considers the implications for UK occupational pension schemes of the USA experience, particularly following the collapse of Enron.

Keywords: *trustee liability; investment funds and choices; default option; lifestyle; US 'safe harbor' provisions*

The major trend for employers to close their defined benefit (DB) occupational pension schemes and switch to defined contribution (DC) arrangements (whether occupational schemes, group personal pensions [GPP] or stakeholder plans) means that investor risk is increasingly transferring from the sponsoring employer to the individual employees.

This paper examines the legal issues for trustees of DC pension schemes and employer sponsors of personal pensions and stakeholder plans with regard to liability to members for poor investment performance.

In order to analyse the investment responsibilities of trustees and employers, it is helpful to look at the historic position and the trend towards increasing statutory intervention before considering the current investment issues for DC arrangements and taking a look at lessons from the USA. The paper will therefore be divided into five parts:

- 1 Trustees' exposure to member claims
- 2 Member choices
- 3 Trustee liability
- 4 GPP and stakeholder
- 5 Looking at the USA experience

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Trustees' exposure to member claims for poor investment return

Living with a bear market

During the prolonged bull market of the 1990s, it was thought that DC scheme members did not always understand that 'the value of your investment can go down as well as up' because for many people investments had only ever gone up.

Perhaps surprisingly, three years of negative returns and a pronounced fall in asset values has not produced a backlash of claims from members against trustees or their employers. But if we go into the fourth year of negative returns, pension scheme trustees (and possibly employers) may face criticism from members for investment losses in a way we have not seen before.

Annuity costs

The historically high cost of annuity purchase is another worrying area where members may seek to blame trustees for loss of expectation. Towards the end of the 1990s, statistics were showing that annuities had reduced sharply between the beginning of the decade and the end. The 'double whammy' of pensions savings decimated by the stock market crash and the ever increasing cost of annuity purchase has accentuated the problem. 'Honey, I shrunk my pension' is now a familiar refrain as the market and annuity rates both move against pension savers within a calendar year.

The Pensions Act 1995 requirement for Limited Price Indexation for money purchase benefits accrued after 5th April, 1997 will further diminish the initial rate of annuity pension.

Statutory money purchase illustrations

It remains to be seen whether the new

government initiative of Statutory Money Purchase Illustrations will cause a fresh wave of concern to members with DC pensions savings. These illustrations will project the annual pension income an individual fund might produce. It will be in real terms, allowing for inflation and is directly comparable with today's prices. Legal & General have apparently estimated that a 46-year-old woman with 18 years to go to retirement will see her estimated pension plummet from £4,960 a year to just £2,030 a year.

Member choices

Number and type of funds

Trustees are presented with a number of dilemmas when choosing a suitable range of investment options for members in a DC scheme. If they play safe with either one 'with profits' insured product or perhaps three fairly conservative options, members' funds may prove smaller than if a higher risk strategy was offered. If a wide range of funds is offered with overseas investment possibilities, members' fund performance could be volatile and potentially disastrous as they do not have access to the same quality of investment advice available to trustees when selecting the initial range of funds.

Switches

How often should switches be allowed and should there be a charge? If switching is only allowed once a year or even once a month, a stock market crash could cause members uncertainty and distress as they could be locked into markets which other investors were abandoning. If daily switching and dealing is allowed, administration costs will rise.

Default option

Selecting the range of funds and choosing which funds to invest in out of the range are two very different activities. What if members cannot decide on their own investment policy — should the trustees choose a ‘safe’ default option such as a managed fund or refuse to accept someone as a scheme member until a choice has been made?

Most investment consultants counsel that trustees should offer a default option, otherwise members either do not join or make ‘silly’ or unsuitable choices. Lawyers advising trustees, however, advocate not having a default fund so that members clearly make their own investment choices. A middle course is for the trustees to select a default fund, which they must monitor regularly with their investment adviser, but to have the default fund as a box to tick on the application form which the member must sign.

The full effect of the Myners Report recommendations for DC investment has not as yet really been felt. Paul Myners made few distinctions between final salary and money purchase investment strategies, although the thrust of his analysis was devoted to final salary schemes and the DC section feels like an afterthought. The Report did, however, recommend that where a DC scheme offered a default option, trustees should ensure that an objective is set for that option, including expected risks and returns and that trustees should ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members. In some ways, therefore, a sort of ‘know your customer’ test.

