

The Nugee Pensions Lectures

# #3: Prudence in investment - impact of Covid-19 turmoil

David Pollard and M Scott Donald



# Part 1: David Pollard

What legally does prudence mean in investment?

- What does prudence mean?
- What does the duty of care require?
- Is it the right test for pension schemes and commercial trusts?



# Investment duty of care

Duty of care and skill is in addition to:

- Staying within trust deed terms – eg authorised investments
  - Wide implied authorised investments: PA 1995, s34, subject to any limitation in the trust deed
  - Duty of care remains, even where wide investment power – *Nestle*
- Proper purpose – [tricky in some cases – eg political risk, ESG factors?]
- Fiduciary duties – eg no unauthorised conflict of interest
- Statutory duties
  - eg SIP, advice, limit on ERI, Investment Regs, consult, appoint fund manager,
  - limit on “day to day” investment decisions



# Current times

Current times – much economic (and physical) turmoil

For occupational pension schemes the trustee board has a duty of care – it needs to consider impact on assets and (mainly for DB schemes) employer covenant

Potential for members (and employers and the PPF) to look at pension fund asset performance in retrospect – should the trustee board have done better?

- Pension Schemes Bill sanctions on trustees?

Pension trustee duty of care in relation to investment is important because:

- assets are large
- exonerations limited by PA 1995, s33

# Duty of Care: *Re Whiteley*

What is the investment duty of care for a pension trustee board?

Commentators (and case law) generally cite *Speight v Gaunt* (1883):

“As a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an **ordinary prudent man of business** would take in managing similar affairs of his own.”

and *Re Whiteley* (1886) Lindley LJ:

“the duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an **ordinary prudent man** would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.”

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# Prudence?

But:

- Judgments are not statutes
- *Speight v Gaunt* and *Re Whiteley* are over 130 years old
- Context:
  - private wealth trusts, with limited implied authorised investments
  - In an era before much inflation
  - Less developed financial markets
- Consolidated a move to a greater duty of care than previously
  - limited before to “good faith” – eg *Gisborne v Gisborne* (1877)

# Victorian judges?

Hoffmann LJ in a 1994 paper:

“After all most of the general statements of equitable principles which we use today are simply a way of putting the matter which occurred to some Victorian judge in the course of an ex tempore judgment which his successors thought sufficiently felicitous to be worth repeating.

There is nothing sacred about such formulations and I do not see why Victorian judges should be regarded as having had some special insight into the mot juste which the Australian Parliament or Professor Goode’s committee or even modern judges lack.

What matters is not the source of the principle but whether the judges are willing to regard it as a principle rather than try to interpret it as a black–letter rule.”

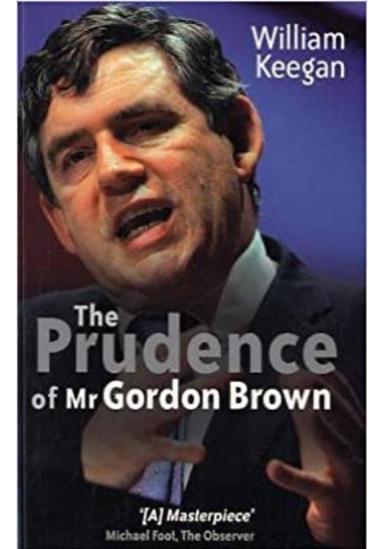
Paper “*Equity and its role for superannuation pension schemes in the 1990s*”

# Prudence?

Duty of care for investment matters:

“Prudence” and “prudent” sound good as a duty of care?

