

Myners Review: Institutional Investment in the UK

The Government's response

HM Treasury & The Department for Work and Pensions

- A. Introduction**
- B. The Government's response to the Myners proposals**
- C. The Government's response to consultation on the principles of investment**
- D. Revised set of principles**

Annex A Text of the Government's announcement on transaction costs, published 27 July 2001.

Annex B Two-year assessment

A. Introduction

1. In March 2000 the Chancellor of the Exchequer asked Paul Myners to carry out a review of institutional investment in the UK. The review was asked to consider whether there were distortions in institutions' investment decision making.
2. The Myners Review concluded that there are a number of areas where change would result in improved investment decision-making. In summary these include:
 - that **pension fund trustees** often lack the resources and expertise required to make informed judgements;
 - as a result trustees rely on **investment consultants**. Yet they often lack specialist skills and rarely have their performance assessed or measured;
 - that **asset allocation** – the selection of the markets a fund will invest in – is under-resourced. The lack of attention these decisions currently receive is likely to affect investment performance;
 - the objectives set for fund managers are often unrelated to the long-term **objective** of the pension fund. Fund managers are often assessed against the performance of a 'peer group'; this encourages managers to herd around a benchmark and undermines active fund management;
 - there is also a lack of clarity about the **timescales** over which fund managers' performance is assessed. This uncertainty leads to an unnecessary emphasis being placed on achieving short-term results;
 - the review found that fund managers are reluctant to take an **activist stance** when dealing with corporate underperformance in firms that they invest in, despite the possible benefits that this might have for their clients;
 - that the substantial costs of **broking commissions** were subject to insufficiently clear scrutiny and control.
3. The Myners review made a number of recommendations including:
 - a set of principles for institutional investment decision-making;
 - the replacement of the Minimum Funding Requirement (MFR) with a scheme-specific regime based on transparency and disclosure;
 - incorporation of the US Employee Retirement Income Security Act (ERISA) principles on shareholder activism into UK law, making intervention in companies, where it is in shareholders' and beneficiaries interests, a duty for fund managers;
 - the Law Commission to look at clarification of the legal ownership of surplus pension fund assets;
 - reduction of the rate of tax on withdrawal of the surplus;

- a legal change which would raise the duty of care for trustees, requiring them to be familiar with investment matters where they take investment decisions;
 - a proposal for an independent review of capital and information flows relating to personal investment products; and
 - a number of measures which take account of the special nature of private equity as an asset class for institutional investors - including changes to the maximum number of partners in a limited partnership and to the taxation of the proceeds from the investments of such partnerships.
4. The Government announced in Budget 2001 that it would take forward all the Myners review's recommendations. The Government consulted on the text of the Myners principles from 15 March to 15 May 2001.
 5. This document sets out the Government's full response to the Myners review in the light of consultation and explains how the Government will be taking forward the Myners recommendations. It includes a revised set of investment principles (section D) and a copy of the Government's statement on transaction costs which was published on 27 July 2001 (Annex A/B).

B. The Government's response to the Myners proposals

6. To promote long-term investment and to protect investors, the Government has said that it will take forward the recommendations of the Myners report. It will be doing so as follows.

Principles of investment

7. The Myners review put forward two sets of principles of investment for pension funds: one for defined benefit schemes and the other for defined contribution schemes.
8. The Government consulted on these from 15 March to 15 May 2001. The results of this consultation are set out below.
9. The Government is today issuing a set of revised principles. These are set out in section D below. The Government expects that pension funds will publicly disclose their compliance with these on a voluntary basis.

Change to duties of trustees

10. The Myners review recommended that there should be a legal requirement that where trustees are taking a decision, they should be able to take it with the skill and care of someone familiar with the issues concerned. The Government intends to legislate to enact such a requirement. It will aim to issue a consultation document setting out its proposals in more detail by the end of the year. In the light of the detailed legislative proposals, it may be necessary to revisit the precise wording of the relevant investment principle in order to ensure no inconsistency; but this will not imply any substantive change to the wording proposed in the principles.

Duty of intervention in companies

11. The Myners review recommended that the US ERISA principles on shareholder activism should be incorporated into UK law, making intervention in companies, where it is in the shareholders' and beneficiaries' interests, a duty. The Government intends to legislate to enact such a requirement for both fund managers and trustees. It will aim to issue a consultation document setting out its proposed change in more detail by the end of the year. In the light of the detailed legislative proposals, it may be necessary to revisit the precise wording of the relevant investment principle in order to ensure no inconsistency; but this will not imply any substantive change to the wording proposed in the principles.

Statement of Investment Principles (SIP)

12. Legislative provisions are already in place regarding provisions for the SIP. The legislation may need amendment in the light of the Government's proposals for a replacement for the Minimum Funding Requirement (see paragraph 15 below).

Defined contribution schemes

13. The review recommended that the Government should keep under close review the levels of employee and employer contributions to defined contribution pensions, and the implications for retirement incomes. The Government agrees that this is an important issue which it will keep under review as recommended.

