Trustees' responsibilities and commission recapture

Received: 19th August, 1999

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Abstract This paper explains commission recapture and how participation in a commission recapture programme can improve investment returns of occupational pension schemes. This is particularly important in the light of the strict duty imposed upon the trustees of pension schemes, by both case law and statute, to maximise their investment returns. Although participation in a commission recapture programme may not be appropriate for every pension scheme, trustees' duties and responsibilities with regard to 'investment functions' do require them to consider such participation. Given the increasingly regulated and litigious environment in which they now operate, it is important for trustees to be able to demonstrate that they have properly considered every method of maximising investment returns. This is particularly the case for trustees of defined contribution schemes whose investment performance, if American experience is replicated in this country, will come under increasing scrutiny.

Keywords: *commission recapture; improved investment performance; trustees' fiduciary duty; trustees' liabilities*

Introduction

Commission recapture is, as the name indicates, an arrangement by which some of the commission paid by a pension scheme to brokers on the sale and purchase of stocks and securities is 'recaptured' and repaid to the scheme. It can also be used to save costs, as a tool in 'transition management', when pension schemes change from one investment manager to another and stocks and securities have to be bought and sold.

In view of the responsibilities of trustees of pension schemes to act in their members' best interests by maximising the pension scheme's financial return, it is arguable that trustees have a

duty at least to consider participation in a commission recapture programme.

What is commission recapture?

Commission recapture was established in the USA in 1986. In effect, it is an arrangement whereby a broker agrees to split his dealing commission with the trustees instructing him. The broker credits back to the trustees of the pension scheme an agreed portion of the commission charged on the trade of shares or securities.

Commission recapture is described as an easy way for trustees to implement an institutional discount brokerage programme, since they pay only for the

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broker's execution services, ie, for the buying and selling of the shares or securities, and not for any research and advisory services which the trustees do not require.

In order to recapture commission, a transaction must be carried out by a broker who is willing to participate in a commission recapture programme. The potential commission generated by a pension scheme and available for recapture is, therefore, dependent upon the level of investment activity generated by its portfolio and the level of commission currently paid on the transactions.

The advantage of commission recapture

The sole reason for trustees to participate in a commission recapture programme is that it saves money. Commission is a direct cost to a pension scheme which, if recaptured, has the effect of improving investment returns. Since trustees will presumably have already paid an investment manager to research and advise on the stocks and securities which they should hold, there is no reason for them to pay for this service again by paying full commission to a broker.

According to Howard Schwartz, Chairman of Lynch Jones and Ryan Inc, reportedly the biggest commission recapture agent globally, the use of commission recapture can add 1 per cent to the return on investments over a ten-year period.

As commission recapture requires no fees, no minimum volumes and no minimum participation period, it would appear to offer a service which pension schemes, small and large, can use.

The USA experience

In the USA, where commission

recapture began, concern about the level of brokerage commission prompted the US Department of Labor to issue a technical bulletin in May 1986.¹

Essentially the bulletin dealt with the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). It reminded trustees of their fiduciary duties under ERISA and how those duties applied to the use of brokers.

ERISA provides that trustees do not breach their fiduciary duties by paying brokerage commissions as long as they have 'determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker dealer'.² This would seem to imply that there would be a breach of fiduciary duty if full commission were paid on a transaction which did not require the advisory and research services of the broker. The technical bulletin concluded that, in the light of trustees' decisions having to be made in the best interests of their members, full brokerage commission should only be payable where:

- the pension scheme would otherwise be obligated to pay for the services, including advisory and research services, being provided by the broker
- the amount being paid is reasonable
- the investment manager obtains 'best execution' from the broker; in other words, no other broker could execute the trade equally effectively at a lower cost.

In a further report issued by the US Department of Labor in 1997,³ by which time commission recapture programmes had been in existence for 11 years, it was stated that 'commission recapture programs have provided pension plans with a choice which plan sponsors want by unbundling services and allowing plan

sponsors to determine if commissions are being used optimally for their particular plan'. It continued that 'a properly structured commission recapture program can assist investment managers, reduce plan costs and help plan sponsors fulfill their fiduciary responsibilities'.

In this way, a direct link was made in the USA between trustees' fiduciary duties to act in their members' best financial interests, and their responsibility to consider whether or not participation in a commission recapture programme would be advantageous.

Trustees' responsibilities

In this country, the basic fiduciary duty of the trustees of a pension scheme with regard to the investment of its funds is essentially the same as set out in the ERISA report — that of acting in their members' best interests by maximising the financial return.

Until we have a policy on socially responsible investment to the contrary, this primary duty takes precedence over any moral and social reservations which trustees may have about any particular investment. This is clear from the decisions in the cases of *Cowan and Scargill*⁴ and the *Bishop of Oxford v. Church Commissioners*.⁵

The provisions of the Pensions Act 1995 extended trustees' powers of investment and the delegation of investment decisions. Equally importantly, the Pensions Act introduced liabilities against trustees (and employers) who do not fulfil their duties with regard to investment. Most specifically, the Pensions Act provides the Pensions Regulator (OPRA) with power to fine and suspend trustees who breach the standard of care required.