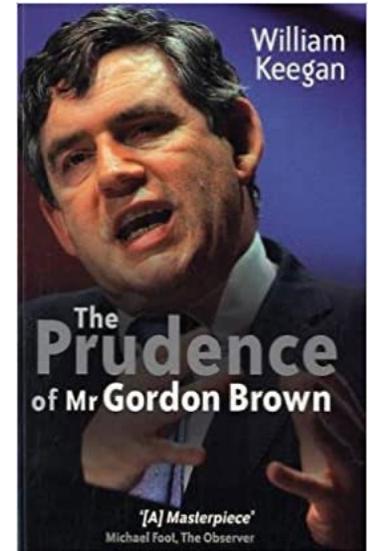
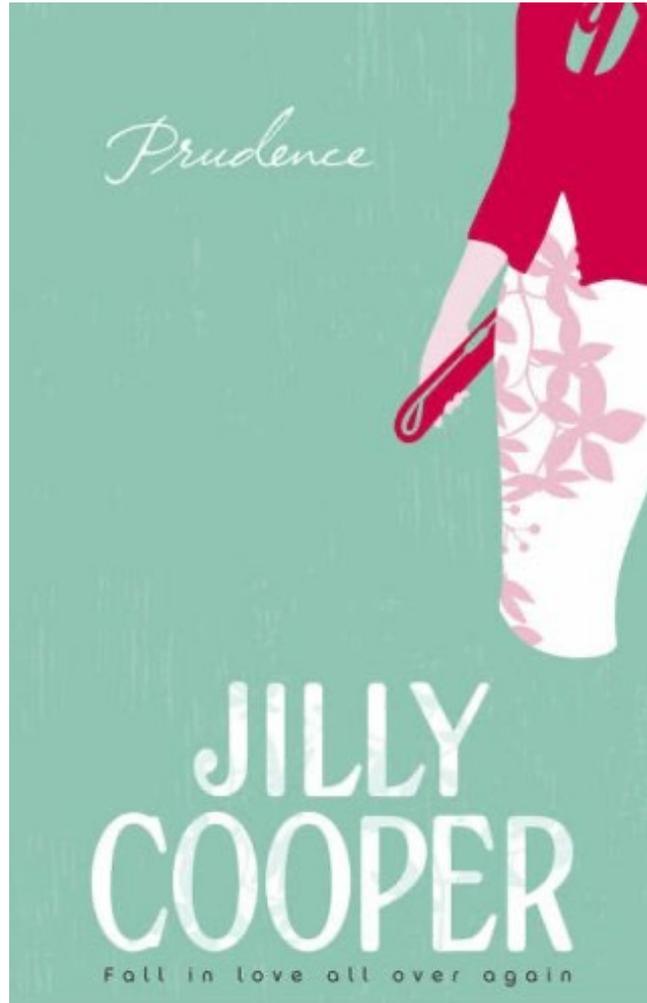
- Gordon Brown liked to be thought of as “prudent”
- Scots are prudent?
- Prudential Assurance Company
- Prudential Regulation Authority (PRA)
- Prudence as a virtue?
- Jilly Cooper?



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# Prudence



# Prudence and the investment duty of care

1. What does the legislation say?
2. What does “prudence” mean? – prudence as a shorthand?
3. What is a better way of describing the duty of care for investment?
4. Applying out the duty of care: context, time of decision, professionals
5. Test for pension trustees?
6. Legal claims – process/perversity – applying *Braganza*?

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# 1. What does the legislation say?

## Statute and Prudence

E&W: no express statutory investment prudence duty on trustees:

- Trustee Act 2000
- Pensions Act 1995/ Investment Regs
  - Contrast other jurisdictions: eg Jersey, New Zealand, Australia

PA 2004 does refer to “prudent” actuarial assumptions for funding

– see Jonathan Hilliard and Leonard Bowman ‘*The virtue of prudence and other funding puzzles*’ APL conf 2019

# Statute and trustee investment

Trustee Act 2000: refers to:

“reasonable in the circumstances”

**1.— The duty of care.**

(1) Whenever the duty under this subsection applies to a trustee, he must exercise **such care and skill as is reasonable in the circumstances**, having regard in particular—

(a) to any special knowledge or experience that he has or holds himself out as having, and

(b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

(2) In this Act the duty under subsection (1) is called “the duty of care”.

Applies to investment functions, whether under the Act or otherwise (Sched 1, para 2)

Does not apply to investment functions of trustees of an occupational pension scheme (s36)

# Statute and Investment

## Pensions Act 1995 and Investment Regs 2005:

- Limited express mention of prudence for investment.

### **PA 1995, s33: Investment powers: duty of care.**

(1) Liability for **breach of an obligation under any rule of law to take care or exercise skill** in the performance of any investment functions, where the function is exercisable—

(a) by a trustee of a trust scheme, or

(b) by a person to whom the function has been delegated under section 34, cannot be excluded or restricted by any instrument or agreement.