Trustee liability

Investment powers

When the Financial Services Act 1986 was brought into force in July 1988 to

coincide with the major changes to City financial institutions and the new system of self-regulation, it was made clear that pension scheme trustees either had to become authorised under the FSA themselves or delegate their investment powers to an FSA-authorised investment manager. The net result was that trustees tended to divorce themselves from anything to do with investments. Day-to-day investment management was delegated by trustees to managers and asset allocation and strategic investment decisions were infrequently reviewed.

The Pensions Act 1995 changed this by requiring trustees to prepare a Statement of Investment Principles. Section 34 of the Pensions Act also gave pension scheme trustees a new statutory power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme. Trustees now only have to check their Trust Deed and Rules and the statutory restrictions on self-investment to see what investments are not available to them rather than the reverse.

Sections 33 and 34 Pensions Act 1995

Section 34(4) of the Pensions Act 1995 provides that trustees are exonerated from responsibility for the acts or defaults of any FSA-authorised or exempt fund manager, subject to the trustees checking that the manager has the appropriate knowledge and experience, is carrying out his work competently and is complying with the other investment-related requirements of the Pensions Act. But s. 34(4) is not generally believed to allow trustees of money purchase schemes to delegate all investment powers to scheme members on the basis that the members become their own ‘fund managers’. The inter-relation of this exoneration with s. 33 of the Pensions Act is also not

entirely clear where members are given investment choices.

Section 33(1) of the Pensions Act 1995 states that liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of investment functions cannot be excluded or restricted by agreement by the trustees or an investment manager. This does not sit happily with the idea of the trustees seeking to exonerate themselves from the effect of members' individual investment choices. On balance, however, it can probably be interpreted as allowing protection against member choices provided the original selection of investments from which the members may make their choices is properly selected by the trustees and monitored by them.

Documentation

Many older DC trust deeds and rules still do not cover the question of member choice at all. They tend to contain conventional wide powers of investment and leave the issue of member choice to the scheme booklet or the application form. More work needs to be undertaken in this area as it is ripe for litigation.

The more recently established schemes seek to adapt their documentation to make it clear that while the trustees retain full responsibility for the choice and suitability of the investment funds offered by the scheme, member choices within those funds are not the responsibility of the trustees. There is no cast-iron guarantee that this type of wording will work given the ambiguities of the Pensions Act wording, but at least it is an attempt to address the liability problem.

The author's view is that trustees cannot delegate the underlying DC investment decisions to the members. All

they can permit is for the members to have a choice between the funds which the trustees have selected. The key point to note is that it is the trustees who are responsible for the investment policy of DC scheme assets, and this will include any additional voluntary contributions contracts.

If the trustees decide, on the basis of advice, to offer a range of funds (perhaps with a lifestyle option within those investment choices), this is an investment decision for the trustees to make. When making their decision they should take into account the financial sophistication of their members and the availability of investment advice which could be offered to those members via written literature from the providers or perhaps through a web-based or intranet application.

Group personal pensions and stakeholder arrangements

While trustees clearly have some role in selection of the investment funds in a DC occupational pension scheme, the situation is very different for personal pensions, GPP and stakeholder arrangements.

Personal pensions

Personal pensions and GPP are individual arrangements which are not set up under trust. A group personal pension arrangement in all other ways is, however, very similar to a DC occupational pension scheme if you look at the eventual pension delivered.

The decision about which provider or insurer to use and the selection and range of funds for a group personal pension falls on the sponsoring employer instead of trustees. Yet under current law the employer has no fiduciary duty to the members in selecting or monitoring

the investment performance of the GPP as it is not a trustee of those arrangements. There may be some implied duty of good faith, but as yet this is a new and untested area of the law.

Statutory exoneration for stakeholder arrangements

The comparison is even greater if we look at the role of the employer for a stakeholder plan. The duty to designate can be exercised by the employer with care after taking financial advice. Alternatively, it can equally be satisfied by choosing a provider's name at random from the Occupational Pensions Regulatory Authority (OPRA) stakeholder website. Either way, the employer has statutory protection from responsibility for the investment performance of any stakeholder scheme offered to relevant employees. It is curious, therefore, why employers have not switched en masse from GPP to stakeholder plans.

The US experience

The Employee Retirement Income Security Act of 1974 (ERISA) governs the creation, management and investment of employee benefit plans in the USA. There are various categories of plan under ERISA, many of which are named after the original sub-section which permitted their creation.