However, the Pensions Act does not prescribe the standard of care to be applied by trustees with regard to

investment, so the 'ordinary prudent man' test, established in *Learoyd v. Whiteley*,⁶ still applies. Put simply, the test dictates that an ordinary prudent man would take advice where and when he required it. This is reinforced by the provisions of s. 30(1) of the Trustee Act 1925 which states that a trustee is not responsible for loss 'unless the same happens through his own wilful default'. In this respect, neglecting to take advice while knowing that advice ought to be sought would constitute wilful default.

S. 33(1) of the Pensions Act provides that the trustees' 'liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions ... cannot be excluded by any instrument or agreement'. This applies equally to authorised fund managers to whom the trustees have delegated investment decisions under s. 34 of the Pensions Act.

The term 'investment functions' is not defined in the Pensions Act or in any other statute or by case law. As a consequence, its range of application is untested and it cannot be stated with any certainty whether or not it applies to the consideration of participation in a commission recapture programme by trustees. Experience dictates that trustees should be prudent in this respect.

The decision in *Nestlé v. National Westminster Bank*⁷ in 1992 — to the effect that the failure of trustees to invest in profitable securities was not a breach of trust — now appears unreliable. In that case, it was held that the trustees' misunderstanding of an investment clause and their failure to conduct regular reviews of their investments was not a breach of trust, but a symptom of incompetence. S. 33 of the Pensions Act appears to override that decision and to place a sterner fiduciary test upon trustees' investment performance.

In the USA there have been several cases of beneficiaries suing the trustees of defined contribution schemes for the scheme's poor investment performance which resulted in their receiving a smaller pension than they had anticipated. There have been no such cases yet in this country but, given our increasingly litigious environment (including the availability of the Pensions Ombudsman and OPRA), the current heightened concern for pensions provision among the general public, and the introduction of contingency fees, it can only be a matter of time before similar actions are brought here.

What next for trustees?

Participation in a commission recapture programme, even with its attendant cost savings, will not be appropriate for all pension schemes. The trustees of a pension scheme may rely upon the advisory and research services which a broker can provide or for which they would otherwise be obligated to pay someone else. Further, participation in a commission recapture programme would not of itself ensure that trustees were fulfilling their duties towards their members, if it resulted in their investment manager being induced to trade with a specific broker and failing to deal with trades on the most advantageous terms to the trustees.

However, given the trustees' duties towards their members, their statutory and common law obligations to take care and to exercise skill in the performance of any investment functions, and the potential financial advantages of participating in a commission recapture programme, it is strongly arguable that trustees have a fiduciary responsibility at least to consider whether or not such participation would be in the best interests of their members.

Even if participation in a commission recapture programme is considered and rejected, the trustees, in the event of an action against them for poor investment performance by a member, could at least confirm that proper consideration had been given to the matter.

Conclusion

Trustees have very strict duties and responsibilities to maximise investment returns, and equally strict liabilities if they fail to fulfil those duties and responsibilities. Participation in a commission recapture programme can help to improve the return on investments by reducing brokerage costs.

Participation in a commission recapture programme will not be appropriate for all pension schemes because some trustees will require the full range of advisory, research and executive services which a broker can provide. Nevertheless, given their duties and responsibilities for investment returns, trustees must be under an obligation at least to consider whether or not such participation is in the best interests of the members. In any event, where such participation is not appropriate, trustees will not only have acted positively by giving consideration to the issue, but will also be taking precautionary action in case they are sued by a member for poor investment performance. This is particularly relevant to the trustees of defined contribution schemes whose investment performance, if American experience is replicated in this country, will come under increasing scrutiny.

Commission recapture has flourished in this country in a very short period of time. Its benefits are obvious to those pension schemes which participate in it. As a corollary, it may act as a catalyst for the general reduction of commission rates

to all pension schemes over the next few years.

References

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- 2 S. 28(e) of the Employee Retirement Income Security Act (1934).
- 3 Report of the working group on soft dollar and

directed brokerage issued by the 1997 advisory council on employee welfare and pension benefit plans to the US Department of Labor on 5th December, 1997.

- 4 *Cowan & Others v. Scargill and Others: Mineworkers' Pension Scheme Trusts* (1984) 2 All ER 750.
- 5 *Harries and Others v. Church Commissioners of England and Another: sub-nom. Lord Bishop of Oxford and Others v. Same* (1992) 2 All ER 300.
- 6 *Learoyd v. Whiteley* (1887) 12 AC 727.
- 7 *Nestlé v. National Westminster Bank PLC* (1992) 1 All ER 118.