- Tricky section – see Fenner Moeran Nugee Lecture 2018

# OPS (Investment) Regs 2005

## 4.— Investment by trustees

- (1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.
- (2) The assets must be invested
  - (a) in the best interests of members and beneficiaries; and
  - (b) in the case of a potential conflict of interest, in the sole interest of members and beneficiaries.
- (3) The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.
- (4) Assets held to cover the scheme's technical provisions must also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.
- (5) The assets of the scheme must consist predominantly of investments admitted to trading on regulated markets.
- (6) Investment in assets which are not admitted to trading on such markets must in any event be kept to a prudent level.

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# OPS (Investment) Regs 2005

## 4.— Investment by trustees

(7) The assets of the scheme must be **properly diversified** in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to **excessive risk concentration**.

(8) Investment in **derivative instruments** may be made only in so far as they:

- (a) contribute to a reduction of risks; or
- (b) facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk), and any such investment must be made and managed so as to avoid excessive risk exposure to a single counterparty and to other derivative operations.

# OPS (Investment) Regs 2005

Designed to enact requirements under IORP.

BUT, no general “prudent person” investment duty in the 2005 regs

Deliberate decision

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# IORP (2003/41/EC)

Directive on the activities and supervision of institutions for occupational retirement provision

## **Article 18: Investment rules**

1. Member States shall require institutions located in their territories to invest in accordance with the "prudent person" rule and in particular in accordance with the following rules: ....

Now IORP 2 (2016/2341), art 19

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# IORP

1. IORP is a directive, so not directly binding on non-governmental entities
  - But national law should be interpreted so far as possible to comply – eg *Marleasing*
2. Refers to the “prudent person” rule. But this is not expressly defined further

Similar rule in Solvency II Directive (2009/138/EC):

1. Member States shall ensure that insurance and reinsurance undertakings invest all their assets in accordance with the prudent person principle, as specified in paragraphs 2, 3 and 4
2. [security, quality, liquidity and profitability etc]

# IORP

In context the “prudent person” rule in IORP is limited to

- compliance with the principles described later in the article (diversification, regulated markets etc).
- Seems arguable (at least)

Eg CA in *Palestine Solidarity* (2018):

- “the article places obligations on Member States to require institutions to invest in accordance with the prudent person rule as more particularly set out in Article 18(1)”

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## 2. What does “prudence” mean?

- prudence as a shorthand?
- Deal with risk?

### OED: **prudence:**

1. The ability to recognize and follow the most suitable or sensible course of action; good sense in practical or financial affairs; discretion, circumspection, caution.

In early use: the wisdom to see what is virtuous, seen as one of the four cardinal virtues.

.....

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# Prudence

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1. The ability to recognize and follow the most suitable or sensible course of action; good sense in practical or financial affairs; discretion, circumspection, caution.

In early use: the wisdom to see what is virtuous, seen as one of the four cardinal virtues.

.....

4. A gathering or group of vicars. Obsolete. rare.



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# Prudence

“**prudence**” and “**prudent**” probably mean no more than “careful” or “cautious”

Effectively means need weigh up risks

- So no different to “reasonable”?
- (some cases refer to “reasonable and prudent” – impliedly a difference?)

# Law Commission

## *Fiduciary Duties of Financial intermediaries (2014):*

- “3.72 There has been a move away from this traditional language of “prudence”. In 2000, trustees’ duties of care were put on statutory footing in England & Wales through the Trustee Act 2000 (the 2000 Act). This implemented, with minor changes, the recommendations of the Law Commission and Scottish Law Commission in our 1999 Report on Trustees’ Powers and Duties. The Act signalled a move towards “reasonableness” as the relevant standard of conduct.”

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# Prudence and risks

Prudence does not mean risk free

Prudence/reasonableness must depend on context  
– what risks is the trustee being cautious or careful about?

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# Prudence and risks

Donald Rumsfeld (2002):

“there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know.”

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# Prudence and risks

## Prudence does not mean risk free

Brightman J in *Bartlett v Barclays Bank Trust Co Ltd* [1980]:

“That does not mean that the trustee is bound to avoid all risk and in effect act as an insurer of the trust fund”

“The distinction is between a prudent degree of risk on the one hand, and hazard on the other. Nor must the court be astute to fix liability upon a trustee who has committed no more than an error of judgment, from which no business man, however prudent, can expect to be immune”

# Prudence and risks

*Harries v Church Comrs* (1991) Nicholls V-C. charitable trust:

