FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES

The Tax Justice Network's response to Law Commission Consultation Paper No. 215

21st January 2014

Introduction

1. The Tax Justice Network ("the TJN") is an independent international network launched in 2003. We conduct high-level research, analysis and advocacy on international tax; on the international aspects of financial regulation; on the role of tax in society; and on the impacts of tax evasion, tax avoidance, tax "competition" and tax havens. We seek to create understanding and debate, and to promote reform.

2. We welcome the Law Commission's consultation paper on the fiduciary duties of investment intermediaries ("the Consultation"). We note that it is prompted by a recommendation in the *Kay review of UK equity markets and long-term decision making: final report* ("the *Kay Review*") that the Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers. We also note that the scope of the Consultation is wider than is envisaged by this recommendation, seeking in addition to (a) clarify how far those who invest on behalf of others may take account of factors such as social and environmental impact and ethical standards, and to (b) identify areas where changes are needed (alongside other additional objectives).

3. As set out below, we have helped shape the public debate about fiduciary duties insofar as concerns company directors' duties and corporate tax behaviour. This paper begins with a summary of our position on that issue and then extends into the realm of financial intermediaries. The paper contains responses to some, but not all, of the questions in the Consultation.

Tax avoidance and the fiduciary duties of company directors

4. Our interest in fiduciary duties stems from the alleged fiduciary duty on the part of company directors to "maximise profits", which is said to translate into a fiduciary duty to avoid tax. The degree of misunderstanding in relation to this issue, even among informed

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commentators, is illustrated by Robert Peston's blog post on the BBC website at http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/09/is_avoiding_tax_immoral.html, in which he writes *"the advice to directors of public companies is quite clear: they are failing in their fiduciary duty if they allow their businesses to pay more tax than necessary".*

5. In order to eliminate this myth from public debate about tax avoidance we instructed Farrer & Co to prepare a formal legal opinion ("the Opinion") explaining that such a duty is unknown to English law. The Opinion is available here: http://www.taxjustice.net/cms/upload/pdf/Farrer_and_Co_Opinion_on_Fiduciary_Duties_and_Tax_Avoidance.pdf. We published it online, and circulated it to the press and to senior officers of all the companies in the FTSE100, in September 2013.

6. Many tax professionals and other expert commentators responded publicly to the Opinion, generally conceding that it was indeed up to directors to decide for themselves where to "draw the line" on tax avoidance (we summarise responses on our blog at http://taxjustice.blogspot.de/2013/09/on-directors-duties-to-avoid-tax-case.html). The strongest point made in response was that there was no countervailing duty militating against tax avoidance either. We agree. In our view fiduciary duties are a red herring in this context. The directors of a company can choose whether to behave aggressively or with an ethos of social responsibility in relation to tax without fear of liability under a "fiduciary duties" rubric either way.

Corporate tax avoidance and stewardship on the part of investment intermediaries

7. Only one expert commentator addressed an important further issue indirectly raised by the Opinion, however, which is the question of what (if not fiduciary duties on the part of directors) is the key factor driving tax avoidance. That commentator was William Underhill, partner at Slaughter and May, who wrote as follows in the *Tax Journal* on 27 September 2013:

   > *One last point to bear in mind, however, is that in the world of listed companies, the directors expose themselves to re-election by shareholders every year. A board that decides to pay more tax than it needs to will have to convince shareholders that it is in their interests to do so, not in a court of law but at the AGM and when they fill in their proxy voting forms.*

8. We do not find this suggestion plausible. We share with Professor Kay the view that "*an investment landscape characterised by a competitive fund management industry and the fragmented holding of shares*" does not lend itself to the degree of shareholder engagement that Mr Underhill posits (*Kay Review*, para 5.34).

9. In our view the culture of tax avoidance that permeates the corporate sphere is driven by precisely the systemic focus on short-term measurable outcomes (as opposed to long-term stewardship) that Professor Kay identifies in his review. It is not so much a matter of company boards fearing that they will not be re-elected if they do not avoid tax, as Mr Underhill suggests. It is more that companies who do not display the short-term measurable financial benefits that arise from the tax avoidance opportunities that are

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available in their sectors will compare unfavourably to their immediate competitors in the market for investment capital.