Taxation rate on pension fund surpluses

14. The review recommended that the Government should reduce the tax rate on the withdrawal of pension fund surpluses. In Budget 2001 the Government reduced the taxation rate on repayments of pension fund surpluses by 5% to 35%. This restored the differential between the main corporation tax rate and the rate of taxation on surplus repayments to its original level. The new rate applies to all surplus repayments from Royal Assent of Finance Act 2001.

Ownership of pension fund surpluses

15. The review recommended that the Law Commission should be asked to review whether the objective of maximum clarity over ownership of the surplus could be achieved through legal change. The Government is discussing with the Law Commission how best to take this recommendation forward.

Minimum Funding Requirement

16. The review recommended that the MFR be replaced by a regime based on a long-term scheme-specific approach. The Government's proposals for a replacement for the MFR were set out in "Security for Occupational Pensions: The Government's proposals" published on 7 March 2001. And on 18 September 2001 the Government published the document "The Minimum Funding Requirement: The Next Stage of Reform". This set out details of the next stage of the reform of the MFR and sought view on the workability of draft regulations that:

- introduce changes to the MFR in advance of its replacement; and
- strengthen the conditions which apply when a scheme winds up.

17. Implementing the Government's proposals in full will require primary legislation. In the meantime the Government is continuing to work with the pensions industry and other interested parties to develop proposals for legislation when Parliamentary time becomes available. To assist with this process, the Government has set up a Consultation Panel with representatives from the pensions industry, consumer organisations, employers and trade unions.

Further independent review

18. The review recommended that the Government initiate a review of personal investment products. The Government announced on 18 June that it had asked Ron Sandler to conduct a review to identify the competitive forces and incentives that drive the industries concerned, in particular in relation to their approaches to investment, and, where necessary, to suggest policy responses to ensure that consumers are well served. Mr Sandler issued a consultation document on 30 July, requesting responses by 28 September.

Two -year assessment

19. The review recommended that there should be a public assessment after two years of the effectiveness of the principles in bringing about change. The Government will begin this review, as recommended, in March 2003. Annex B sets out in further detail how the Government expects the review will assess progress.

Private equity

20. The review recommended that the Government continue to strengthen its programme of public-private venture fund partnerships, with the aim of filling gaps in the regional and technology venture capital markets. The review also recommended that as the venture capital market evolves, the Government keeps under close review the impact of its tax and regulatory measures in this area. The Government has recently announced the introduction of Regional Venture Capital Funds (RVCFs) which will be managed by private fund managers but which will be financed by up to £80million of Government money.
21. The review recommended that the Government should consider change to the law affecting limited partnerships to increase the maximum number of partners per partnership. The Government has completed a public consultation on a proposal to abolish the statutory maximum of 20 partners for both partnerships and limited partnerships. Ministers will consider the response and announce their decision later this year.
22. The review recommended that the Government reform taxation of insurance companies' investments in limited partnerships. The Government announced consultation in Budget 2001 on proposals to change the rules for life insurance companies that invest in venture capital limited partnerships, which will significantly reduce compliance costs.

Local authorities

23. The regulations which govern the way in which local authorities manage and invest their pension funds are being reviewed. An informal consultation exercise will begin shortly to take forward the report's recommendations to apply to local authority pension funds and several other matters of specific interest to the Local Government Pension Scheme. The principles of investment will be applied to the Scheme by means of a combination of amendments to the current statutory framework, particularly in respect of Statements of Investment Principles, and authoritative best practice guidance being developed by the Chartered Institute of Public Finance and Accountancy.

Proposals addressed to other organisations

24. The Myners review also made a number of recommendations addressed to other bodies: the NAPF, the BVCA and the FSA.

FSA

25. The review recommended that the FSA establish a centre of expertise within its organisation to deal with the regulation of private equity. The FSA has said it is keen to make effective use of its existing expertise in the area of private equity, which will be to the advantage of both the FSA and the industry. The FSA has in any case as part of its recent restructuring established two teams in its Investment Firms Division who will together concentrate that expertise and have responsibility as first port of call on private equity matters.
26. The review recommended that the practical effect of the 10 per cent ceiling on investment in limited partnerships should be kept under review by the FSA. The FSA has said it will keep the practical effect of the current admissibility limits of 1% in partnerships from any one issuer, and 10% in aggregate, under review should investment in private equity rise considerably.
27. The review recommended that the FSA should publicise its willingness to consider concessions from the readily realisable rule. The FSA has published in extant guidance its willingness to consider concessions to modify the effect of asset valuation and admissibility rules, and this has been carried forward into the Interim Prudential Sourcebook.

NAPF

28. The review recommended that the NAPF should investigate ways of collecting more comprehensive data on the investment decisions of defined contribution pension schemes. The NAPF has included additional questions on these issues in its annual survey.