- Guiding principle “to further the purposes of the trust”
- Investment property: “seeking to obtain .. the maximum return, whether by income or capital growth, which is consistent with commercial prudence”
- “investments should be made solely on the basis of well-established investment criteria, having taken expert advice where appropriate and having due regard to such matters as the need to diversify, the need to balance income against capital growth and the need to balance risk against return”

(at p304)

# Prudence/ capital preservation

*ASIC v Drake* (2016) per Edelman J:

“271. The short point is that the refrain in the older cases about caution and avoidance of hazard, if read in isolation, suggests a duty which is abstracted from the terms of the trust instrument and the nature of the trust business. But whether an investment is incautious due to its speculative nature, or impermissibly hazardous, may be affected by the terms of the trust instrument. To give a simple example, a trust established for the purposes of speculation, with terms requiring investment in speculative ventures, requires a different assessment of hazard from a trust which requires investment in government bonds.

# Reckless Prudence?

Not taking risks can itself be not prudent/careful?

Being over cautious, so not taking even remunerated risk?

- Parable of the talents

Matthew ch25, 24-30

- “and cast ye the unprofitable servant into outer darkness: there shall be weeping and gnashing of teeth”

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# Reckless Prudence?

- **Michael O’Higgins (then TPR Chair) in a speech in 2012:**  
“The best support for a DB pension is a properly funded scheme supported by a strong employer. While we believe contributions should be made where they are affordable, we do not want trustees to be ‘recklessly prudent’ in the valuation assumptions they make and in their negotiations with employers. There will be occasions when the right thing to do for the employer and the scheme will be to invest in the growth of the sponsoring company rather than making higher pension contributions.”

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# Reckless Prudence?

Not taking risks is not prudent?

Wikipedia on Prudence:

“In modern English, the word has become increasingly synonymous with cautiousness. In this sense, prudence names a reluctance to take risks, which remains a virtue with respect to unnecessary risks, but, when unreasonably extended into over-cautiousness, can become the vice of cowardice.”

# Hazard and Speculation

What is the dividing line?:

- I invest
- You save
- He speculates/gambles

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# Hazard and Speculation

Caselaw refers to hazard and speculation.

What is the dividing line?:

- Theodore Roosevelt: There is no moral difference between gambling at cards or in lotteries or on the race track and gambling in the stock market (1908)
- JM Keynes in *The General Theory of Employment, Interest and Money* (1936) compared investing on a stock exchange as being similar to a casino:

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# Pension Schemes Bill and risk?

Is risky investment caught by new criminal/CN/penalty provisions in current PS bill (if enacted)?

## **s58B Offence of conduct risking accrued scheme benefits**

“Likelihood” = balance of probabilities? Or just a risk?

Investment by trustees in equities? Potentially fall within section? Reasonable excuse?

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# Prudence: twitter shorthand?

## Prudence or prudent

- Sounds like a well defined concept
  - But is not
- Treat as a “twitter” shortcut for “reasonably” or “cautiously”
- Similar multiple meaning problems with other concepts:
  - “best interests”,
  - “good faith”,
  - “fiduciary duty”

### 3. A better way of describing the duty of care for investment?

Trustee Act 2000: codifying the common law:  
“reasonable in the circumstances”:

**1.— The duty of care.**

(1) Whenever the duty under this subsection applies to a trustee, he must exercise **such care and skill as is reasonable in the circumstances**, having regard in particular—

(a) to any special knowledge or experience that he has or holds himself out as having, and

(b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

(2) In this Act the duty under subsection (1) is called “the duty of care”.

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# TA 2000

“reasonable in the circumstances”

Implies context of:

- the trust
- the times
- the trustee

# Companies Act 2006 s174

Directors: CA 2006 codifying the common law:  
“reasonably diligent person”

174 Duty to exercise reasonable care, skill and diligence

- (1) A director of a company must exercise reasonable care, skill and diligence.
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
  - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
  - (b) the general knowledge, skill and experience that the director has.

# Prudence and the investment duty of care

- 4. Applying the duty of care:**
  - **context,**
  - **advice,**
  - **good judgment test,**
  - **time of decision**
  - **diversification /portfolio theory**
  - **professionals**

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# Family wealth trust

“economic and financial conditions of that time”

*Nestle* in the CA (1992):

Dillon LJ:

“Mr Nugee QC for the bank rightly stressed the duty of a trustee to act prudently. The best known formulation of this is in the judgment of Lindley LJ in *Re Whiteley*”

“This principle remains applicable however wide, or even unlimited, the scope of the investment clause in a trust instrument may be. Trustees should not be reckless with trust money. But what the prudent man should do at any time depends on the economic and financial conditions of that time—not on what judges of the past, however eminent, have held to be the prudent course in the conditions of 50 or 100 years before. It has seemed to me that Mr Nugee's submissions placed far too much weight on the actual decisions of the courts in the last century, when investment conditions were very different.”