10. We take it as axiomatic that corporate tax avoidance (even where it is legally effective in achieving the tax reduction it sets out to achieve, which is of course by no means always the case) has an adverse risk-profile in the long term. There are a number of reasons for this, including the following.

    i. Tax avoidance drives systemic legal risk for business in the form of (for example) (a) specific anti-avoidance legislation which may catch "innocent" transactions, and (b) unpredictable reform of general global corporate tax norms.

    ii. Tax avoidance results in underfunded public exchequers, resulting in lower standards of public health, education and infrastructure, which adversely affects workforces, operations and markets both directly and (as inequality rises and social cohesion is lost) indirectly.

    iii. Tax avoidance adversely affects the reputations of companies among governments, tax authorities and the public, and adversely affects the relationship between the corporate sector generally and society at large.

11. This adverse long-term risk profile is to be contrasted with the short-term boost that tax avoidance provides in terms of measurable financial performance. That boost may be necessary in order for a company to keep abreast of its sector competitors in terms of superficial performance data, but (crucially) it says nothing about the value or profitability of the underlying business. It is often nothing more than a paper exercise, serving only to (in effect) extract value from the public exchequer at the expense of other taxpayers, and bearing no relation to the value-creating operations with which proper stewardship should concern itself. To adopt an analogy from nutrition, tax avoidance bears a similar relation to corporate performance as refined sugars do to the performance of the human body – tax avoidance brings empty financial calories and long-term health risks.

12. Tax avoidance is therefore a paradigmatic illustration of the failure of the prevailing systems of intermediated share ownership to encourage long-term stewardship as contrasted with a focus on short-term measurable financial outcomes. We would therefore propose it as a "litmus test" issue when considering suggested reforms to the prevailing systems of intermediated share ownership, at least to the extent such reforms have (as was indicated to be needful in the *Kay Review*) the encouragement of long-term stewardship as their aim. If the reforms are not such as would tend to suppress corporate tax avoidance, those reforms must be taken to be demonstrably inadequate on their face.

Responsible corporate tax behaviour as a shareholder "value"

13. Further, since tax paid has a measurable beneficial social impact (in terms of funds available for public spending) which is quantitatively equal to the adverse short-term impact of not avoiding it on a company's financial performance, tax behaviour is perhaps the starkest "zero-sum game" of all the diverse claims on the social responsibility of

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companies. Viewed through the lens of tax avoidance, the issue of long-term stewardship therefore appears to bear a substantial overlap with the question of how progressive or ethical shareholder values can be realized in practice, in circumstances where the journey of those values, from the mind of the collective investment scheme participant or pension fund beneficiary to the mind of the corporate decision-maker, takes place across that hostile "*investment landscape characterised by a competitive fund management industry and the fragmented holding of shares*" (*Kay Review*, para 5.34).

14. The specific progressive shareholder "value" in this context might be the belief that tax on corporate profits is not a cost to be eliminated, but is rather a distribution of profits to society (as stakeholder) which a company should be proud to make in full.

15. There are some who believe that companies should not be required to pay tax at all, for reasons promulgated by the libertarian fringe of academic economics, and there are others who believe that a company's contribution to society should be measured by reference to the consumption and labour taxes that it collects rather than solely by reference to the taxes that it actually bears. There are even people who positively approve of corporate tax avoidance on the basis that the state is evil and should be starved of funds by any means possible. But many people, including collective investment scheme participants and pension fund beneficiaries, believe that a company's social licence to operate requires it to contribute a share of its profits towards the costs of maintaining the human, infrastructural and institutional substrate out of which its profitability arises.

16. As the Opinion makes clear, that specific progressive shareholder value could translate into an "enlightened shareholder value" to be pursued by the board of a company by virtue of section 172 of the Companies Act 2006, without fear of liability under a "directors' duties" rubric, provided that the value itself can find safe passage across the intermediating badlands that Professor Kay identifies.

Fiduciary duties and the transmission of shareholder values: Consultation conclusions

Areas where we agree with the conclusions of the Consultation

17. We agree with the view expressed in paragraph 10.64 of the Consultation to the effect that fiduciary duties do not militate in favour of ethical behaviour, and this view chimes with the consensus response to the Opinion noted above. We share the view expressed in the Consultation at paragraph 10.91 that the discretionary powers of a fiduciary will be constrained by the purpose pursuant to which the powers have been vested in her (as embodied in the terms of the vesting instrument), which in an investment context would not ordinarily include the pursuit of progressive social and environmental objectives.