BVCA:

29. The review recommended that the BVCA increase its efforts to educate potential investors, the media, Government and Parliament about the role and economic contribution of private equity in general and about the differing characteristics of the various sub-sectors within it. To increase awareness of the role and economic contribution of private equity the BVCA has hired a new Head of Communications, is working closely with the Treasury and has started a direct mail programme of information to MPs.
30. The review recommended that the BVCA should continue an active dialogue with the UK institutional investor community to educate investors about the validity of valuation techniques. The BVCA are continuing their active dialogue within the UK and are working closely with the EVCA on the new EVCA guidelines to ensure as far as possible there is comparability across the UK and the EU.
31. The review recommended that the BVCA establish and disseminate guidelines on the comprehensive and independently audited valuation of investments. The BVCA has said that much of this area is already covered by the BVCA Valuation Guidelines

referred to above and which have been widely adopted. It has said that where private equity firms use valuations for marketing or fund raising purposes, then as widely adopted market practice, the fund document / prospectus is normally vetted and approved by a major accounting firm.

32. The review recommended that the BVCA enhance the quality and credibility of the industry benchmark data by further increasing coverage among its UK private equity member firms from the current level of 95% and introducing some degree of independent auditing or reported returns. The review also recommended that the BVCA work closely with the EVCA to produce comparably accurate, detailed and credible performance data for European private equity funds as a whole. The BVCA has said that it continues to strive to produce data of the highest quality and credibility and will work closely with the EVCA.
33. The review recommended that the BVCA, in consultation with established UK institutional investors in private equity, should encourage greater transparency among its members about contract terms. The BVCA is continuing to work with its membership to encourage greater transparency among its members about contract terms.

C. GOVERNMENT RESPONSE TO CONSULTATION ON MYNERS PRINCIPLES

34. The Government consulted on the principles of investment proposed by the Myners review from March to May 2001.

35. Over 115 responses were received from institutions, pension funds, fund managers and other interested parties. The Government wishes to thank all those that took part in the consultation.

General Issues

36. In general, respondents reacted positively to the proposal for a set of principles and to many of the principles themselves. The major specific concerns raised are considered below.

37. While the Government welcomes the generally positive tone of responses, it is also concerned by some assumptions about the principles which respondents made.

38. A number of respondents appeared to imply that large pension funds are already fully compliant with the principles, and that therefore adopting them would not require change. The Government agrees with the Myners review that while many funds may currently comply with some elements of the principles, few if any at all comply with all or even most of them. If large pension funds, which in terms of funds under management dominate the industry, already complied with the principles, then the Myners review would not have found the distortions which it did. The Government concludes that compliance with the principles is at present less widespread than many respondents believe.

39. The Government also notes with some disappointment that a number of respondents argued against changes proposed by the principles by repeating assertions that had been considered in the Myners report and shown to be incorrect or otherwise lacking evidence to support them. While the Government believes that trustees should debate and consider the applicability of each of the principles to their fund, it is important that they do so in a spirit of real engagement with the agenda for change set out by the Myners review.

40. A number of respondents also suggested redrafts of various elements of the principles using language akin to that of regulation or legislation, involving much tighter specification of the meaning and scope of the principles. While the Government is grateful for these respondents' efforts to engage with the principles, it believes there may be some misunderstanding of the nature of the principles which it is important to correct.

41. The present principles are specifically intended to be different from regulation or legislation in their nature. This reflects the voluntarist approach, which the Myners

review recommended (and the Government agrees) should be tried. They are not a legal document, divergence from which is subject to sanction by an outside authority, and on which trustees take legal advice on compliance. Rather, they are intended to be a short common-sense statement in plain English of the basic principles of investment for pension funds, enabling trustees to assess whether they are carrying out their investment responsibilities sensibly and effectively. Trustees should consider whether they are complying with the spirit and intention of the principle rather than simply with the specific wording. Where they seek advice on implementation, this advice should generally focus on investment issues, not legal ones.

42. For instance, respondents often suggested the inclusion of explicit references setting out sets of circumstances where compliance may not be appropriate for some schemes – most commonly, because the cost of doing so exceeds the benefits. Since the present principles are not compulsory, the Government believes such references are not necessary in the principles themselves. The appropriate course of action in this case is for individual schemes to explain to their members any instances where they have not complied with the principles.
43. There also appeared to be some important misunderstandings of the nature of the proposals relating to trustees. The focus of concern appears to have been the secondary issue of whether or not to pay trustees. It may be helpful to clarify the Government's thinking on the wider issue.
44. One of the central distortions to investment decision-making identified by the Myners review was the divergence between legal requirements and practical reality in investment decision-making. In law, many trustees are taking investment decisions, particularly ones relating to asset allocation. In reality the limited understanding of investment issues of many trustees and their consequent heavy reliance on investment advice means that the views and analysis of their advisers effectively determine the decision.
45. The Government believes that to tackle this undesirable situation, all trustee boards need to consider which decisions they wish to take and which investment decisions they do not wish to take. Where they wish to take a decision, they should ensure that they do in fact have the skills and the resources to take investment decisions effectively. This does not require them to be investment experts or investment professionals, but it does require them to be familiar with the issues and to be able effectively to challenge the advice they receive.
46. If trustees are not at this standard, it can be achieved through a mixture of training existing trustees and recruiting new ones with appropriate skills. Alternatively, trustees are fully entitled to decide that for some or even all investment decisions, it is not practical or desirable for them to take the necessary steps to reach this level. In that case, they must clearly delegate responsibility for this decision to someone who does have the skills and resources to take it effectively.

