The diminishing role of fiduciary law in discretionary portfolio management under English law.

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Abstract

The thesis reviews the diminishing role of fiduciary law in discretionary portfolio management. Protection for investors against manager misconduct is provided principally by the Financial Conduct Authority (the 'FCA') as regulator of the conduct of investment management; and the Financial Ombudsman Scheme (the 'FOS') as the provider of compensation for retail investors. The Courts have only a peripheral role, primarily as the ultimate appeal against the reasonableness of a FCA regulatory enforcement decision or a FOS decision.

This is the result of a process that began with the introduction of the regulation of financial services in 1988. Regulations that modify the common law fiduciary prohibitions are incorporated into contract terms that provide for a 'reasonable' standard for manager conduct that encompasses regulatory compliance. Conflicts of interest are permitted provided the manager identifies them, decides on management measures that are fair to the investors affected or only proceeds if a proposed solution has received their fully informed consent. Regulations also reduce the scope for a claim for unauthorised profits which are permitted provided there is no risk of loss to an investor and so permits profits that could not have accrued to the portfolio.

Market and technology developments have reduced the scope of the manager's investment mandate and increased the potential for close and timely supervision of portfolio content. Discretion and thus fiduciary status nevertheless remain in all manager appointments, even if the modified conflicts regime bears little resemblance to the common law prohibitions. A breach of the regime by the manager will therefore still provide portfolio owner(s) with access to equitable remedies. These could provide some additional benefit to compensatory damages for breach of contract but only in such exceptional circumstances that this calls into question whether, in practice if not in theory, fiduciary duty plays any meaningful role.

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Preface

This thesis can be summarised as the answers to two questions and a conclusion. The first question is whether the version of the common law fiduciary duties that apply to an agent with discretion to alter the property of the principal and is incorporated into the contract between a discretionary portfolio manager and its client represents not so much a modification as an exclusion of fiduciary duties. If an exclusion it follows that the manager cannot be described as owing fiduciary duties and accordingly is not a fiduciary for the purposes of English law.

The second question is whether, assuming the manager is a fiduciary, the availability of equitable remedies in addition to the remedies available for breach of contract provides any additional benefit to an investor whose manager has breached the management contract. If not, it follows that the manager does not satisfy the conditions necessary to be a fiduciary for the purposes of English law.

The thesis consists of five chapters. The first contains a description of the business of discretionary investment management under the laws of England and Wales and includes a review of the role played by the Financial Conduct Authority (the 'FCA') and the Conduct of Business Source Book (the 'COBS'). The chapter ends with a description of the contents of a typical investment management contract and includes a brief resume of the applicable law which is not dependent on fiduciary status.

The second chapter outlines the law that governs the relationship between the manager and the portfolio owner on the basis of the manager having fiduciary status. The chapter examines the interplay between fiduciary duties at common law, the terms of the management contract and the obligation to comply with the COBS that forms part of the authorisation necessary to carry on investment business in the United Kingdom.

The third chapter illustrates how a number of practices that appear to be in breach of the fiduciary prohibitions have been permitted to become, initially, subject to regulatory scrutiny, then to regulation and thereafter to steadily more restrictive regulation that has, in some cases, seen a practice no longer permitted or permitted only in compliance with regulation that makes continuing the practice uneconomic. The chapter reflects a battle between the demands of commerce and the need to protect investors from unfair practices, with the latter role being assumed by regulators after the Courts proved ill-suited to the task.

The fourth chapter examines the remedies available to a portfolio owner dissatisfied with the performance of its manager. These include remedies for breach of contract, in particular compensatory damages, and, on the basis the manager is a fiduciary, the equitable remedies of rescission, equitable compensation, an account of profits and proprietary claims, including the imposition of a constructive trust. The operation of the FCA as enforcer of the regulations and the Financial Services Compensation Scheme (the 'FSCS') as the source for compensation for retail investors is examined. The chapter concludes that the principal source of remedies is not the Courts but the FCA in its role as enforcer and the FSCS, which operates a scheme designed to provide compensation to retail and other non-professional investors that seeks to avoid the uncertainties of the law by taking the law into account but not being bound by it when deciding complaints against managers on a fair and reasonable basis.

The fifth chapter then begins with a brief commentary on the impact of digitalisation and artificial intelligence on portfolio management before returning to the two questions and providing answers. The chapter ends with the conclusion that fiduciary law is still present, but its presence is, in practice, already only vestigial with its diminution likely to continue.

Chapter One: Discretionary investment management in England and Wales

I – Introduction

Firms carrying on business as discretionary portfolio investment managers (each a 'portfolio manager' or 'manager') in England and Wales operate subject to, and typically under a series of contracts governed by, the laws of England and Wales ('English law'). This chapter investigates the relationship between the portfolio manager and the investors who have an interest in the performance of a portfolio under its management, either as a party (a 'Client') to a contract with the manager (the Investment Management Agreement or 'IMA') for the provision of portfolio management services or through a contract or other relationship with a Client.

The chapter begins with a description of the investment management industry, both globally and in the United Kingdom ('UK'). There follows a brief history of the industry and an overview of the current legal and regulatory regime. The portfolio management process is then described, including an outline of the processes and practices that are involved in portfolio management for the benefit of third parties. The importance of the investment mandate is explained, including its role in setting the limits within which the manager is authorised to alter the content of the portfolio and thus change the financial assets owned by the Client. A description of some of the principal investment strategies and the practices involved in the duty to seek 'best execution' when implementing decisions to change portfolio content follows. The role of the FCA as regulator is then described before the chapter concludes with a review of the principal terms, including those relevant to the manager's duty of loyalty, in an IMA. The chapter does not examine fiduciary law and fiduciary duties and their impact on portfolio management in any depth, as these are the subjects of the chapters that follow.

As the chapter will explain, discretionary portfolio management is only part of investment management, which includes the provision of information and advice to investors. Other related services include administration and custodianship (the safe keeping of financial assets, the exercise of rights the assets confer on the owner and the completion of investment purchase and sale contracts). Some of these other services and roles may include fiduciary obligations but this thesis is concerned only with the discretionary portfolio manager whose status as an agent with discretion for the Client, its principal, would normally be expected to involve a fiduciary duty of loyalty. The expression 'assets under management' refers, in the context of investment managers, to assets within portfolios under the discretionary portfolio management of the manager.

II - The investment management industry

The UK based discretionary portfolio management business is part of the global asset management industry, the participants in which operate under the laws and regulations applicable in each of the 44 jurisdictions in which firms providing investment management services carry on business, with the value of assets under management ('AUM') estimated at $103 trillion at the end of 2020. By some way the largest market for asset management, by continent and AUM, is that of North America (the USA and Canada) with AUM estimated at $48.6 trillion.[1] Europe is second, with AUM estimated at $27.1 trillion. Of this the largest share, in the order of 37%, is managed in the UK. It is estimated that, while the vast majority of these AUM are managed by firms based in or within easy reach of London, almost a quarter are managed by discretionary investment businesses headquartered in Scotland, although much of this is managed under IMAs governed by English law (and the regulatory regime is the same in both jurisdictions).[2]

It follows that the UK is the largest centre for asset management in Europe with an estimated 43% of UK AUM managed for overseas clients and the AUM in the UK exceeding the aggregate AUM of the next three European centres (France, Germany and Switzerland). The consequences for the industry as a result of the UK leaving the EU remain uncertain but will have no direct bearing on the conclusions reached in this thesis.

Industry estimates suggest that there are in the order of 1,050 asset management firms operating in the UK, of which roughly 70% are, or are part of, independent

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[1] Hereditia Lubasha and others, *Global Asset Management 2021: The $100 trillion dollar machine,* The Boston Consulting Group July 2021.

[2] European (including UK) statistics in this paragraph are sourced from *Asset Management in Europe: An overview of the Asset Management Industry* (12th ed, European Fund and Asset Management Association, September 2020).

businesses and the balance a member of a group that includes either a bank or an insurance company. Many of the smaller firms have AUM under £1 billion and the 138 companies which are members of the Investment Association - the principal industry association - manage in the order of 85% of UK AUM. At the same time a large number of the larger investment management businesses in the UK are part of a global investment management business, with the AUM of the 400 largest investment management business estimated at in excess of £65.7 trillion. Of the largest 25 global investment managers, measured by AUM, 16 have their main headquarters in the US, three in the UK and France and one in each of Germany, Switzerland and Japan. Furthermore 12 of the businesses headquartered outside the UK had their largest business in Europe in the UK with only one other based in France.[3]

A note of caution as to portfolio management statistics, which should be considered as little more than a guide and indicator of trends. Not only are phrases such as ‘asset management’, ‘investment management’, ‘portfolio management’ and ‘fund management’ often used interchangeably but also there are questions as to what constitutes an investment[4] and how to measure size. Take, as an example, the common practice of investment through a fund of funds, whereby an investment fund invests only in other investment funds: if the fund has four investments each with a value of £25 million one could argue that the aggregate under management is £200 million - the sum in respect of which investment decisions are being made; or alternatively £100 million - the aggregate value of the investments to external investors. The answer will depend on the context in which the statistic is being used. Similarly, the structure of global businesses may often hide businesses that operate in association but not within a single group. Fidelity, for example, operates in the US as an independent company and internationally in close co-operation with Fidelity International, which was formed as the international arm of Fidelity in 1969 but became an independent company owned by its employees in 1980.