# Directors

Prudence was initially used as the standard for directors as well – *Overend Gurney* (1869)

But later this reduced to a general subjective “good faith” standard.

Given the entrepreneurial and trade/risk taking purpose of many (most?) companies, prudence (old style) was seen as too cautious

*Daniel v Anderson* (1995); *ASIC v Drake* (2016); *ASIC v Cassimatis* (2020)



# Directors

Trustee companies

Directors owe duties to the trustee company

Company is trustee and owes duties to beneficiaries etc

Directors can be liable:

- To beneficiaries if dishonestly assist in breach of trust by the company
- To trustee company if a breach of duty by the director to the company – eg claim by a liquidator (or perhaps a new trustee):
  - *HR v JAPT* (1997) and *Gregson v HAE* (2008)). As to level of duty, - *Bishopsgate Investment Management* (1994) and *Cassimatis* (2020)

## 5. Test for pension trustees? Pension schemes are different?

Having worked out that “prudence” does not say much even for family wealth trusts, where do commercial trusts such as pension schemes fit in?

- Unit trusts?
- Express investment duty in the trust deed?
  - in my experience unusual

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# Pension schemes are different

Hoffmann J in *Nestle* (1988):

“... the investment considerations in family trusts such as this were different from those in unit trusts. I agree ...”

In practice probably too late to argue no “prudence duty” for pension trusts

- *Cowan v Scargill*
- IORP

But prudence just means take reasonable care – take into account the context of the pension trust.

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## 6. Legal claims – Process/perversity

“**prudence**” and “**prudent**” probably mean no more than “careful” or “cautious”

Effectively: weigh up risks

So, assuming investment was authorised, a process test?

Did the trustee board:

- follow the statutory process (SIP etc)
- take reasonable steps to identify the relevant risks
- take advice? (statutory requirement);
- consider the material relevant factors (eg liquidity, diversification)?

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# Prudence

“**prudence**” and “**prudent**” probably mean no more than “careful” or cautious”.

Effectively process: act carefully/weigh up risks

But with an objective outcome element –

- Did the trustee board make a decision that no reasonable/prudent trustee would make?
  - *Nestle, Wight v Olswang, Daniel v Tee*



# Prudence

Looks to be similar to a two limb *Wednesbury/Braganza* test:

- Process: due consideration of what ought to be considered (relevant factors); and
- Outcome: not perverse - “no reasonable decision maker”

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# Bedtime reading

Advert:



**NEW TITLE:**

Pensions, Contracts  
and Trusts:  
Legal Issues on  
Decision Making

David Pollard

Bloomsbury Professional  
Law

# Where does this leave the investment duty of care for pension trustees?

## Overview:

1. What does the legislation say?
  - No express mention of prudence mention
2. What does “prudence” mean? – prudence as a shorthand?
  - Take care, consider risks
3. Is there a better way of describing the duty of care for investment?
  - Apply reasonableness standard
4. Applying the duty of care:
  - context, time of decision, professionals
5. Test for pension trustees?
  - yes
6. Legal claims – process/perversity – applying *Braganza*?
  - Need evidence of loss; no reasonable trustee would have acted

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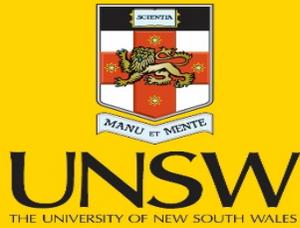


# Where does prudence end up?

“prudence” or “prudent” gives a mixed message

- Fine as a short-hand, but need to realise this
- Trustees need to consider level of risk and reward in the context of the scheme
- Means need to take care – involves working out purpose/ relevant risks eg inflation, asset return, economic prospects, pandemics etc
- Investment regs/TPR guidance point toward advice/consultation etc
- Means that a Trustee board taking advice is probably OK
  - Need to properly instruct adviser about risk level
  - Consider and monitor advice
  - Document reasons for investment strategy
  - Potential breach if perverse (no reasonable trustee) or contrary to statutory limits
  - Claimant for compensation would need to show that breach has caused a loss to the trust/claimant