47. A number of conclusions follow from this.

48. First, that under no circumstances do these proposals create any requirement for trustees to become “professional” in the sense that they earn their living from being trustees of various pension schemes. The Government has made clear that it believes that the system of Member-Nominated Trustees (MNTs) is a valuable and important one, which should continue, unchanged. In that sense it is fully in favour of the continuing “amateur” status of trustees.

49. Second, there is no absolute requirement for trustees even to become sufficiently familiar with a given issue. But if they do not, there will be a requirement for them not to continue to take the decision concerned themselves, even with advice. They must delegate it.

50. The issue of payment is a secondary one arising out of this proposal. To the extent that trustees are retaining responsibility for investment issues, they are fulfilling a complex, important and responsible role. At the very least serious consideration should be given to paying them for fulfilling such a role and to providing them with sufficient time to carry out their responsibilities.

Small schemes

51. Many respondents raised practical concerns about the ability of smaller schemes to comply with the principles. In particular, the concern was that the fixed costs involved in some of the proposals – for example, separate tenders for investment consulting and actuarial contracts – meant that they were more expensive for small schemes to implement than for large schemes. The Government recognises these concerns. Particular issues are raised by insured schemes, which face very different issues from self-administered schemes. For such schemes, the trustees have effectively delegated responsibility for all investment decisions except for the choice of provider. The applicability of the principles to such schemes is therefore very limited.

52. At the same time, the Government believes that it is important that smaller schemes should seek where practical to comply with the principles. Not all the principles are necessarily more difficult for small schemes to implement.

53. The Government therefore proposes that:

- the principles should not apply to insured schemes. The issue of investment decision-making by such schemes will be covered by the Sandler review of retail savings;
- other small schemes are covered by the principles, but the Government recognises that their size may make certain elements of the principles difficult to implement. In these cases the appropriate course of action is for the scheme to explain why it has not implemented the element in question.

Changes made to principles for defined benefit schemes

54. Following consultation, the Government has made a number of changes to the text of the principles. An amended text is found at Section D.

Changes made to principles for defined benefit schemes

Trustee training: Principle 1

55. A number of respondents suggested that reference be made to training in the principles. The following has been inserted:

“Where trustees elect to take investment decisions, they must have sufficient expertise **and appropriate training** to be able to evaluate critically any advice they take.”

Fund manager mandates: Principle 5

56. The wording of the provision on timescales appears to have caused some confusion. The intention is that where trustees have set a timescale over which managers' performance is measured, they will not terminate the manager's mandate before that date simply because they underperform. Clearly where there have been other relevant developments – major change in the fund manager's organisation, change in the nature of the pension fund's liabilities – they may need to terminate the agreement early. Rather than seeking to list all of these possible eventualities, which is clearly not practical, the text has been amended to read:

“clear timescales of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale **for underperformance alone** .”

57. Following consultation, the principle relating to investment restrictions has also been amended in order to include trust deeds. Thus “The mandate and **trust deed and rules** should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.”

58. On 27 July, the Government set out its views on the issue of transaction costs. A copy of the statement is attached. This statement included the following amendment to this principle:

“Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy - whether through direct financial incentives or otherwise - for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.”

Activism: Principle 6

59. As noted above, a number of respondents repeated arguments which had already been addressed by the review. The Government has set out a short clarification of the issues below.

60. A number of respondents also made the valid observation that effective activism policies depends on trustees setting the right framework for managers, and that if trustees were opposed to activism, then managers could not unilaterally engage in it. The Government agrees, and therefore intends that the legal duty which it will create to intervene where this is in shareholders' and beneficiaries' interests will apply to trustees and managers. The text of the principle has also been amended to read:

“The mandate and trust deed should incorporate....Trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which ...”

Transparency and reporting: Principles 9 and 10

61. Respondents were concerned that sending a full Statement of Investment Principles to all members of the scheme would be costly and risked reducing transparency rather than increasing it because the full SIP would contain too much information.

62. While the Government believes that the full SIP should be available to members, it is also important that schemes should be able to communicate with members in an appropriate way and the Government does not wish to make this process more difficult. The text has therefore been amended to:

“Trustees should publish their SIP and the results of their monitoring of advisers and managers. They should send key information from these annually to members of these funds, including an explanation of why the fund has chosen to depart from any of these principles.”

Changes made to principles for defined contribution schemes

Parallel changes to those above have been made. The following additional changes have also been made.