[3] Unless otherwise specified, UK statistics in this section sourced from Investment Association - fund statistics: <theinvestmentassociation.org>accessed 5 September 2021.

[4] See, for example, IG MacNeil, *An introduction to the Law of Financial Investment* (2nd ed, Hart Publishing 2012), ch 4.

This thesis is concerned with the management of financial assets, which broadly relate to equity or debt instruments and thus rights acquired against an issuing entity in return for the transfer of capital or agreement to repay sums advanced to that entity. In economic terms financial assets are contrasted with 'real assets', for example ownership of real property or the provision of goods and services,[5] which are acquired in exchange for capital. The rights may be acquired either in the primary or secondary market so that a portfolio may contain rights acquired in securities issued by the owners of businesses, real estate and infrastructure, as well as in the 'alternative' asset classes of hedge funds, private equity and venture capital. While other assets may well be bought and sold with a view to profiting from an increase in realisable value, this thesis is concerned with firms carrying on a business of the management of portfolios of financial assets for third parties. This, when carried on by way of a business in the UK, is 'investment business'[6] and requires the portfolio manager to be authorised under the Financial Services and Markets Act 2000 (as amended) ('FSMA'). The European Court of Justice has held that 'managing portfolios of investments' involves three elements: (i) an investor authorising a firm to take investment decisions on its behalf; (ii) the portfolios to be managed including one of a list of qualifying instruments that includes transferable securities; and (iii) management must be carried out on a discriminatory client-by-client basis.[7]

The Chartered Financial Analyst Institute (the 'CFA') is generally recognised as the principal global organisation for investment management professionals. Its guide to 'The Asset Management Industry'[8] refers to the central service provided by discretionary portfolio managers as 'professional investment portfolio management'. Investment managers, the guide continues, act typically 'on behalf of investors, using investors' capital to implement investment strategies, and generally assume the role of a fiduciary - a guiding legal standard ensuring that asset managers act solely in the interests of

[5] Z Bodie, A Kane and AJ Marcus, *Investments* (10th ed, McGraw–Hill 2014), 4.

[6] Art 37 Financial Services and Markets Act 2000 (Regulated Activities) order 2001, SI 2001/544 as amended ('RAO').

[7] Decision in Case C-356/00EC of the European Court of Justice (fifth Chamber) of 21 November 2002 that concerned the meaning of 'managing portfolios of investment' for the purposes of the Council Directive 92/22/EEC (commonly known as the Investment Services Directive or 'ISD').

[8] The CFA Institute, *The Asset Management Industry* (CFA Institute 2015) ISBN 978-1-942713-03-6. Unless otherwise specified the information concerning the CFA is derived from the website <https://www.cfainstitute.org>.

investors and avoid conflicts of interests'.[9] This principle does not fit easily with a number of conflicting and wide-ranging market practices, although several are necessary if a portfolio manager is to act for multiple clients, an essential requirement if the UK portfolio management industry is to remain internationally competitive.

The CFA plays an important role by providing and supervising the 'CFA credential', a professional qualification for investment management professionals that can only be obtained after four years of industry experience and the passing of three exams of increasing difficulty. The exams take a minimum of three years to complete and only 20% of candidates pass the third and highest level at the first attempt. Although only some 150,000 professionals are entitled to use the credential, many more study the first level when first entering the industry without prior financial markets experience, while the second is considered a potentially useful addition to a CV for those seeking to change employer while staying within the industry. The syllabuses for this and other CFA professional certifications, available in 'Investment Performance Measurement', 'Institute Investment Foundations' and 'ESG',[10] are generally available to CFA members and updated on a regular basis. They accordingly represent a generally accepted compendium of the processes, practices and theories currently practiced by and within the industry. The publications are updated on a continuous basis and contain a description of the range of the services that an investor can reasonably expect to be provided by a discretionary portfolio manager subject always to the terms of the specific IMA.

The purpose of this chapter is to describe the business of discretionary investment management, outlining the activities that it involves and the legal and regulatory framework in which the business is carried on in England and Wales. The practices involved in the portfolio management process, whether carried out by a proprietary investor or an investment manager, are very similar, indeed all but identical if the services of a financial services provider are engaged. In contrast the legal regimes differ. The proprietary investor is dealing only with its own financial assets with any indirect

[9] Ibid p 6.

[10] Environmental, Social and Governance.

investor having only contractual rights against the manager, for example an insurance or assurance company. In contrast the portfolio manager is an agent of the Client granted the discretion set out in the investment mandate.

This contrast is notwithstanding that the investors have all but identical economic interests (whether direct or indirect) in the investment performance of a portfolio, whether managed by a proprietary investor or an investment manager. The solution is to a material extent provided by regulation that seeks to provide similar protection for the investor despite the differences in the underlying legal position. Indeed the marketing of all investments in the form of financial assets is already covered by the same regulations and enforced by the same regulator, the FCA, with only the capital requirements differing for insurers and other companies whose solvency might endanger the stability of the financial system regulated by the Prudential Regulatory Authority (the 'PRA').

Discretionary portfolio management also provides the means whereby multiple investors can have an indirect interest in a portfolio being managed by a portfolio manager in accordance with a disclosed investment mandate. This allows the investors to benefit from diversification and economies of scale. In these cases, the portfolio manager is appointed either as the agent of all the investors acting jointly as the Client or as an agent of a third party, an investment structure with separate legal personality, e.g. a company or limited liability partnership. In the latter case the investors have only indirect rights in the portfolio under the constitution of the investment structure, e.g. as shareholder or partner, through a contract with the structure, e.g. a debt security, or as a beneficiary of a trust of which the trustee, typically a company providing trustee and administrative services, is the Client. In the first case the manager has rights over the portfolio with an obligation to act in accordance with the investment mandate and exercise its discretion powers on behalf of all the investors jointly. Fiduciary duties as agent with discretion would therefore be owed to the investors jointly but not individually. In the second case the agency appointment is by the investment structure, with duties owed to the structure and no direct contractual relationship between the manager and the investor.

There is an important distinction between a private person, that is a non-professional or private investor,[11] who is often referred to as a 'retail investor', and other investors, typically referred to as 'a professional investor'. A retail investor is an individual investor who is not acting in the course of carrying on a business and thus falls within the protection afforded to consumers under the Consumer Rights Act 2015 (the 'CRA').[12] The protection for the retail investor includes specific provisions restricting or even prohibiting the retail investor's access to more complex and risky financial assets and requiring a manager that seeks to contract with a retail investor to take steps to ensure the services being provided are suitable for that investor. To be eligible for direct investment by retail investors a CIS must also comply with detailed regulation, including the preparation of a 'prospectus', a document that must comply with detailed regulations as to content designed to ensure that all information necessary for an investor to make an informed judgment whether to invest, is publicly available. The retail investor also has a statutory right to compensation if he suffers loss because of a breach of the regulations.[13]

In contrast the law of contract and thus the terms of the IMA govern the relationship between manager and a professional investor, an expression defined in the Handbook but broadly means entities engaged in financial services business and other entities satisfying certain conditions, e.g. as to minimum net assets, or individuals with appropriate expertise [14] (with a retail investor any investor who is not a professional investor) . The effect of the regulations is to inform what might reasonably be expected of the manager by the Client and thus assist, but not determine, what is required to satisfy the duty of care owed by a provider of services, as well as other duties framed in terms of acting reasonably in specific areas of practice. Funds restricted to professional investors are, in turn, only relatively lightly regulated, principally, but not only, to ensure no

[11] LD Van Setten and T Plews 'Chapter 12 – England and Wales' in D Busch and A DeMott (eds), *Liability of Asset Managers* (OUP 2012).

[12] Consumer Rights Act 2015, s 2. The protection extends beyond a retail investor to include some persons transacting for a combination of personal and business reasons.

[13] Financial Services and Markets Act 2000, s.138D; for a review of the protection for the retail investor protection see, e.g. Niamh Moloney, *How to Protect Investors from the EC and UK* (CUP 2010), chs 1&2.

[14] FCA Handbook: COBS ch 3.

marketing to retail investors under the Alternative Investment Funds Directive ('AIFMD') of the EU as incorporated into UK regulation by the FCA.