# Over to Scott



Scott Donald PhD CFA  
Director, Centre for Law Markets and Regulation

Never Stand Still

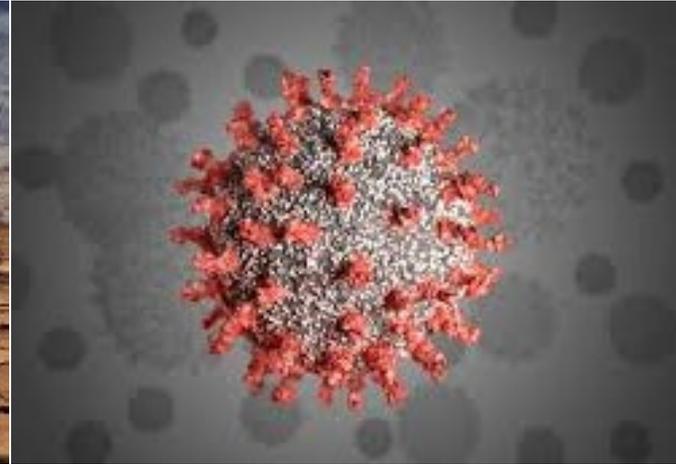
Faculty of Law

## Prudence *in extremis*

Nugee Lectures  
Wilberforce Chambers  
London, 24 June 2020



# The challenges of 2020 ...



# Are traditional notions of prudence sufficient?

## The historical trajectory

- From gilts → non-sovereign debt → equity → modern portfolio theory
- From legal lists → duty of care + best interests + proper purposes

## The familiar trustee toolkit to address risk

- Careful research to reduce information uncertainty
- Diversification, incl strategic asset allocation
- Insurance to curtail specific risks



# The challenge of climate change

## What we 'know'

- Slow moving (ie we might have time)
- Ubiquitous (ie we cannot get out of the way)
- Mitigation is expensive (and compounded by crisis of the commons)
- Trustees must maintain narrow focus on members' best financial interests

## Where is the uncertainty for trustees?

- How quickly things will happen and when markets will react
- Political risk
- What peers are doing

## What to do?

- Identify potential 'winners' and insure specific risks
- **Brief external investment managers**
- **Product design: launch tailored ESG options**
- **Governance: revisit board protocols**
- **Communicate with members (see *REST*)**
- **Join 'norm-ing' movements**



# Coping with COVID-19

## What we 'know'

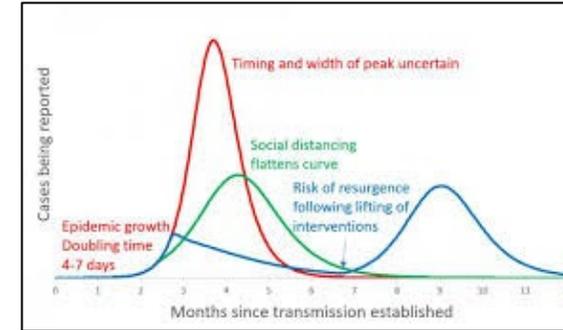
- “When?’ not “If?”
- Fast moving and (somewhat) predictably viral
- Has real and financial market impacts
- Can affect decision-makers personally

## Where is the uncertainty for trustees?

- How long it may take to tame
- How members will react in the meantime
- Political risk

## What to do?

- Disaster recovery plans
- Ensure liquidity management plans account for ‘catastrophe’ risk
- **Ensure switching procedures are efficient, robust and fair**
- **Harness information network**
- **Ensure efficient governance structures and processes**



# Bitcoin blues ...

## What we 'know'

- Very trendy – and now widely recognised as an asset capable of being held on trust
- Extreme price volatility

## Where is the uncertainty for trustees?

- Endemic unpredictability
  - Lack of transparency
  - Thin trading volumes
- Custody risk
- Scandal risk

## What to do?

- Avoid



# Traditional 'prudence' is outgunned in the face of extreme risk

The capacity to respond decisively and in a timely manner depends on governance structures and processes

- Delegations
- Risk frameworks
- MIS
- "Institutional memory"

Product design crucial in a DC world

- Investment menu
- Switching and unit pricing

Member communications are crucial



Questions, observations, ideas?

