

Exoneration Clauses

How can trustees protect themselves from negligence claims in relation to DC investments, especially default options - bearing in mind what the legislation says about relying on exoneration clauses?

1. This talk will consider a typical DC scheme where the trustees select a number of funds and the members choose a preferred fund with a default option if the member does not make a choice. (A default option is compulsory for auto enrolment.) In many cases the funds may include automatic lifestyling and in particular the default fund may well do so.

What are the Trustee's responsibilities as regards Investments?

2. The starting place is the trust deed and rules but these are subject to s33 PA 1995. That section provides:

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.
 - (2) In this section, references to excluding or restricting liability include—
 - (a) making the liability or its enforcement subject to restrictive or onerous conditions,
 - (b) excluding or restricting any right or remedy in respect of the liability, or subjecting a person to any prejudice in consequence of his pursuing any such right or remedy, or
 - (c) excluding or restricting rules of evidence or procedure.
3. The section is not well drafted. It applies in respect to “investment functions”. They are not defined. It prevents the exclusion of liability for breach of an obligation to take care. It does not in terms prevent a restriction of a duty as regards investment other than it prevents “excluding or restricting any right” in respect of the liability. Does that prevent the exclusion of any duty at all? The section is likely to be widely construed.

4. It is clear, however, that at least where they are subject to a duty, Trustees must act as a reasonable man of business and to take care in relation to selecting investments (schedule 1, para 1 Trustee Act 2000) and liability for a breach of that duty cannot be excluded.
5. It is unlikely to be practicable or desirable to try to exclude a duty to monitor funds and communicate with members regarding them and any attempt to restrict liability to monitor and communicate regarding the funds (and in particular information that is unlikely to be known to the members) is likely to be ineffective as a result of s33. Such communications are probably part of the Trustees' "investment functions". (As mentioned above, the term is not defined in PA 1995 but the investment functions of trustees of a DC scheme can properly be described as selecting the range of funds, monitoring their performance and passing on relevant information gained from such monitoring.) It is also clear that trustees are under an equitable duty to exercise care in passing on information and s33 prevents liability for breach for that duty from being excluded.
6. Trustees are therefore exposed to the risk of claims in relation to their investment functions and these include selecting investments and probably passing on information about them.

How can Trustees protect themselves?

(1) Taking an indemnity from the employer.

7. This may offer a level of protection. It is less than bomb proof however. For example, if the employer becomes insolvent an indemnity will be worthless. Also, it has been suggested that in some circumstances the employer could claim against the trustees (thereby rendering the indemnity worthless) because the trustees owe a duty to the employer in relation to investments.¹

¹ David Pollard also suggests in *The Law of Pension Trusts* that s33 PA 1995 applies to an indemnity on the basis that an indemnity is like an exoneration clause in effect and also that it would make a claim more onerous. This is doubtful – the claim is being brought by a member so an indemnity from the employer would not nullify the member's claim rather it merely alters the person who bears the cost of it and would not make a member's claim more onerous.

(2) Insurance

Adequate insurance is important. But insurance policies do not always pay out in full and claim prevention is better.

(3) Prevention

8. Trustees can protect themselves in broad terms by:
 - (i) Ensuring that the rules of the Scheme are clear about where responsibility lies and what action is and is not permitted;
 - (ii) Taking, considering and where appropriate following advice;
 - (iii) Formulating and following proper policies;
 - (iv) Following statutory and regulatory requirements;
 - (v) Communicating clearly.

(i) Clear Rules

9. The delineation between the Trustees' functions and the choices of the members should be made clear. It should be clearly stated that the Trustees are responsible only for selecting funds for the members to choose and that Members are responsible for choosing the fund. That should be set out in the trust rules and in communications e.g. in the scheme's booklet.
10. The funds available and members' ability to invest in them should be clearly defined. Difficulties can arise where a fund is closed. Does that mean:
 - (1) that it is closed only to new investors but contributions from existing investors will continue to be paid into it until the member chooses not to do so;
 - (2) that it is closed to all new contributions;
 - (3) that it is closed to all new contributions and the Trustee has the right to move the investments?

Ideally the Trustee will have the ability to decide that any of the above should apply.

11. The rules should specify clearly what powers the Trustees have if for example they are advised that members should all switch out of a fund. Are the Trustees restricted to communicating that advice and closing the fund or can they also switch funds between

options. This is not an easy decision: the latter will protect members better but may expose the Trustees to claims.

(ii) Proper Advice

12. In short:

- (1) Decide what advice is required
- (2) Choose the advisor or advisors.
- (3) Obtain advice on the investment range and how often they should be monitored.
- (4) Follow the advice.

13. The first task is to select an investment range that should offer choice without over-complicating matters. The Trustees should after taking advice select the fund managers best suited to each type of fund and regularly review their work. A target performance should be set for each fund.

14. There should be regular advice on performance and suitability. Performance and cost should be considered. As regards the default fund, Trustees are under a duty to review the suitability of the funds on a regular basis and are required to do so at least every three years. I suggest that more regular reviews are necessary. Regular advice will tend to reduce the occasions when urgent decisions have to be made.