These regulatory constraints have only indirect consequences for a manager as the processes necessary to achieve compliance in the main precede the investor becoming party to an IMA or acquiring an interest in a portfolio under management. In the former case the protection will be reflected in the IMA and in the latter the regulations will establish whether the investor is permitted to acquire a holding, with the IMA unchanged. As a result, the consequences will have no direct relevance to the duty of the portfolio manager to manage the portfolio in accordance with the investment mandate.

III - Discretionary investment management: basis and history

At its simplest discretionary investment management describes the process whereby a firm controls the content of a portfolio of financial assets owned by one or more third parties. In this context portfolio means a collection of financial assets for which the portfolio owners have identified and agreed, often with the benefit of professional advice, a single investment objective. The attainment of the objective has then been delegated to a discretionary portfolio manager under an IMA, the terms of which grant the manager the power to control the content of the portfolio as agent of the portfolio owner within a discretion described in the 'investment mandate' that forms part of the IMA.[15]

The term 'investment' shares a number of definitions: for example the economic approach distinguishes 'financial' from 'real' assets; the legal approach defines the term by reference to the sources of proprietary rights, interests and powers that may be acquired in exchange for capital; and a third more pragmatic approach refers to the process whereby capital is allocated and reallocated for use by third parties for the

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[15] The description of the industry in this section is drawn from, in addition to the sources quoted, the author's personal experience over 35 years of practice as a solicitor in the City of London and is also the subject of a wide range of literature with the emphasis on industry practice rather than law, e.g. Timothy Spangler (ed), *Investment Management Law and Practice* (OUP 2010); Paul Dickson (ed), *Asset Management Review* (Law Business Research 2017); Danny Busch and Deborah A DeMott (eds), *Liability of Asset Managers* (OUP 2012), ch 11.

purposes of a specified business or undertaking in return for a return, whether in terms of a share of profits - dividends - or payment of interest and repayment of principal.[16] To this primary market is then added the secondary market, in which the investments - financial assets - are realised for a capital sum that the recipient may use to acquire other financial assets or for other purposes. Financial practitioners tend then to split financial assets into five primary classes: public equity, fixed income, money markets, foreign exchange markets and alternative investments. The financial markets - markets, exchanges and other trading platforms on which financial assets are bought and sold - are then conventionally classified as primary and secondary markets; debt and equity markets; exchange and over the counter ('OTC') markets; and money and capital markets.[17]

There is a traditional distinction between investment and banking with the latter commonly then split between commercial banking and investment, or merchant, banking. Commercial banking involves borrowing money in the form of short-term deposits on which no or low rates of interest are paid and using the proceeds, to the extent not retained to meet demands for repayment, to make loans to third parties, in the main for the longer term and carrying higher rates of interest. The investment or merchant bank concentrates on the provision of finance and related financial products for businesses, including raising capital and debt from third parties to invest in businesses, project or trade finance and complex financial products. These banks are the prime example of 'sell-side' firms that promote and sell investments. Although merchant banks and investment banks, in their purest form, are different kinds of financial institutions, developments in modern practice have seen a blurring of the fine lines that separate their historically separate functions. Both are now involved in the raising of capital for business and government, as well as in mergers and acquisitions.

In contrast, a discretionary investment manager controls the assets of its clients and does not seek investors for any specific business or project, but instead seeks investors willing to entrust portfolios of financial assets to its discretionary management.

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[16] MacNeil (n 4) 3-24.

[17] John L Maginn and others, *Managing Investment Portfolios,* (3rd ed, Wiley 2007),Ch 5 section 4 (and CFA level 2 syllabus).

The manager will receive suggestions from investment bankers and other sell-side financial intermediaries as to how the manager might deploy the assets under its management, its 'managed portfolios', or exercise the rights attached to securities therein. The manager may also receive invitations to participate in capital raisings or to support potential corporate actions. These propositions will be taken into account as part of the review and monitoring of the managed portfolios - and the manager may, or may not, decide to take up a proposal on behalf of one or more of the portfolio owners. Asset managers are thus 'buy-side' institutions that work on behalf of themselves or their clients and seek to identify securities and investments to acquire and in due course to sell, preferably but not always at a profit.

Neither investment nor merchant bank will generally deal with the public, though an associate may well provide private banking or wealth management services, including portfolio management, to High-Net-Worth Individuals, known as 'HNWIs'. This term is currently used to refer to individuals with assets available for investment in excess of $1 million as this is generally considered the minimum level at which portfolio management services can be provided for a fee acceptable to the investor while permitting the discretionary portfolio manager to glean a profit from the relationship. The service provider will, however, decide whether to accept a client and, as a generally rule, the greater the wealth of the client the wider the range of services that will be made available. For example, a number of boutique wealth managers only provide services to investors with assets available for investment in excess of $30 million – Ultra High Net Worth Individuals ('UHNWIs') – and provide services going well beyond portfolio management to include the acquisition and sale of businesses, complex financial and succession planning and often luxury pursuits.

Investors below the $1 million threshold will normally rely primarily on independent financial advisers ('IFAs'). These advisers make recommendations to the investor as to suitable investments with the significant majority of these recommendations being to acquire holdings in CIS and thereby obtain diversification of risk through the indirect holdings in each asset in the CIS portfolio that this provides. As the IFA does not make any investment decision, the IFA is not carrying on portfolio management. If instructed to acquire or sell an investment the IFA will carry out the instructions as the agent of the client, but, in contrast to a discretionary investment manager, as an agent without discretion and thus not owing fiduciary duties in its agency capacity. Fiduciary duties may, however, arise under the investment advisory relationship (which is outside the scope of this thesis).

The range of financial assets that are permitted in any specific portfolio under the management of a discretionary investment manager will be set out in the relevant IMA. In addition to investments in the categories outlined above these will typically include holdings in CIS and contracts with banks and other providers of finance. These contracts are commonly referred to as 'financial products' and vary considerably in complexity. A financial product typically provides a return that depends on specified outcomes described in the contract that are often, but by no means always, related to the results of other investments or groups of investments (including the performance of an index such at the FTSE 100) or events, for example a 'weather derivative' might pay the investor a return based on the average weather in the Chicago metropolitan area over a series of calendar months.

As the return on these contracts is based on other investments or external events they are commonly referred to as 'derivatives'. Under some the investor risks no more than the sum invested; under others the potential 'return' may be negative and even involve the investor being obliged to pay the counterparty many multiples of the sum originally invested, as well as oblige the investor to provide security sufficient to cover any potential liability on a daily basis. Access to contracts under which the potential for loss exceeds the sum invested are typically restricted or prohibited, by law, for retail investors.

Investment management owes its origins in the UK to the growth of insurance, in particular life insurance and life assurance, after Royal Exchange Assurance and London Assurance each received a parliamentary charter in 1720.[18] This was the year the South Sea Bubble burst. The South Sea Company was granted a monopoly over trade with South America and the surrounding islands, then known as the South Seas (hence the name), as

[18] Insurance refers to policies on which the insurer may make a profit or loss; assurance to policies that provide a sum based on the performance of investments linked to the policy and on which the insurer runs no risk of loss.

part of a scheme for privatising and amortising the national debt. Its collapse caused the first stock market crisis in London when, following a period of spectacular increase in the share price based almost entirely on speculation, the 'bubble burst' with an even more spectacular share price collapse, by some 87% in a matter of weeks, leaving many investors who had borrowed to invest in the later stages facing bankruptcy.[19].

This not only indicated the risks involved in speculation but also involved many of the then limited investment owning elite. These included a number of the procedural judges of the High Court - known as 'Masters'. A number of Masters had borrowed sums paid into Court by litigants, over which the Masters had control. The sums were then invested in the South Sea Company and when the share price collapsed the Masters were unable to repay the loans. The consequences included the introduction of severe restraints on the powers of investment of trustees, many of which restraints remained in force, in one guise or another, until the beginning of the twentieth–first century. The restraints could, however, be evaded by the inclusion of express wording to the contrary in the trust instrument (which had become standard practice long before the Trustee Act 2000 removed the need for this).

By 1850 the two initial life companies had grown to over 200, though investment management was still very much seen as secondary to the underwriting process. Private trusts and their trustees have only ever represented a small part of the UK investment markets, which were dominated by insurance and assurance companies until well into the last century. Occupational pension funds only started to emerge as important investors after employers first received significant tax incentives to set up their own pension funds in 1921 and arguably only became a significant investor class only in the 1950s, with their significance continuing to increase as demographic changes have led to an increasing reliance on pensions provided by the private rather than public sector.[20].It was thus late in the process that has been described as the 'democratization of investment'[21] that investment management services became generally available to

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[19] Ron Harris, 'The Bubble Act: Its Passage and Its Effects on Business Organization', (1994) 54(3) The Journal of Economic History 610.