'Safe harbor' protections

A '404(c) Plan' is a DC plan with a range of permitted investments where the member chooses the specific investments for his contributions. The most notable feature of a 404(c) Plan is that, under ERISA, the member becomes responsible for investment

performance and cannot sue the plan officials for losses arising from his decisions. The 'safe harbor' protection for Plan officials provided by a 404(c) Plan is only achieved when the Plan meets the following criteria:

- the member must truly have independent control of choice of his investments;
- there must be a broad range of investment alternatives;
- the member must be told that the Plan officials do not have responsibility for investment performance when he chooses the investment; and
- the member must be given sufficient information to allow him to make informed decisions about his investments.

In considering an appeal on a motion for summary judgment, the US Third Circuit Court of Appeals opined that a 'broad range of investments' for the purposes of the second criterion meant 'a wide array of investments with materially different risk and return characteristics' *Meinhardt v Unisys Corporation* [1998] PLR 253, para. 90.

The United States Department of Labor, Employee Benefits Security Administration branch, provides the following examples of the information which must be supplied under a 404(c) Plan by the Plan officials to meet the fourth criterion above:

- a description of each investment option, including the investment goals, risk and return characteristics;
- information about designated investment managers;
- an explanation of when and how to make investment instructions and any restrictions on when investments can be changed;

- a statement of the fees that may be charged to the member's account when changing investment options or buying and selling investments; and
- information about the member's shareholder voting rights and the manner in which confidentiality will be provided when he votes shares or stock.

The duty obviously extends to ensuring that the information given is correct. It is not clear if there is a positive obligation to update plan members if, for instance, an investment provider becomes less creditworthy — *Unisys*, para. 77. The duty to inform is ongoing — there is a positive duty to inform members if the list of available investments is changed — *Franklin v First Union* (2000) 84 F Supp 2d 720.

Fiduciary obligations

If the stringent requirements of ERISA s. 404(c) are not met, then the Plan officials will retain their fiduciary duties protecting the member against mismanagement and misuse of assets. ERISA defines a 'fiduciary' as anyone who exercises discretionary control or authority over Plan management or Plan assets, anyone with discretionary authority or responsibility for the administration of a Plan or anyone who provides investment advice to a Plan for compensation or has the authority or responsibility so to do. Obvious fiduciaries are Plan trustees, administrators and any investment committee; but commonly investment managers and what we would call investment consultants can also be within the ERISA definition of 'fiduciary'.

Enron

Fiduciaries must act prudently and must diversify the Plan's investment in order

to minimise the risk of large losses. While they are required to follow Plan documents, that is only to the extent that the Plan terms are consistent with ERISA. The litigation following the collapse of Enron is, at the time of writing, still ongoing. The Department of Labor has become involved as *amicus curiae* in the case of *Tittle v Enron* — an action brought by members of the Enron Corporation Savings Plan, Employee's Stock Ownership Plan and Cash Balance Plan. In this litigation, the Department of Labor has argued that ERISA requires Plan fiduciaries not to follow Plan documents where it would be imprudent to do so. (The Plan document provision in question was one which specified that the only equity investment permitted under one of the Plans was to buy Enron stock and retain it.)

Adoption of the US position, therefore, would be more onerous than the current UK position for the trustees of DC schemes with member investment choice. First, the amount of information to be provided to the member is greater and more strictly defined; secondly, failure to do so brings home a greater burden on the trustees including one to look beyond the rules if they provide only for investments which are imprudent; thirdly, the duty to inform is ongoing and could involve a duty to communicate on investment performance related issues.

Conclusion

Until recently, DC schemes were seen as the poor relation of final salary schemes. Members are exposed to investment risk and employers typically contribute less than into a final salary scheme.

But the underfunding of final salary schemes at present means in many cases that those members are less protected than in a DC arrangement. Members of

a final salary scheme do not have a guarantee that their pension will be delivered. They are not only exposed to investment risk, but also to employer covenant risk and cross-subsidy with other members higher up the statutory priority order on a winding-up. Transfer values are also at risk of suspension due to underfunding, thus locking members into what they perceive as an underperforming investment. Having a money purchase pot with your name on it, even if it is shrinking in size, suddenly seems rather attractive.

The increasing switch to DC on an individual as opposed to a group basis is moving the question of liability for poor investment performance away from

trustees and trust law, and even away from employers. Each man for himself in his own individual DC arrangement seems to be the way forward. What a shame that we are abandoning all the advantages of pooling and shared investment advice just at the time when it is most needed.

The key to the future in this area must therefore be increased and better investor education. Members must be able to make informed decisions. In a DB scheme, the underlying investment strategy is hidden away in a summary chart in the annual report. DC schemes bring the investment strategy and the investor risk centre stage as a personal decision for the individual member.