15. The frequency of reviews is something on which advice should be obtained from the investment adviser. In general, many funds review matters quarterly but typically not in depth and review matters in depth annually. Some funds may, because of their risk profile for example, require more frequent monitoring.

16. A recurring difficulty is the under performing fund. For what period should Trustees tolerate under-performance before removing a fund or a fund manager? Trustees would not want to be criticized for horizons that are too short but equally would not want to be criticized for leaving money in underperforming investments. This is something on which advice should be taken. Communication may offer a partial solution, e.g. by advising the members that a fund's performance had not met its benchmarks and that members should consider its continued suitability.

17. Suitability is often a matter of seeking advice from an appropriate investment adviser. If the advice is that the fund remains suitable or should be removed the Trustee's choice is clear. What if the advice is that a fund remains suitable for some but not others? The safety first approach would be to close the fund. Alternatively, issuing a specific warning to members may suffice if the warning is about something that members could be expected to understand and be able to assess the risks. I will come back to this.

(iii) Formulating Proper Policies

18. The Trustee should ensure that it has clear policies:

- (a) Stating the aims and objectives in respect of each class of investment;
- (b) In relation to-
 - (i) the kinds of investments to be held;
 - (ii) the balance between different kinds of investments;
 - (iii) risks, including the ways in which risks are to be measured and managed;
 - (iv) the expected return on investments;
 - (v) the realisation of investments; and
 - (vi) the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;
- (c) how those aims and objectives are intended to ensure that assets are invested in the best interests of the relevant members.

19. If those policies have been formulated they will provide a good yardstick for most if not all future questions that may arise.

20. If lifestyling is to be offered, the start and profile of the "glidepath" should be clearly defined.

21. As regards default options:

- (a) They should be aligned with an overall objective and should be selected with a view to its suitability for the bulk of membership likely to invest in it; its affordability and potential risks.
- (b) The investment strategy should manage risks by diversifying asset allocation.
- (c) The investment strategy should take into account, on reasonable grounds, the retirement profile of members.
- (d) Members should not be locked into the default option.
- (e) Information on the default option, including the charging structure, should be clearly communicated to members.

(iv) Following Statutory and Regulatory Requirements

22. In addition to those set out above, Trustees should ensure that they comply with legislation and regulatory guidance and in particular that they:

- (a) have a SIP
- (b) review the aims and objectives and the performance of the funds -
 - (a) at least every three years; and
 - (b) without delay after any significant change in-
 - (i) investment policy; or
 - (ii) the demographic profile of relevant members.
- (b) review the extent to which the return (after deduction of charges) is consistent with the aims and objectives.
- (c) revise the statement of principles after every review unless they decide that no action is needed.

(v) Communication

23. Members should be informed about the investment strategy of each fund offered. This will enable a member to review the ongoing suitability of his fund.
24. Regular up-to-date information should be provided on the investment objectives, fund performance, costs and charges of the funds and whether lifestyling applies and how it applies.
25. Funds should be clearly labelled and the risk profile of each fund should be described. This will help members review and understand the nature of the funds they are invested in and assess the suitability of a fund to their changing circumstances.
26. Trustees are not under a duty to give advice and in general should not do so. Their role is to ensure that quality information is provided to members. Communications should recommend that members consider taking financial advice when making investment decisions.
27. Communications should make it clear to members that they may incur a loss by being out of the market when switching funds.
28. The risk profile and the costs and charges of the funds should also be presented clearly in the information provided in an understandable format.
29. Trustees should map out when routine communications should be made.

For example,

- (1) A joining pack,
- (2) An annual benefit statement
- (3) Pre-retirement communications – this would cover communications about lifestyling a suitable number of years before retirement as well as communications immediately before retirement.

- (4) Periodic reminders: such as the ability to switch investments or redirect future contributions.

- 30. Where there is a significant change (for example to a fund's investment objectives or costs and charges structure, the range of investment options or the profile of the default strategy), trustees should provide information to members that clearly explains the changes, any implications for members and any action that they may need to take. Members should be given adequate time to consider the changes and to take action if appropriate.
- 31. The speed of communication should be considered. Typically trustees don't pass on information to members as it arrives but consider it at the next trustees' meeting.
- 32. In many cases a quarterly communication will be sufficient. But in others a more speedy communication may be required. For example, the investment adviser may advise that a fund's risk profile has changed (e.g. because it is overweight in a particular category of investments which the investment adviser considers to be risky). If the Trustees wait until their next meeting it might be too late for the members to switch investments before any adverse movement in the fund. Trustees could be criticized for not passing on such information quickly when today's technology makes that relatively easy in most cases. Emails and posting a warning on the website should be considered at a minimum. As suggested above, ideally Trustees would have the choice of switching members out of funds if that is considered wise.
- 33. Any additional information should be easily accessible. For example, on the scheme's web site. Other means of access may be useful e.g., online resources, mobile phone applications.