[20] Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No. 350, 2014) paras 1.24 - 1.27 et seq.

investors separate from insurance. Insurers adopted a cautious and conservative approach, with preservation of capital a key principle,[22] but their actions did establish that long-term investment could be successful and thereby paved the way, however inadvertently, for investment management to become first a primary rather than secondary activity[23] and second, in due course, an independent activity.

This independence was arguably first evidenced by the launch of the Foreign and Colonial investment trust in 1868.[24] This initiated the development of the investment company sector, which was followed and in due course dwarfed by the unit trust sector, with the first unit trust launched in the UK in 1931.[25] This new investment vehicle, mirroring the USA mutual fund, gave the investor immediate access to funds based on the value of the holding rather than relying on demand and supply to fix the realisable price in the secondary market. Both vehicles initially involved little active investment but this was soon remedied, with active portfolio management a feature of The Scottish American Investment Trust, launched in 1873 and introduced to unit trust portfolios in December 1935 with the launch of the Limited Investment Trust by Municipal and General Securities Ltd ('M&G').

The prime movers in the process were (i) the emergence of the modern corporate form, (ii) the ongoing commercial and industrial revolution and (iii) the development of mechanisms for those outside the landed gentry, in particular the newly moneyed, often as a result of (ii), to acquire a personal stake in independent investment projects. The first

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[21] Norton Reamer and Jesse Downing, *Investment - A History* (Columbia Business School Publishing 2016), chs 2 and 3.

[22] AH Bailey, 'Principles on Which the Funds of Life Assurance Societies Should be Invested' (1862) 10(3) The Assurance Magazine, and Journal of the Institute of Actuaries 142.

[23] Strictly speaking The Pelican Life Office, established in 1797, can claim to be the first institution to be organised as an asset management business intending to profit from its investments – and make up for its poor underwriting record. Clive Trebilcock, *Phoenix Assurance and the Development of British Insurance: Vol 1* (CUP 1985), p 524.

[24] John Newlands, *Put Not Your Trust in Money* (Association of Investment Trust Companies 1997). The trust was originally called the Foreign & Colonial Government Trust, reflecting its initial portfolio consisted of debt securities issued by a variety of UK and overseas governments and public bodies.

[25] The 'First British Fixed Trust', the first UK unit trust was launched by Municipal & General Securities Company Limited launched in 1931.

provided investors with limited liability (and thus risk limitation); flexibility in terms of type of investment; and durability of investment with reduced dependency on individual longevity. The second provided investors the opportunity to share in the economic surplus generated other than from the agricultural and other primary sector activities,[26] essentially the profits from new industries, initially for their proprietors and managers and in due course for shareholders with no direct involvement. The third was achieved through the emergence of public securities markets that offered partial ownership, publication of generally accepted valuations, liquidity and lowered transaction costs. These in turn lead to the diversification of risk through investment in investment companies and other CIS that circumvented the cost barriers involved in acquiring multiple small personal stakes.[27]

In the UK the various parties involved in investment management or related businesses, including life and general insurance companies, brokers, commercial and investment banks, operated for practical purposes independently with no or only very limited active cross-ownership or common control; for example banks and stockbrokers often competed for the custom of High Net Worth Individuals, while stockbrokers also acted both as brokers and investment advisers without necessarily clarifying their role. This was the result of a series of restrictive practices, including restrictions on cross-ownership, prohibition of companies and non-UK citizens from stock exchange membership and the 'single capacity' rule which required separation between brokers, acting as agents for their clients, and 'jobbers' who acted as market markets. These had developed over time in a largely unregulated marketplace and the consequences included that, in contract to the rest of the City, the stock exchange had become something of a backwater.[28] In 1979 the Office for Fair Trading decided to launch an investigation and the restrictions were considered, in a preliminary ruling, anti-competitive and thus unenforceable as contrary to the public interest. A compromise was reached under which

[26] In economics the primary sector consists principally of activities based on the exploitation of natural resources, such as timber and mining.

[27] The investment objective of the Foreign & Colonial Government Trust as stated in the 1868 prospectus: 'To provide the investor of moderate means the same advantage as the large capitalist in diminishing risk…by spreading the investment over a number of stocks'.

[28] Nigel Lawson, forward to 'Big Bang 20 years on' (Centre for Policy Studies 2006).

the Stock Exchange agreed to reform the restrictions were severely diluted or repealed – the process that came to be known as the 'Big Bang'.[29]

As a result, financial conglomerates that offered multiple financial services through different associates were able to enter the UK marketplace, so muddying the waters that had separated the different lines of business. This raised the prospect of multiple and enhanced conflicts of interests. Examples that have since led to regulatory enforcement proceedings in the USA or UK include brokers being influenced to publish unjustifiably favourable reports on initial public offerings on which an associate investment bank was instructed; investment managers being subject to pressure to support corporate actions that would allow the rescue of a company which was a substantial and potential bad debtor of an associate bank if the rescue did not proceed; and special 'advisory fees' being offered to potential investors in a rights issue by a bank by an associate that appeared to be paying well over the market price for the advice.[30] A general review of the laws governing financial services followed.

By 1986 it was already fair comment that there was a remarkable unanimity about the need for comprehensive regulatory controls governing financial institutions and markets[31] and thus that the then all but unregulated City of London was very much the global exception. In contrast the continuing role of London as a global financial sector was heavily based on its leading role in the unregulated Eurodollar and Eurobond markets.[32] These provided a home for dollars received in exchange for goods and services by providers outside the USA, including the oil producing nations that had benefitted from

[29] Although strictly 'Big Bang' referred only to the changes to the Stock Exchange Rules that permitted corporate and overseas membership and removed the rule that only 'jobbers' could deal with 'brokers' over time the phrase became a euphemism for the influx of foreign companies, as providers and clients, to the London and UK financial services markets. Kynaston, *The City of London Vol IV: A Club No More* (Chatto & Windus 2001).

[30] S Neupane, 'Conflicts of interests in IPOs: the case of investment banks - a systematic review' (Cranfield University 2008); DR Dalton, S Certo and CM Daily, 'Initial Public Offerings as a Web of Conflicts of Interest: an Empirical Assessment' (2003)13(3) Business Ethics Quarterly 289-314.

[31] DT Llewellyn, *The Regulation and Supervision of Financial Institutions* (Institute of Bankers, London 1986).

[32] David Kynaston, *The City of London Volume II: Golden Years* (Chatto & Windus 1995) 324.

the surge in oil prices after the 1973 Arab Israeli war, that wished to keep their receipts outside the USA.

The reasons included not only regulation restricting interest on US dollar deposits within the USA but also the perceived risk of freeze and/or seizure by the USA authorities for political reasons. The validity of US restrictions on dollars held by Iranian state entities with London banks following the seizure of hostages when the US embassy in Tehran was stormed during the Iran 1979 revolution was the subject of litigation involving billions of dollars held by Iranian state entities with banks in London, with a trial set for November 1980 and then postponed to April 1981. The trial never commenced as the release of the hostages by the Iranian authorities supervened, with the plane carrying the hostages leaving Iranian airspace contemporaneously with a plane carrying gold bullion with a value equivalent to the dollars held in London entering that airspace.[33] The issue did come to Court again almost a decade later, in connection with deposits held in London for the Libyan state after US sanctions against the Libyan regime followed the revelation of the regime's links with terrorist organisations, when the restrictions were held not to prevent the withdrawal of the deposits. The judgment was subject to appeal, but this was superseded by another intervening diplomatic solution.[34]

Professor Gower admitted, in his personal account of the reforms to the UK financial services industry from summer 1983 to implementation of the Financial Services Act 1986,[35] that he started his review of investor protection, which the UK government had invited him to conduct in 1981, with a belief that the planned opening of the domestic financial services markets to international competition and the removal of restrictive practices represented a fundamental change that called for something similar to the statutory control of investment business that had already existed in the

[33] Richard Edwards, 'Extraterritorial Application of the U.S. Iranian Assets Control Regulation'(1981) 75(4) American Journal of International Law 870.

[34] Corinne R Rutzke, 'The Libyan Asset Freeze and its Application to Foreign Government Deposits in Overseas Branches of United States Banks: Libyan Arab Foreign Bank v Bankers Trust Co.' (1988)3(1) American University International law review 241.

[35] LCB Gower, 'Big Bang and City Regulation' (1988) 51 MLR 1.

USA for nearly 50 years and had been copied with modifications in many Commonwealth and foreign countries.