Principle 1

63. It was suggested that the principles should reflect the need to provide members with information to enable them to choose investment options. The following has been added to Principle 1:

“Where scheme members are given a choice regarding investment issues, sufficient information should be given to them to allow an appropriate choice to be made.”

Principle 2

64. It was suggested that members' preferences are difficult to define and understand. The principle has been redrafted to refer to members' **circumstances**.

Changes not made to principles

65. Respondents also made a number of suggestions which were not accepted by the Government. The most frequently made are considered below.

66. There was widespread concern about the idea of paying trustees. Some respondents also raised related concerns about the importance of retaining the "amateur" status of trustees and concerns about higher standards of care for trustees. The most frequently raised grounds for objection were that:

- a paying trustees would or could expose them to a higher standard of liability;
- b paying trustees would attract unsuitable candidates, who were motivated by financial considerations rather than by altruistic aims of helping beneficiaries;
- c requiring a higher level of understanding from trustees would deter candidates;
- d professional trustees did not understand the scheme, its sponsor or its members and would represent a retrograde step away from the move towards greater member involvement;
- e the costs involved were excessive.

67. The broader issues of the Government's approach to investment decision-making by trustees have been addressed above. In terms of the specific arguments above:

- a Pension fund beneficiaries are entitled to expect that their trustees will act with a high standard of competence and professionalism. The Government is concerned at the suggestion that funds refrain from paying trustees in order to lower the standard of care required.
- b The argument that paying trustees will attract unsuitable candidates is not one that is normally deployed with regard to responsible and important positions.
- c Clearly raising the standards required will deter some candidates, but the Government believes that the higher standard is the right one.
- d As explained above, there is no intention that only trustees who are "professional" in this sense should be employed.
- e The principles are voluntary in nature. Funds are not compelled to pay their trustees. However, the Government finds it hard to imagine many circumstances where the costs of paying trustees are likely to be significant when compared to, for example, the fund management fee.

Investment subcommittees

68. A number of respondents argued that establishing investment subcommittees would undermine the sense of collective responsibility that exists between trustees and separate the people with investment expertise from the main board but not absolve the main board of legal responsibility for making investment decisions.

69. The Government believes that this concern is overstated. Companies routinely use precisely such a system, despite facing the same issue of the main board retaining

legal responsibility. Indeed, a number of pension funds already have investment subcommittees.

Investment objectives

70. Some respondents appeared to have misinterpreted the principle relating to the setting of investment objectives - specifically, that objectives set for fund managers should be coherent with the overall investment objective of the fund. The concern was that this might mean that fund managers should have the same objective as the overall fund.

71. This is not the case. The principle merely states that the fund manager's objectives should be coherent with the fund's investment objective, not identical with it. The intention behind the principle is for trustees to address properly the question of how their fund managers' investment objective align with the fund's own investment objective. At present this is often not the case.

Actuarial and investment consulting contracts

72. Some respondents were concerned that the principles might require awarding the contracts for actuarial and investment consulting services respectively to two different companies. The principles do not insist on this – they state that the contracts should be competed separately. There may well be practical advantages in actuarial and technical advice coming from a single firm, as some respondents argued. However, funds should consider these advantages in the context of two separate decisions: which firm to hire to provide actuarial advice and which to provide investment consulting advice. Funds should not automatically use their actuarial advisers to provide investment consulting advice. Where funds feel the costs of two separate tenders are so great as to make a single tender the only cost-effective option, it is, as ever, open to them to diverge from the principles and explain to their membership why.

Restrictions on use of certain financial instruments

73. The principles state that fund manager mandates “should not exclude the use of any set of financial instruments without clear justification in the light of the specific circumstances of the fund”. The Myners review also recommended more broadly that trust deeds should also not prohibit the use of particular instruments.

74. Some respondents objected on two grounds:

- a the principle as drafted ruled out specialist mandates for managers, which clearly must exclude investment in all but the relevant asset class;
- b prohibitions in the trust deed are the only means whereby the sponsor can control the risk exposure of the fund.

75. The Government disagrees. The first objection is an instance of respondents interpreting the principles as a set of regulations whose precise wording is subjected

to quasi-legal analysis. The purpose of the principle is not to rule out specialist mandates, but rather to prevent simplistic blanket prohibitions based on ill-informed beliefs that certain instruments (such as derivatives) are inherently risky. The second objection implies a low level of confidence on the part of the sponsor in the ability of the trustees to manage the fund sensibly and prudently. Either such concerns are misplaced, or if they are not, there are much more serious issues of governance and trustee competence raised by the fund in question which the sponsor needs to tackle with a range of measures. Bans on derivatives in particular would be of little use in such circumstances.