18. By the same token and for the reasons set out in paragraph 10.102 of the Consultation we agree that the pursuit of social or environmental objectives by a fiduciary can only be properly conducted within a stipulated framework of values. We agree that, absent such a framework, it would not ordinarily be appropriate for someone managing assets in a fiduciary capacity to apply her own ethical values or the perceived values of her principal so as to materially affect her investment decisions, for the reasons referred to in paragraphs 10.108 and 10.119 of the Consultation. We also agree with the proposition in

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paragraph 10.113 of the Consultation (which as the Consultation notes is borne out by the reality of the pensions landscape) that it would be consistent with an investment intermediary's fiduciary duties to make investment decisions within such a framework of values, even in circumstances where such decisions produce sub-optimal investment results, provided the principal or beneficiary consents to the framework.

19. It follows from the foregoing that fiduciary duties are at least capable of serving as a vehicle for specific progressive or ethical values on the part of a principal or beneficiary, even if in practice they are not generally deployed in this way among investment intermediaries more widely and more creatively than is set out in 10.111 to 10.114. In paragraph 10.110 it is said that trustees should only be swayed by ethical factors in the ways set out in paragraph 10.111 to 10.114. We agree with this to the extent that those are the only existing mechanisms for transmitting ethical values across the investment landscape of fiduciary intermediaries, but we would strongly resist any suggestion that this limitation derives from the law in this area rather than from the paucity of such mechanisms in the current market.

Paragraph 10.116 of the Consultation perpetuates the prevailing misconceptions

20. Broadly, then, we agree with the conclusions of the Consultation regarding the existing law of fiduciary duties as they apply to investment intermediaries. We would, however, sound a note of caution or even alarm regarding the views expressed at paragraph 10.116. We do not agree that, as a matter of trust law, investment intermediaries are prohibited from taking decisions based on ethical factors which are to the financial detriment of the scheme or fund.

21. The observations at paragraph 10.116 of the Consultation may be correct in respect of an investment intermediary where the terms of the relationship require the fiduciary only to produce financial benefits for beneficiaries, but it is not consistent with the broad principle expressed in paragraph 10.91 of the Consultation, which is that the discretionary powers of a fiduciary will be constrained, not by a general legal requirement to optimise financial performance, but by the purpose pursuant to which the powers have been vested in her, which will be embodied in the terms of the vesting instrument. Those terms may provide for the pursuit of ethical values even to the detriment of financial performance. This is recognised at paragraph 10.113 of the Consultation, where it is noted that financially sub-optimal decisions may be taken by an investment intermediary with the informed consent of the principal or intermediary.

22. The conclusions in paragraph 10.116 of the Consultation are, in addition, not supported by the material offered in their support. DLA Piper's observations, cited in that paragraph, are predicated on an express assumption that the objects of the investment intermediary are merely to produce financial benefits. Those observations do not even purport to be a summary of the law as it applies to all investment intermediaries.

23. We therefore believe that the material in paragraphs 10.98 to 10.116 of the Consultation "Ethical Factors" would better describe the law if it had ended with the observations of the 1993 Pension Law Review Committee at paragraph 10.115. Those observations are balanced, considered, consistent with the foregoing material in the Consultation, and we

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agree with them. The observations at paragraph 10.116, by contrast, do not correctly state the law, are not consistent with the foregoing material in that section of the Consultation, are unsupported, and seem to us to reflect a bias in favour of regarding investment intermediaries as ultimately and necessarily constrained by financial performance factors. In other words the conclusion of the Consultation's section on "Ethical Factors" perpetuates the very misconception about fiduciary duties which resulted in the *Kay Review* recommendation that those duties be clarified.

The categories of values-driven investment intermediation are not closed

24. The overall impression given by the section of the Consultation on "Ethical Factors" is that the existing exceptions to the industry norm of pursuing financial benefit to the exclusion of all other considerations are the only exceptions permitted by law. As noted above this is a possible reading of paragraph 10.110 of the Consultation, and the impression is borne out by the summary of conclusions in Chapter 14, which asserts at paragraph 14.6(4) that ethical factors "may only" be taken into account in the existing ways identified in paragraphs 10.111 to 10.114. We believe that this impression is misleading, and confuses existing market practice with law. We believe the law of trusts and fiduciary obligations to be tremendously flexible, and we believe that innovative instruments could be developed which would serve to convey ethical values across the investment landscape of fiduciary intermediaries.