It is perhaps unsurprising that, in the prevailing background of opposition to state intervention, he concluded that such a dramatic change was not politically possible in the short term and so recommended a hybrid solution, self-regulation. This allowed existing City practice to continue, but under a much more structured form and overseen by a statutory body, the Securities and Investments Board (the 'SIB'). Rather to his surprise his proposals met with less opposition than he expected, which he attributed to a series of financial scandals that became public at the time, possibly combined with a failure of the financial institutions to realise the potential impact of the SIB. The latter is certainly consistent with the author's experience as a legal adviser to two Self Regulating Organisations ('SROs') and the draftsman of the first set of regulations for one. It soon became very clear that many of the industry participants which comprised the SRO members expected the new rules to provide a set of factual requirements which, if satisfied, would represent a complete defence to any regulatory or legal claim that the marketing or management had been at fault, for example for failing to disclose sufficient information about a product or service to allow a potential investor to make an informed decision whether to proceed.

In practice a further series of scandals, in particular the mis-selling of personal pensions to retail investors, and the 1997 election resulting in a change of government led to a version of the full statutory regime Professor Gower favored being introduced by FSMA. This restructured the SIB and the SROs it had overseen into a single statutory regulator, the Financial Services Authority (the 'FSA'), with a considerably expanded remit and powers, in 2001. In contrast to Professor Gower, who had been widely criticised for failing to take sufficient account of the potential costs of the new regime,[36] the FSA adopted the 'market failure' or 'consumer welfare' theory of regulation but sought to counter industry concerns about the costs of 'compliance' by adopting the theory that market failure was a necessary but insufficient condition for regulatory

[36] RA Posner, 'Theories of Economic Regulation' (1974) 5(2) Bell Journal of Economics and Management Science 337; JM Hinchcliffe, *The Financial Services Act : a case study in regulatory capture* (Doctoral, Sheffield Hallam University 1999).

intervention because of the possibility that regulation could in fact make the problem worse.[37]

As a result, cost benefit analysis ('CBA') was a feature of the FSA's practice when proposing new regulations from its establishment, with a paper explaining its practices published in 2006.[38] The process was expanded by a statutory requirement that estimates of both the costs and the benefits of any proposed new regulation be published by the new regulator, the FCA, when it assumed the role of regulating conduct of investment business. This followed the demise of the FSA after its perceived failure to foresee the global financial crisis of 2007/8 as part of the reforms introduced, after another change of government, by amendments to the FSMA implemented in 2012. That said, the task of estimating let alone quantifying the benefits to be gleaned from a new regulation is far from easy and on occasion, under the FSA, the result has been a rather lame conclusion that the potential benefits exceed the rather easier to quantify and estimate costs. This has led at least one commentator to conclude that 'precise, reliable, quantifiable CBA remains unfeasible'.[39] The current regime is described in more detail below.

The insurance industry maintains a role within the investment management industry by providing financial products that provide very similar benefits to the IMA and CIS but without ownership of the portfolio being held by the investors and thus without the insurer adopting, as a matter of law, an agency role. The principal examples are life assurance, whereby policy claims are based on the value of a portfolio 'wrapped' by the policy; and the investment bond, under which the investor is offered the opportunity to acquire a bond the return on which is based on the investment performance of an identified portfolio less a fee paid to the issuer, an associate of the insurer. The investor acquires what, from the investor's perspective, is essentially the same product - investment management services – and the protection of the investor who acquires a

[37] Harry McVea, 'Financial services regulation under the Financial Services Authority: a Reassertion of the Market Failure Thesis?' (2005) 64(2) CLJ 413.

[38] Financial Services Authority, 'Economics for Effective Regulation' (Occasional paper 13, FSA, March 2016).

[39] John C Coates IV, 'Cost-Benefit Analysis of Financial Regulation: Case studies and Implications' (2014/5) 124(4) Yale Law Journal 882.

financial product from an insurance company is provided in a similar way by FCA regulation that largely ignores the difference in the legal ownership of the financial assets on the performance of which the return to the investor is based.

IV – Overview of current legal and regulatory regime

There has been criticism that the history of regulation in the City of London can be seen as part of a series of repeating cycles starting with the South Sea Bubble. A financial crisis leads to a call for more restrictive regulation that duly follows, only for its effectiveness to be watered down over time until another crisis intervenes … and the call for stricter regulation marks the beginning of the next cycle.[40] What is not in dispute is the extraordinary expansion of the 'compliance industry' that hardly existed in the UK as little as thirty years ago. The regulatory system is 'costly, complex, centralised and captured'.[41] The administrative costs of regulators now exceed £1.2 billion per annum, more than six times the costs in 2000. The rules, guidance and supervisory statements published by the two regulators, the FCA and the Prudential Regulatory Authority (the 'PRA'), run to over 13,000 pages. The FCA Handbook itself contains over 10,000 pages and is divided into 15 topics, each with its own section containing between 5 and over 350 items, although by no means all of these relate to discretionary portfolio management. The PRA does not regulate conduct but is responsible for monitoring the financial position of firms whose failure might endanger the stability of the financial system, which does not currently include any portfolio managers.

The FCA has the following statutory objectives: the strategic objective of ensuring that the relevant markets in financial markets function well; and three operational objectives: (i) to secure an appropriate degree of protection for consumers; (ii) to protect and enhance the integrity of the UK financial system; and (iii) to promote effective competition in the interests of consumers.[42] These objectives encompass, as with most

[40] André Spicer and others, 'Cultural Change in the PRA, FCA and the Bank of England: Practising what they Preach?' (New City Agenda and CASS Business School 2016).

[41] Ibid.

[42] Financial Services and Markets Act 2000, s.1.

financial services regulation, the resolution of market failure although it is accepted that not all market failure can be solved by intervention, indeed that intervention could make the problem worse and, in some circumstances, the benefits could be outweighed by the costs.[43] The principal causes of failure are seen as lack of competition, information asymmetry, conflicts of interests, externalities and misaligned incentives. Conduct regulation, while not without its critics,[44] is a means to solve market failure by improving market outcomes and consumer welfare.

The regime provides for the FCA to be responsible for, amongst other matters, the conduct of portfolio management business in the UK. The FCA provides a manager with the authorisation required to carry on investment business in the UK. To qualify a firm must satisfy the FCA that it has the knowledge, skills and experience necessary to provide investment management services; a viable business plan which satisfies the 'operating conditions'[45]; and the resources sufficient to satisfy a financial test in the form of a 'minimum capital requirement'.[46] The requirement is based on the firm holding reserves that are sufficient to fund the business for three months with the amount required adjusted periodically to reflect the latest financial reports, including annual audited accounts.[47] The concept is that breach of the capital requirement (which must be reported immediately to the regulator) will enable the regulator to oversee whatever is required to avoid losses being suffered by investors, in particular to portfolios under management, whether through a further capital injection or a reconstruction or merger of the business. Discretionary portfolio managers are thus subject to supervision by the FCA and obliged to comply with the FCA Handbook when conducting discretionary portfolio management business.

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[43] Financial Services Authority, 'Economics for Effective Regulation'Occasional paper 13, FSA, March 2016).

[44] I MacNeil, 'Rethinking conduct regulation' (2015) 30(7) Butterworth Journal of International Banking and Financial law 413-420.

[45] Broadly covering regulatory compliance; conflict of interests, continuity and regularity of service; (supervision of) outsourcing; procedures and control mechanisms, including as relevant to risk management; record keeping and adequate arrangements to safeguard clients' ownership rights.

[46] The requirements are summarised at < www.fca.org.uk/firms/asset-managers-authorisation> accessed 17 August 2020.

[47] The detailed financial requirements are set out in the European Capital Adequacy Directive ('CAD') but are under review following the UK leaving the EU.

The FCA Handbook and the rules and regulations it contains can be analysed as comprising three main constituents relevant to discretionary portfolio managers: first the COBS, regulations binding on all managers breach of which leads not only to potential regulatory enforcement but also gives any retail investor who suffers loss as a result of the breach a statutory right to recover damages from the manager;[48] second, various statements of principles for business breach of which leads to potential regulatory enforcement but does not trigger any statutory rights to compensation, although agreement to make payments to investors who suffer damage as a result of breach will often form part of regulatory enforcement; and third, guidance which operates as an indication of what the FCA considers to be 'best practice' and, while not binding, compliance with which is highly unlikely to result in regulatory enforcement. The eleven main principles for business are general statements of the main regulatory obligations that apply to every firm that is authorised to carry on investment business and more often than not breach of one or more of these principles is a feature that leads to enforcement action.

There are also FCA publications that describe how the FCA operates and discuss aspects of investment business, including consultations on possible future regulatory changes and papers publishing and describing changes to the rules prior to their coming into effect. The FCA seeks to influence market practice through 'Dear CEO' letters, in which the Chief Executive Officer of an authorised firm receives details of the FCA's concerns about regulatory failings in specified areas of investment business, the applicable regulations and the steps that the FCA expects authorised firms to take. The CEO is required to confirm the contents of the letter have been read and understood and that the firm is operating in compliance with the regulatory rules. The letter may also identify areas of practice to be under enhanced short-term review with failure to implement the proposal risking enforcement action. The increasing use of these letters, with over 20 issued in recent years against rarely more than one a year in the previous decade, indicate perceived success in improving compliance. CEO letters aimed at investment management include a CEO letter addressing conflicts of interest in 2012

[48] Financial Services and Markets Act 2000, s.138D FSMA (as amended).

and more recently a CEO letter titled 'Asset Management Supervisory Strategy' in February 2020.