Principle 7: Appropriate Benchmarks

76. Some respondents argued that the principles should permit a range of active strategies, including those with narrow tracking error limits ie aiming at a modest outperformance of the index. The present wording effectively requires funds to permit relatively high tracking error limits. Respondents argued that the principles were compelling funds who wished to adopt active strategies to adopt only “risky” ones.
77. As the Myners review has already argued, the belief that tight tracking error limits are less risky for the fund than wider ones is mistaken. Respondents are continuing to confuse the manager’s risk – namely, the risk of underperforming the benchmark – with the pension fund’s risk – namely, the risk of not meeting its liabilities. Tracking error limits the former, not the latter. It is true that trustees will probably wish to prevent very high levels of tracking error, such as might be created by a portfolio with a very small number of stocks. Such a portfolio is likely to have an investment performance significantly different from the wider asset class from which it is drawn, and as such would be effectively frustrating the trustees’ asset allocation strategy. But that is an extreme case. Reducing tracking error limits from, say, 5% to 3% is highly unlikely to have any impact on absolute volatility ie on the risk of not meeting the liabilities. The reason is that, as the Myners review observed, indices are subjective and approximate representations of an asset class, which cannot be used in such a precise way. The main impact of tight tracking error limits is simply to force managers to make sub-optimal investment decisions driven by the need to respond to arbitrary changes at the margin in the composition of the index – buying funds which are entering the index even though they believe them to be overpriced, for example. This leads to real opportunity costs for the fund.

Transparency

78. Some respondents argued that the inclusion of too much detailed information on projected investment returns for each asset class might prove detrimental to member’s confidence in the management of a scheme. They felt that since the returns will invariably differ from projections, providing information on projected returns and actual returns mislead members that the long-term investment strategy is either ineffective or overly pessimistic.

79. Others raised concerns about the market impact of revealing planned asset allocation. The Government believes these concerns to be overstated. It is hard to see how the sums involved, even for the largest funds, could be sufficient to have market impact given the level of generality of the information.

D: REVISED TEXT OF PRINCIPLES

Defined Benefit Pension Schemes

1. Effective decision-making

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide the appropriate focus.

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward-looking business plan.

2. Clear objectives

Trustees should set out an overall investment objective for the fund that:

- represents their best judgement of what is necessary to meet the fund's liabilities given their understanding of the contributions likely to be received from employer(s) and employees; and
- takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.

Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.

3. Focus on asset allocation

Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity. Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.

4. Expert advice

Contracts for actuarial services and investment advice should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.

5. Explicit mandates

Trustees should agree with both internal and external investment managers an explicit written mandate covering agreement between trustees and managers on:

- An objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances;
- The manager's approach in attempting to achieve the objective; and
- Clear timescale(s) of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.

The mandate and trust deed and rules should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy - whether through direct financial incentives or otherwise - for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.

6. Activism

The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

7. Appropriate benchmarks

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;

- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and
- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving the managers the freedom to pursue genuinely active strategies.

8. *Performance measurement*

Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

9. *Transparency*

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- the fund's investment objective;
- the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at;
- the mandates given to all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

10. *Regular reporting*

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers. They should send key information from these annually to members of these funds, including an explanation of why the fund has chosen to depart from any of these principles.

Defined Contribution Pension Schemes

1. Effective decision-making

Decisions should only be taken by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.

Where scheme members are given a choice regarding investment issues, sufficient information should be given to them to allow an appropriate choice to be made.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide appropriate focus.

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward-looking business plan.

2. Clear objectives

In selecting funds to offer as options to scheme members, trustees should:

- consider the investment objectives, expected returns, risks and other relevant characteristics of each fund, so that they can publish their assessments of these characteristics for each selected fund; and
- satisfy themselves that they have taken their members' circumstances into account, and that they are offering a wide enough range of options to satisfy the reasonable return and risk combinations appropriate for most members.

3. Focus on asset allocation

Strategic asset allocation (for example for default and lifestyle options) should receive a level of attention (and, where relevant, advisory or management fees) that fully reflects the contribution they can make to achieving investment objectives. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.

4. Choice of default fund

Where a fund is offering a default option to members through a customised combination of funds, trustees should make sure that an investment objective is set for the option, including expected returns and risks.

5. Expert advice

Contracts for investment advice should be open to competition, and fee rather than commission based. The scheme should be prepared to pay sufficient fees to attract a broad range of kinds of potential providers.

6. Explicit mandates

Trustees should communicate to members, for each fund offered by the scheme:

- the investment objective for the fund, its benchmark(s) and risk parameters; and
- the manager's approach in attempting to achieve the objective.

These should also be discussed with the fund manager concerned, as should a clear timescale(s) of measurement and evaluation, with the understanding that the fund mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy - whether through direct financial incentives or otherwise - for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.

7. Activism

The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Managers should have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

8. Appropriate benchmarks

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular,

whether the construction of the index creates incentives to follow sub-optimal investment strategies;

- if setting limits on divergence from an index; ensure that they reflect the approximations involved in index construction and selection;
- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and
- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving managers the freedom to pursue genuinely active strategies.