25. While we would not wish to take the analogy too far, because we would not perceive the innovative instruments that we posit to necessarily serve a public benefit function, the "programme-related" and "mixed-purpose" investment on the part of charity trustees which the Consultation notes at paragraph 10.132 illustrate the flexibility offered by the law of trusts when it comes to building hybrid fiduciary obligations which (a) require the fiduciary's activity to be in the nature of investment, but also (b) mandate the pursuit of specified values even where such pursuit brings financial detriment as compared to optimal investment performance. Like the ethical retail investment offering described at paragraph 10.113, these activities sit on a spectrum between pure performance-driven investment at one end and the pure pursuit of non-financial values at the other.

26. Given that one of the purposes of the Consultation is to clarify how far those who invest on behalf of others may take ethical factors into account, and given the context of the *Kay Review* which calls for innovation tending to broader and deeper stewardship in the holding of equities, we believe it is an error on the part of the Consultation to suggest that the categories of values-driven conduct on the part of investment intermediaries are closed. There is no reason in law why innovative fiduciary machinery could not be developed which carries specified progressive values on the part of individual collective investment scheme participants or pension fund beneficiaries across the landscape of investment intermediaries, into decisions by intermediaries as to which investments to prefer, and consequently on into the decision-making processes of company directors.

Our response to Consultation questions 1 & 8

27. Our response to Consultation question 1 is therefore as follows:

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> Q1: We broadly agree with the Consultation's conclusions as regards the existing state of the law on fiduciary duties, but we take issue with the suggestions that (i) the categories of machinery whereby investment intermediaries may take into account ethical factors are closed, and (ii) that outside those categories the law is that investment intermediaries must pursue financial benefit to the exclusion of ethical factors.
>
> As is recognised by the Consultation, a decision of a fiduciary in an asset-management role can lawfully have a hybrid purpose on a spectrum between financial performance and the pursuit of non-financial values, provided that the purpose is clearly embodied in the terms of the instrument giving rise to the fiduciary relationship.
>
> It follows that there is no reason in law why innovative fiduciary machinery could not be developed which carries specified progressive values on the part of individual collective investment scheme participants or pension fund beneficiaries across the landscape of investment intermediaries, into decisions by intermediaries as to which investments to prefer, and consequently on into the decision-making processes of company directors.

28. It follows from the foregoing that Consultation question 8 is wrongly put.

> Q8: It is not the law that prohibits trustees from considering ethical issues except in limited circumstances. What prohibits trustees from considering ethical issues except in limited circumstances is the prevailing practice regarding the terms of the instruments giving rise to their fiduciary obligations.

Fiduciary duties and the transmission of shareholder values: the future

Fiduciary duties are not "the problem": Consultation questions 7 & 18

29. The world of investment intermediaries is currently under sustained criticism from a number of quarters. Whether it is said to have failed to act in the long-term interests of beneficiaries, or failed to foster greater social and environmental responsibility in the corporate sector, its defence is often that it is compelled to behave as it does because of fiduciary duties. This creates an impression that fiduciary duties are (so to speak) "the problem" with the system of intermediated share ownership.

30. The Consultation takes a defensive stance on behalf of fiduciary duties. It seeks to refute the suggestion that fiduciary duties are "the problem". We agree with the Consultation that fiduciary duties do not, in themselves, contribute to short-termism, thwart stewardship, or prevent investment intermediaries from fostering greater social and environmental responsibility in the corporate sector.

31. Fiduciary duties are, however, a crucial part of the legal underpinning of much of the

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system of intermediated share ownership, and that system does encourage short-termism, thwart stewardship, and prevent investment intermediaries from fostering greater social and environmental responsibility in the corporate sector. This is not to blame fiduciary duties for those problems; the system could in our view be structured to (a) encourage stewardship and (b) carry progressive values from ultimate beneficiary to company director, without the nature of fiduciary duties having to be changed. Our responses to questions 7 & 18 are therefore as follows:

Q7: Yes

Q18: Yes

Fiduciary duties could, however, be part of the solution: Consultation questions 12 & 13

32. We acknowledge in common with the Consultation that many progressive values are not shared by everyone, and that a default purpose for investment, once all other values are stripped away, is financial performance. The pursuit of financial performance *at any cost*, however, is itself a "value" in this sense, and it is not one shared by many collective investment scheme participants or pension fund beneficiaries.