The FCA and the FCA rules and regulations are aimed at prevention of misconduct as much as, if not more than, punishment for breach. They are, however, enforced proactively with a primary intention of preventing loss to investors as a result of manager misconduct and the consequences of misconduct a necessary but to an extent secondary requirement if and when the primary objective of prevention has failed.[49] The topic is addressed in Chapter 4 ,which considers remedies available for breach of the IMA by the manager.

The FCA also issues discussion papers, for example in an attempt to encourage financial institutions to adhere with 'compliance culture' rather than concern themselves with 'compliance risk'.[50] 'Compliance' has been defined as 'conscious obedience to or incorporation of values norms or institutional requirements'[51], while 'culture' deals with 'intraorganisational processes';[52] 'compliance risk', in contrast addresses 'the risk of legal or regulatory sanctions, material financial loss or loss to reputation as a result of failure to comply with applicable laws, rules, related self-regulatory organisation standards and codes of conduct.[53] While it perhaps unlikely that practitioners, even those employed in compliance, spend much time discussing the ever increasing volume of academic literature, it is fair comment that there has been a distinct shift to the FCA and other UK regulators seeking to foster a compliance culture after the failures that were seen as part of the causes of the Global Financial Crisis of 2007/8 (the 'GFC').

[49] FCA publications, 'Our Mission 2017: how we regulate financial services' (FCA, Oct 2016),ch 2 section 4.

[50] FCA publications, 'The importance of culture in driving behaviours and how the FCA will assess this' (FCA April 2013); 'Behaviours and Compliance in organisations' (Occasional paper 24, FCA, Dec2016); 'Culture and conduct -extending the accountability regime' (FCA, Sep 2017); and see PRA, 'The use of PRA powers to address serious failings in the culture of firms' (Statement of policy, PRA 2014).

[51] C Oliver, 'Strategic responses to institutional processes' (1991) 16(1) Academy of Management Review 145.

[52] AZ Kondra and DC Hurst, 'Institutional processes of organisational culture' (2009) 15(1) Culture and Organisations 39.

[53] Basel Committee on Banking Supervision, 'Compliance and the compliance function in banks' (2005).

Even if the compliance culture may have been aimed primarily at the banking sector, whose practices were seen as the principal cause of the GFC, the asset management sector was certainly not excluded.[54] There have been many changes in the regulation of discretionary portfolio managers since and as a result of the GFC , many of which are discussed in the next two Chapters. The FCA also conducted a two-and-a-half-year study of the asset management market with a final report published in June 2017.[55] The study sought to understand how UK based investment managers compete to deliver value to retail and professional investors. The result was FCA proposals (i) to provide protection or investors not well placed to find better value for money; (ii) to drive competitive pressure on managers; and (iii) to help improve the effectiveness of intermediaries. A policy statement and detailed proposals followed in April 2018 which remain in effect.

The principal changes the study intended to bring about include: an enhanced duty on portfolio managers to act in the best interests of investors, with increasing responsibility and accountability for senior management; disclosure of a single 'all in fee' for retail investors comprising both the management fee and estimates of transaction costs and other charges to be met from the portfolio with standardised disclosure of costs and charges to institutional (professional) investors; an end to the retention of 'box profits'; and greater clarity in objectives, benchmarks and performance reporting. The study also led to the recommendation that investment consultants be regulated, while subsequent work has included measures aimed at greater involvement by investment managers as shareholders in the context of the UK Stewardship Code and the Kingman report.[56]

More recently, the Senior Managers and Certification Regime ('SMCR"), originally introduced for the banking sector after the GFC and providing that a senior executive be assigned personal responsibility for each section of a bank's regulated business who

[54] David Kenmir and David Hislop, 'FCA conduct regulation'(2013) 110(Oct) Compliance Officer Bulletin1.

[55] FCA, 'Asset Management Market Study Final Report' (Market study MS152.3, FCA, June 2017).

[56] Sir John Kingman, 'Independent Review of the Financial Reporting Council' (HM Government, December 2018); Iris H-Y Chiu, 'Is the time ripe to subject asset management to more regulatory governance?' (2019) 40(7) Company Lawyer 205.

would personally be in breach of the regulations if he or she had failed to take reasonable steps to prevent a regulatory breach with the prescribed area of responsibility, was extended to all investment firms, thus including portfolio managers, from December 2019.[57]

The FCA Handbook also includes many other applicable regulations, derived from the need to comply with not only FSMA (as amended) but also the UK anti-money laundering regime requirements set out in the Proceeds of Crime Act 2002 ('POCA') (as amended by the Serious Organised Crime and Police Act 2005 ('SOCPA')), the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ('MLR 2017') and the Terrorism Act 2000. These other regulations have no direct bearing on investor protection against portfolio manager misconduct in the context of the duty of loyalty and fiduciary obligations and are outside the scope of this thesis. Breach of either regulation or principle is potentially the subject of enforcement action by the regulator, which may include financial penalties or even loss of authorisation and is reviewed in Chapter 4.

The relationship between regulation and the common law has long been a topic for debate,[58] as well as two references to the Law Commission since the implementation of the FSA 1986 in 1988.[59] In the context of fiduciary law, the most significant aspects of FCA regulation are that the COBS permit a wide range of activities that enable the portfolio manager to continue to provide portfolio management services despite the presence of conflicts between the interests of the Client and the interests of (i) the portfolio manager and/or (ii) other clients of the portfolio manager provided, broadly speaking, steps are taken to provide a fair result for all clients involved. The manager and its associates are also permitted to earn profits from the portfolio manager appointment provided that there is no risk of loss to the Client. These changes represent significant modifications to the fiduciary prohibitions and are incorporated into the relationship by

[57] FCA Handbook: Principles for Businesses ('PRIN'); Senior Management Arrangements, Systems and Controls ('SYSC').

[58] Ibid.; Jenny Hamilton, 'Negligence in the corridor? The interaction between "separate rooms" and the common law in financial services' (2007) 23(3) Tottels Journal of Professional Negligence 134-50.

[59] Law Commission, 'Fiduciary Duties and Regulatory Rules' (Law Com No 236,1995); and Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No 350, 2014)

provisions in the IMA. This is a topic that is considered in more detail in the next Chapter.

The portfolio manager has vicarious liability for the misconduct of those individuals who take investment decisions on the portfolio manager's behalf following the principle that a master is responsible for the actions of his servant except when the servant is 'going on a frolic of his own', formulated by Parke B in 1834.[60] This provides the basis for the liability of a manager for portfolio management decisions taken on its behalf by its directors, officers and employee(s) in the course of satisfying, or otherwise, the obligations under the relevant IMA. The scope of the employee's 'frolic' required to allow the employer to escape liability has been curtailed in the subsequent 180 years, most notably by the House of Lords decision that vicarious liability requires only that there is 'sufficient connection' between the employee's misconduct and the duties involved in the employment.[61]

Even if such a test allowed a portfolio manager to escape liability for a portfolio management decision by an individual(s) acting on the manager's behalf questions would immediately arise as to whether this indicated the operational arrangements of the portfolio manager failed to comply with the regulatory requirements for oversight and review. Employees, directors and officers do not, of course, have a monopoly over portfolio management decisions taken pursuant to an IMA. Where the manager is not a company the same principles apply, with the legal entity that is the portfolio manager being responsible for the decisions of its agents – and thus an innocent partner being held liable for the fraudulent conduct of the misconduct of his or her partners absent exceptional circumstances, the cases making clear that this issue is ultimately fact and circumstance specific.[62]

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[60] *Joel v Morison* [1934] EWHC KB J39,(1834) 6 C & P 501, 503.

[61] *Lister v Hesley Hall Ltd* [2001] UKHL 22, (2002) 1 AC 215; *Bellman v Northampton Recruitment Ltd* [2018] EWCA Civ 2214, [2019] 1 All ER 1133.

[62] *Dubai Aluminum Co Ltd v* Salam [2002] UKHL 48, (2002) 2 AC 366; *WM Morrison Supermarkets Plc v Various Claimants* [2020] UKSC 12, [2020] AC 989.