9. Performance measurement

Trustees should arrange for measurement of the performance of the funds and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

10. Transparency

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- each fund option's investment characteristics;
- the default option's investment characteristics, and why it has been selected;
- the agreements with all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

11. Regular reporting

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers. They should send key information from these annually to members of these funds, including an explanation of why the fund has chosen to depart from any of these principles.

Annex A: Government statement on transaction costs, published 27 July 2001

Paul Myners made proposals on this in his report *Institutional Investment in the UK: a review*. The Government proposes to take this issue forward as follows.

Despite a great deal of controversy over Mr Myners' proposals on commissions, few responses to the Government's recent consultation disagreed with his central proposition, that these costs "which are substantial" are "subject to insufficient scrutiny" and that "clearer and more rigorous disciplines could be applied". On the contrary, the clear message from the consultation responses is that the problem is, if anything, greater than Mr Myners originally suggested.

As respondents pointed out, commission payments are only one part of the costs of share transactions. In the view of many respondents, more effective disciplines on one form of transaction costs (commissions) could simply be offset elsewhere (for instance, through a general widening of dealing spreads). The widespread implicit assumption – that neither sufficient competitive pressure in broking and market-making, nor the present obligation of Best Execution, would protect clients from such effects – is, in the Government's view, a matter of serious concern in itself. It does create a real danger that the mechanism originally suggested by Mr Myners might not be fully sufficient to tackle the problems he identifies.

Nor, however, does the Government agree with those responses which suggest that greater information flows to pension fund trustees about transaction costs are likely to be, on their own, a sufficient solution to the problem. Decisions about how and with whom to trade are both technically complex and highly specific to the transaction in question. Trustees are rightly distant from this sort of day-to-day decision-making. It is clear from responses by those trustees that have sought to address the issue that their ability to bring about effective pressure for change can be only limited.

Certain other aspects of the responses also suggest that the problems run deeper than lack of information alone. These include:

- frequent references to cross-subsidies in the present system;
- fear that clients will, should they seek to put pressure on costs, suffer in other ways (for instance, lose out in access to Initial Public Offerings); and
- the evident difficulty for many institutional clients in obtaining access to "unbundled" services (for instance, separating out transaction services from research).

It is clear from the responses, therefore, that beneath the problems rightly diagnosed by Mr Myners lie competition issues of some complexity.

Like Mr Myners, the Government has a strong preference that such issues should be tackled, where possible, through market mechanisms and commercial negotiation between the parties concerned. However, this is a significant challenge, especially for pension fund trustees. The need is for structures which:

- result in optimal trade-offs between quality of execution and cost, underpinned by vigorous competition in broking and market-making and proper customer pressures;
- do not distort decision-making through perverse incentives (for instance, to trade in one way rather than another, or to pay for research by one kind of provider rather than another); and
- do not create conflicts of interest (for instance, for fund managers to deal with particular brokers because of so-called "soft" commission arrangements).

Mr Myners has suggested one mechanism which would help, and which would represent a significant step forward from the status quo. There may, and probably will, also be others. The Government does not wish to prescribe one particular mechanism at this stage. The challenge for the pensions and investment industries is to identify satisfactory ways of achieving the aims above. As a first step, the Government has agreed with Mr Myners that he should develop a set of questions to assist pension funds in requiring better disclosure and clearer incentives for their managers and brokers. These will be included in the Government's final response to the review, which it will publish (taking account of points made in the recent consultation) in September.

The Government will look for clear evidence in its two-year review that improved structures of the sort above are being developed. Options at that stage, should they not be, would include asking the competition authorities to examine the whole area.

The two-year review will be looking for evidence, in particular, that:

- trustees have a much better understanding of the costs they are incurring, and why;
- they have more effective arrangements in place, whether including direct financial incentives or not, for controlling them; and also that
- the market has developed so pension funds have a fuller range of options genuinely open to them, on competitive terms and on a level playing-field, in relation to the way they procure transaction and other services, including research.

The Government's final response to the review in September will also include an amended set of principles for defined-benefit and defined-contribution funds. In respect of transaction costs, the Government is minded to propose the following wording in place of the final sentence of principle 6:

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy - whether through direct financial incentives or otherwise - for ensuring that these costs are properly controlled without jeopardising the fund's other objectives.

The Government has also identified at this stage two further issues where progress would be helpful in achieving the desirable structures outlined above.

Soft commission

Financial regulators have rules subjecting soft commission practices of authorised financial services firms to disclosure and other requirements. In April the FSA published a discussion paper on Best Execution obligations in securities markets, including brokers' duties to clients generally, which noted soft commission as an issue. The Government has discussed and agreed with the FSA that its study of best execution will be widened to review explicitly the regulatory requirements bearing on soft commission practices of authorised firms.

However those regulatory requirements evolve, the government is concerned meanwhile to promote close consideration by pension funds themselves – as the ultimate clients – of fund manager and broker practices on soft commissions. Such practices can blunt incentives for fund managers to manage commission levels effectively. Moreover, as not all execution methods will necessarily involve the same softing arrangements or indeed any softing arrangements at all, distorting incentives can be created to deal through one channel rather than another. The Government has been struck by the number of respondents who argued for these reasons that soft commission arrangements should be banned.