33. Many people recognise that the pursuit of financial performance *at any cost* can lead to a huge range of adverse social and environmental consequences which should not be subordinated to the accumulation of private wealth, including gross human rights violations, corruption, circumvention of the rule of law, armed civil conflict, catastrophic pollution, runaway exhaustion of the Earth's resources, severe labour abuses of various kinds which pervade the supply chain, and tax dodging.

34. A value system which treats these matters as irrelevant to investment decisions is systemically imposed upon most low-to-moderate-net-wealth beneficial owners in the world of intermediated share ownership. Those least likely to share the values of rapacious unfettered capitalism – salaried workers making monthly pension contributions out of modest wages, people with modest savings held in consumer collective investment schemes – are currently compelled to adopt those values in their most extreme form, and are denied the opportunity theoretically afforded by an equity participation in the world of business to withdraw their capital from activities they do not agree with.

35. Taking tax avoidance as an example, it is not currently possible for a collective investment scheme participant or pension fund beneficiary to tick a box which asserts the progressive value we identify in paragraph 14 to the effect that tax on corporate profits is not a cost to be eliminated but is, rather, a distribution of profits to society which a company should be proud to make. But if there were such a tick-box, and the implications of ticking it were made clear to the investor so as to amount to consent along the lines referred to in paragraph 10.113 of the Consultation, fiduciary machinery could mandate investment intermediaries to pursue that progressive value, even to the investor's financial detriment as compared to optimal investment performance, provided always that the decisions

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taken in pursuit of that progressive value are proper and prudent investment decisions on other grounds.

36. If, in order to discharge their fiduciary duties, investment intermediaries were required to pursue that specific progressive value to the extent possible within the range of prudent investment options, it would be available to companies to differentiate themselves from their sector competitors in the market for investment capital by implementing fair and progressive tax policies at the conservative end of their wide range of tax behaviour options within the scope of s.172 Companies Act 2006, and to eschew the empty financial calories of tax avoidance.

37. No doubt other companies could seek to appear to have adopted such policies without actually having done so, and consequently a certain amount of due diligence would be required on the part of the investment intermediary to establish whether or not any given company had properly adopted the value on an operational level rather than merely making a show of it. That due diligence exercise would be wasted effort on the part of the investment intermediary in circumstances where a short-term exit is in prospect, and so long-term engagement and stewardship on her part would be encouraged. A virtuous circle could thereby be established between the adoption of values-driven investment by intermediaries and the ethos of stewardship that is widely thought to be lacking in the current system.

38. This improvement to the system of intermediated share ownership could be effected by reference to a number of progressive social and environmental values, and without change to the law of fiduciary duties. Indeed it would be by virtue of the law of fiduciary duties that such a system would take effect. Accordingly, rather than merely concluding that fiduciary duties are not broken and do not require fixing, we suggest that the Law Commission's final report on this topic recommends that creative use of fiduciary duties be made so as to bring about a progressive transformation of the world of intermediated share ownership.

39. For example, civil society in consultation with the investment industry could develop something amounting to an industry-standard questionnaire of "tick-box" progressive social and environmental values in the nature of the progressive value we have identified in relation to tax conduct. The investment industry in consultation with specialist bodies such as the Society of Trust and Estate Practitioners, the Charity Law Association or the Chancery Bar Association could at the same time develop new fiduciary investment instrument norms effective to carry those values along the investment capital supply chain so that investment decision-makers give effect to them, with the consequence that those values are fostered and encouraged in the boardroom.

40. Since the values on the questionnaire would not be shared by all beneficiaries, and indeed as the Consultation notes at paragraph 10.102 some values would be inconsistent with others, the system of intermediated share ownership would gradually repurpose itself under the pressure acting on its fiduciary participants, evolving into a mechanism which enables those individual tranches of investment capital that share a similar pattern of progressive social and environmental values to find each other as they cross the landscape of intermediated share ownership, group together, and ideally effect the real change in the

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world that the ultimate beneficiaries would like to see.

41. Our responses to questions 12 & 13 are therefore as follows:

> Q12: No; we believe that investment industry norms currently impose a value system on pension fund beneficiaries and collective investment scheme participants that they do not necessarily share, so that they are denied the opportunity to withdraw their capital from activities they do not agree with.
>
> Q13: Innovative systems of intermediated share ownership need to be developed which carry progressive social and environmental values from the beneficiary across the intermediating territory and ultimately into the boardroom.

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