V - Portfolio management process

To turn to current market practice, discretionary management of a portfolio is only part of the process whereby the holdings of a single investor, whether individual or institutional, are 'managed' – which is, to some extent confusingly, referred to as the 'portfolio management process'. The potential confusion arises from 'portfolio' being used to describe (i) the complete pool of financial assets owned by a single investor; (ii) a pool of financial assets being managed by a single portfolio manager for a single investor but representing only a portion of the portfolio owned by the investor; (iii) the complete pool of financial assets held within a CIS (in which multiple investors have a direct or indirect interest) being managed by a single portfolio manager; and (iv) a pool of financial assets held within a CIS but forming only part of the portfolio of the CIS and managed by a discretionary portfolio manager that does not have responsibility for the complete portfolio as, for example, in the 'fund of funds' vehicle.[63]

The 'portfolio management process' applies whenever a portfolio owned by a single investor is managed either by the investor itself, which is referred to as 'proprietary investment', or with the benefit of advice from one or more investment professionals, for example by the investor ascribing separate portions of the investor's total investment portfolio to different portfolio managers, potentially with the benefit of advice from, or even delegated decision making by, other investment professionals. The process is conventionally analysed as comprising three stages: planning; execution; and feedback. The first involves establishing information about the investor, its financial situation, knowledge and experience and using this to determine the investment objectives and portfolio constraints which, when combined with the expectations as to future capital market performance of the adviser(s), lead to identification of a strategy for allocating the portfolio between asset classes - 'strategic asset allocation' - with a view to achieving the determined objectives within the agreed restraints.

[63] This section is based on the author's personal experience and the CFA syllabus for the CFA level one and level two exams. In addition, there is also an extensive literature a detailed review of which is provided by Hany Fahmy, 'Asset Allocation and Security Selection in Theory & Practice: A Literature Survey from a Practitioner's Perspective' (2015) 1(2) Applied Finance and Accounting 10.

The second stage involves two elements: first the construction of a model portfolio based on the strategic asset allocation decided at the first stage, with the investments to be acquired combining to achieve the risk and return balance consistent with the allocation; and second the acquisition of the investments specified in the portfolio taking into account the costs both implicit, e.g. price movement between decision and transaction, and explicit, e.g. dealing costs and broker fees.

The third stage is portfolio evaluation, monitoring and rebalancing. Evaluation involves using the current estimated value of the portfolio and its individual components to calculate rates of return for portfolio and the asset categories within it. The factors that have contributed to these returns are then identified, for example in terms of level of risk and weighting between asset categories, with the results then reviewed, often in both absolute and relative terms (i.e. to any specified benchmark) with the result identifying possible portfolio rebalancing and the manager then deciding what rebalancing is considered appropriate in order to satisfy the investor's investment objectives within the agreed restraints and then implementing these decisions.

A key feature is that these stages are continuous, with the findings of each segment being fed into the others and reflected in the decisions being made. When evaluation of the portfolio results against the overall market background indicates a need for rebalancing, this feeds into the strategic asset allocation and leads to a new model portfolio, with the changes required to the existing portfolio being identified and then implemented by way of acquisitions and sales made by the manager as the Client's agent operating within the discretion provided in the IMA. Once the decisions have been implemented, indeed in the course of implementation if this takes time, the results of the changes are evaluated as the cycle continues. The process also includes regular review of the investor's circumstances in order that objectives and restraints can be adjusted to reflect changes.

At the heart of the process is access to data, including economic and market developments, company reports and announcement and other financial news items and information, some of which may be acquired from financial data vendors such as Bloomberg and Morningstar. This data is then analysed, either by in-house financial analysts and/or by independent research companies, with the results used in the strategic asset allocation and portfolio construction. Major factors in the industry development have included the steady increase in the speed and efficiency of electronic communication that has led to ever increasing availability and volume of up-to-date data and the capacity of computers to analyse the increasing volume of data at speed, indeed now all but instantaneously - with, in some cases, the role for humans in investment decisions limited to little more than systems maintenance and upgrade and overall supervision.

A portfolio manager will not always be involved in all aspects of the portfolio management process. For example the portfolio of a CIS will have a prescribed investment mandate selected by the promoter of the CIS and set out, with all the other material terms, in the documentation on the basis of which a holding is acquired, typically a prospectus if the CIS is offering securities to the public or an 'offering memorandum' if investors are restricted to institutional investors. A holding in the CIS may then be chosen by a separate manager as a suitable security for inclusion in the model portfolio that emerges as part of the portfolio management process for one or more of its Clients. Alternatively, a retail investor with a portfolio too small to be of interest to an investment manager may well decide to invest based on recommendations from an IFA who will, if a recommendation is accepted, arrange the acquisition as the agent of the investor, but as an agent without discretion (or perhaps with discretion only as far as price, e.g. within an agreed range).

A professional investor, an expression defined in the FCA Handbook but broadly entities engaged in financial services business and other entities satisfying certain conditions, e.g. as to minimum net assets, or individuals with appropriate expertise [64] (with a retail investor any investor who is not a professional investor) may also decide to appoint the manager to manage a discrete part of its overall portfolio with the manager's role then restricted to portfolio construction and evaluation within the asset categories and objective specified for the part. The decision to appoint the manager may be made by the investor based on advice from investment consultants or by a 'fiduciary manager' that

[64] FCA Handbook: COBS ch 3.

typically has actuarial skills that permit estimation of the value of future liabilities (e.g. to future pensioners or for insurance claims): as these roles need not involve advice in relation to specific investments neither is currently required to be authorised under FSMA 2000 (as amended), although this has been recommended[65] in light of concerns over anti-competitive practices.

An investment manager will be involved in the portfolio management process if the investor appoints the investment manager to manage his complete portfolio as part of wealth management or private banking services made available by the manager and its associates to HNWIs. The gathering of information about the investor will normally be undertaken by personnel employed by the manager involved in client contact roles rather than direct portfolio management with the results – appropriate investment objective and restraints – appearing in the IMA and fed into the strategic asset analysis undertaken by financial analysis and investment management specialists. The portfolio management role involves agency with discretion while the other roles potentially involve investment advice, which may itself involve fiduciary obligations[66] but not as an agent with discretion (and thus outside the scope of this thesis).

The strategic asset allocation and model portfolio components of the first two management stages, together with the evaluation analysis of the third, are an integral part of the portfolio management process and provide the basis on which the manager exercises the discretion granted in the IMA. The allocation decisions are separate from the exercise of the agency discretion and will not require authorisation as investment managers and, if at all, will only require authorisation as investment advisers. The process whereby the manager reviews the portfolio content and makes decisions as to portfolio content, including a decision not to take action, can be compared to what is commonly referred to as 'stewardship' role of a fiduciary with control over the property

[65] The changes suggested by the Competition and Markets Authority were welcomed by the government in March 2019 but no legislation is expected in the near future in light of other governmental priorities.

[66] *Springwell Navigation Corp v JPMorgan Chase Bank (formerly Chase Manhattan Bank) & ors* [2010] EWCA Civ 1221.

of its principal.[67] This aspect does not extend to the manager entering into contracts as agent of the Client: the portfolio is kept under continuous review and the need for change identified in light of developments both within and external to the portfolio.

Although the financial assets in portfolio remain the property of the portfolio owner with their safe custody the responsibility of the custodian, the manager has responsibility for the content of the portfolio with the authority to change the content by transacting as agent for the principal within the limits prescribed by the investment mandate. If the review processes lead to a decision to change portfolio content the manager then faces another decision - how to implement the change. The obligation is to obtain 'best execution': the duty of an investment services firm executing orders on behalf of clients to ensure the 'best execution' possible for their customers' orders, which is considered in section VII below.

VI - Portfolio manager: role and investment mandate

The traditional role of the portfolio manager, to control the content of a portfolio of financial assets in accordance with the objectives and constraints specified in the investment mandate that forms part of the IMA, remains unchanged. The objectives and constraints emerge either from the initial stage of the portfolio management process and the strategic asset allocation process that follows; or because of a decision by an investment manager to establish a CIS with a fixed investment mandate investment in which is open to third party investors through subscription. The investment objectives are set out in the 'investment mandate' and are likely, in the case of an institutional investor, to specify a target performance (e.g. 1% above a specified index or benchmark less fees over a specified time period, perhaps a year or 'market cycle')[68] with excess returns, known as 'alpha', being generated within a risk restraint which is typically measured in terms of excess returns achieved and the volatility (or risk) in the portfolio

[67] Charles Mitchell, 'Stewardship of property and liability to account' (2014) 3 Conveyancer and Property Lawyer 215.

[68] The cycle is the period between successive points in the cycle that sees the market rise for a period and then fall, only to rise again, at the end of which the market begins to slide and a new cycle commences.

over a period.[69] In essence excess returns combined with high volatility suggests a weaker performance over the longer term than if the same return were achieved with lower risk. The benchmark or index may be a publicly available index, such as the FTSE 100, or a bespoke index created specifically for the mandate by reference to a particular grouping of assets, asset class or sub-division of a class, or some combination of all three.[70]

The investment mandate for retail investor or a CIS, in particular an open-ended CIS that is eligible for direct investment by a retail investor – often referred to as a 'regulated fund' in the UK[71]– is likely to follow similar lines but be more general and incorporate a number of the restrictions required by regulation, in particular the UCITS directive for open-ended funds[72] or the London Stock Exchange listing rules for closed-ended investment companies (LSE listing being a requirement for direct investment in a closed ended investment company[73] by retail investors in the UK). There are a vast number of possible variations, not least in terms of complexity, for investment mandates. The main distinctions are between the asset classes in which the manager can invest.