The Government therefore proposes, for the purposes of the Myners principles, that:

Pension funds should not without good reason permit “soft” commissions to be paid in respect of their transactions.

Unbundling

The second issue where progress would be helpful would be the unbundling of services provided by brokers and broker-dealers. The Government has already identified the prevalence of bundling as suggesting the existence of competition issues of some complexity. In particular, it believes that greater unbundling would facilitate the emergence of the transparent and competitive structures envisaged above. It would also, through enabling clearer price comparisons between different methods of execution, improve the ability to achieve best execution. The FSA’s work on best execution is therefore also relevant to this area, and the Government has discussed and agreed with the FSA that their work will also include examining possible regulatory change relating to unbundling.

Small schemes

Respondents to the principles have expressed concerns that it would be difficult for smaller funds to implement all the principles, and these concerns were raised in the context of commissions too. This issue will be dealt with as part of the Government’s response on the principles as a whole

Annex B: two -year assessment

1. The Myners review considered, and rejected for the moment, the possibility of direct Government intervention at this point to compel the industry to change its behaviour through regulatory action. It concluded that it would be preferable for a largely voluntarist approach to be tried. However, it also recommended that the Government should after two years conduct a public assessment of the effectiveness of the principles in bringing about change.
2. This assessment will begin in March 2003. It will employ two methods of assessing whether the principles have been successful in driving change:
 - a qualitative assessment using a relatively small number of case studies of individual funds; and
 - a quantitative assessment of a larger sample of funds using a survey. In order to capture effectively the differences between different sizes of funds, separate samples will be drawn from different sizes of fund.
3. On the basis of these assessments, the review will report on the extent to which the industry has developed its approaches along the lines recommended by the Myners review. Whether or not it recommends further action by the Government and what any action could be will depend on the results of its analysis. One option would be to require disclosure against the Myners principles. Clearly a preferable outcome from the Government's point of view would be for sufficient change to have occurred for further action not to be necessary.
4. The industry has already made clear that it would be helpful if the Government would give some indication of the areas it would expect the two-year review to examine.
5. Set out below, therefore, is a possible series of measurable criteria which will form part of the assessment.

The take-up of the principles

5. Increase towards 100% in the proportion of funds (DB & DC) which have produced a statement setting out, principle by principle, their compliance with the principles.
6. Increase towards 100% of funds which have sent their members this statement.
7. Percentage of funds which report that they have complied with each principle

Effective decision-making

8. Increase towards 100% in funds which have told their members which decisions they are taking, and which they have decided to delegate.
9. Increase in in-house investment staff.

10. Increase in percentage of funds with an investment subcommittee

Clear objectives

11. Increase towards 100% of funds which have a) produced and b) reported to their members a measurable investment objective, which is not expressed in terms unrelated to the fund's liabilities.

12. Reduction towards zero in the proportion of pension funds managed to total peer group benchmark.

Focus on Asset Allocation

13. Significant increase in ratio of spending by funds on strategic asset allocation to spending on stock selection. This is likely to require a case study approach, as the calculation of such figures requires some subjective judgements to be made.

14. Increase towards 100% in percentage of funds reporting to their members that they have considered private equity as an asset class

Expert advice

15. Increase towards 100% in the proportion of funds which have competed actuarial and investment consulting contracts separately.

16. Significant reduction in Herfindahl-Hirschman Index for investment consulting market from the figure cited in the report.

17. The emergence of specialist firms providing an asset allocation service. Again, this is likely to require a more qualitative assessment.

Explicit mandates

18. Reduction towards zero in the proportion of mandates which exclude the use of any set of financial instruments without appropriate justification in the light of the specific circumstances of the fund.

19. Increase towards 100% in the proportion of mandates which set explicit timescales of measurement and evaluation for fund managers, before which the mandate will not be terminated for performance reasons alone.

Activism

20. Increase towards 100% in the proportion of mandates incorporating the principle of the US Department of Labor Interpretative Bulletin on activism

21. Increase towards 100% in the proportion of funds reporting to their members the strategy of their managers on activism, and how they measure the effectiveness of this strategy

Appropriate benchmarks

22. Significant widening of average tracking error limits (where set) for active management.

Performance measurement

23. Increase towards 100% in the proportion of trustee boards that have published to their members a formal assessment of their own performance and that of the performance and decision-making delegated to advisers and managers

Transaction Costs

24. On the issue of transaction costs, the Government has already announced that the review will be looking for evidence that:

- trustees have a much better understanding of the costs they are incurring, and why;
- they have more effective arrangements in place, whether including direct financial incentives or not, for controlling them; and also that
- the market has developed so pension funds have a fuller range of options genuinely open to them, on competitive terms and on a level playing-field, in relation to the way they procure transaction and other services, including research.