The traditional divide is between equity, fixed income and money market investments, with foreign exchange to an extent treated as a separate class, for example where investors whose portfolios have different base currencies share similar objectives. These classes are then sub-divided: equity broadly by geographical regions and within the regions by market capitalisation (large, medium and small); fixed income by currency zones and then time to maturity (short, medium and long) and likelihood of default, known as credit ranking. The most widely used standard for classification is the Global

[69] Ingo Walter, *The Industrial Organisation of The Global Asset Management Business* (CFA Institute Research Foundation 2015), Ch 2.

[70] Based on the author's experience in negotiating IMAs and see Norton Reamer and Jesse Downing, *Investment: A History* (Columbia Business School Publishing 2016) Ch 7.

[71] CIS eligible for retail investment in the UK include 'recognised funds': funds which have been authorised by a regulator in the European Economic Area (the 'EEA)pursuant to s.265 FSMA or elsewhere under s.272 FSMA as providing equivalent protection for investors as an UCITS qualifying fund.

[72] FCA Handbook: Collective Investment Schemes Sourcebook ('COLL').

[73] Closed ended means that the investor has no right to redeem its investment in a security out of the assets of the issuer at a price based on Net asset Value.

Industry Classification Standard or 'GICS'. This was established jointly by MSCI and Standard & Poor's in 1999 and currently consists of 11 sections, 24 industry groups, 68 industries and 157 sub-industries.[74] Other classifications in use include the Industry Classification Benchmark or 'ICB', a classification structure maintained by the FTSE Group.[75]

The traditional classes are then augmented by alternative investments, 'alternative' as the risk-return characteristics have a low correlation – a measure of how often one moves in tandem with the other - with the traditional classes. These include real estate, infrastructure, private capital, venture capital and commodities. The low correlation is also a factor that leads some to treat certain hedge fund strategies such as 'distressed debt' as 'alternative'. A feature of alternative investments is that the investment management may require different management techniques to that for the traditional classes, while risk analysis may differ and risk need to be assessed in separate ways. Liquidity (or the lack of it) is an additional feature to be taken into account.

An investment mandate will likely include specific risk restraints in terms of permitted maxima for any single holding, for example in a portfolio of equity securities these might include maxima either as a percentage of portfolio net asset value ('NAV') and/or against its benchmark weighting (e.g. no holding to exceed X% of portfolio NAV or no holdings in a sector to exceed Y% of its index weighting), total percentage of portfolio NAV in a specified sector, maximum cash holding as percentage of portfolio NAV, maximum percentage holding in any one issue or issuer or as a percentage in a specified class, e.g. no more than Z% of the portfolio NAV to be invested in preference shares or debt to have a minimum independently assessed credit rating.

There may also be limits or prohibitions on the portfolio being involved in corporate transactions, for example new issues (an issue of shares by a company that has not made an issue of shares to the public before, though sometimes also a generic

[74] The latest CIGS can be viewed at <https://www.msci.com>accessed 21 October 2021.

[75] FTSE International Limited, trading as FTSE Group and FTSE Russell, is a company wholly owned by the London Stock Exchange that provides stock market indices and associated data services. FTSE stands for Financial Times Stock Exchange.

reference to a company raising money from a share issue); rights issues (an issue of shares by a company that gives each shareholder the right to acquire shares sufficient to retain its proportionate share of the enlarged capital if all the new shares are issued; placings (an issue of shares by a company to a selected group of investment professionals who are not the shareholders who would normally be permitted to acquire new shares based on their proportionate holding in a rights issue, with this a method, cheaper than underwriting, of ensuring a new issue raises money when it is unlikely that shareholders will want to take up their rights); or underwritings (an underwriter undertakes to subscribe for any shares that shareholders choose to acquire in a rights issue: the underwriting fee is a percentage of the aggregate sum being raised before fees and expenses and the underwriter has no certainty as to the number of shares it will acquire below its specified maximum).

The restraints will normally differ between asset classes reflecting their different characteristics, but each will be capable of measurement and thus breach will normally be simple to establish, though the IMA will typically differentiate between breach as a result of manager activity and 'inadvertent' breach which results from market movement in prices. Thus a mandate for fixed income portfolio might specify a minimum number of holdings, the permitted range of credit ratings and whether leverage or short selling is permitted. Leverage involves gearing investments, for example by borrowing funds and investing them in the hope that the gain exceeds the borrowing cost and increase the rate of return on the capital invested: 'short selling' is the process of selling a stock in the expectation that it can be acquired in due course for a lower price than the sale proceeds.

The mandate thus sets out the extent of the discretion that the manager has been granted to enter into contracts on the client's behalf, in terms of permitted asset classes, permitted restrictions and limits on the holdings in each class and permitted limits based on the aggregate for holdings in the portfolio, most commonly in terms of permitted ranges for risk based on specified measurement criteria, of which there are many. Value at Risk ('VaR') is one of the most common and remains an industry standard despite having many critics and being based on assumptions that academics and others have questioned. The statistic provides an estimate of the loss that it is expected will be exceeded for a given level of probability over a specified time period, measured as the percentage of the reference portfolio value. Thus a 5% quantile VAR of minus 20 in respect of a year means there is a 5% chance that the value of the portfolio will fall in value by 20% or more over the year: a 1% quantile VAR with the same values would mean a 1% chance of such a minimum fall over the period – or a 99% chance that the portfolio value would perform better than a 20% fall. The mandate may thus specify not only ranges of acceptable VaR but other, often many other, statistical measures of risk, often based on the processes the manager prefers in light of the specific investment strategy being deployed.

By way of an illustration of the complexity of risk management statistical analysis, the daily risk report for a typical CIS available to retail investors includes not only VAR but 15 other statistical measurements.[76] The exact meaning of each statistic is not an issue; however, their number illustrates the multitude of ways in which the reaction of the portfolio to 'risk' can be measured. Furthermore, the measurements available and in common use change over time as their usefulness is measured, with replacement a potential result if a new process appears to provide a more useful basis for portfolio valuation or simply becomes more popular.

The aim of the investment mandate can be described as to provide a range of permissible portfolios among which the investment manager will be expected to identify, as part of the second stage of the portfolio management process, on an ongoing basis and taking into account the investment strategy, the portfolio that combines the best possible level of expected return with the lowest level of risk. This reflects what has come to be called 'modern portfolio theory', the analytical basis for which was first published in 1952.[77] At its root is the hypothesis that investors can reduce risk through diversification using a quantitative methodology. Portfolio analysis accordingly requires not only analysis and measurement of individual holdings but also analysis and measurement of the portfolio as a whole, in particular the extent to which movement in one or more

[76] Value-at-Risk (VaR); Component VaR (CoVaR); VaR contribution; Sharpe Ratio; Sortino Ratio; Expected Shortfall; Maturity Structure; Duration Structure; Rating Structure; Synthetic Risk Reward Indicator (SRRI); Diversification effect; Worst Case stress; Volatility Stress; Correlation Stress; Stress Scenarios; Clean Backtest; Gross leverage; Commitment Leverage. The author is a non-executive director of two funds that measure risk in this manner.

[77] H Markowitz, 'Portfolio Selection' (1952) 7(1) Journal of Finance 77.

holdings is likely to be balanced by movement by others in the opposite direction. The original thesis has been augmented by a very large volume of subsequent academic and practitioner comment, though the principle of risk diversification has been around for much longer and formed the basis for the first investment trust, Foreign and Colonial Trust, launched in 1868.

The theory assumes that the risk element for any investment can be divided into (i) systemic or market risk, which reflects factors of general application to the particular class or sub-category and thus that cannot be diversified; and (ii) a systemic or specific risk that applies to the holding itself and represents the risk of the return being lower (or higher) than expected for that particular class or sub-division. The latter reflects the component of the return that is not correlated to general market moves and thus which can be matched by specific risk elsewhere in the portfolio, in effect by a holding whose performance will deviate from the expected average for the category of that second holding in the opposite direction. The overall level of risk accordingly depends on the difference, or covariance, between the specific risks of the holdings in the portfolio. Risk itself is measured by reference to the difference between the price of the holding and the average price for the category or sub-division over a period of time.

The theory is based on the assumption that for every level of risk there is a portfolio that offers the highest rate or return and that for every level of return there is a portfolio that offers the lowest level of risk. The combinations can be plotted on a graph, with risk measured in terms of the standard deviation of price from the mean and return in terms of percentage return. The result is the 'efficient frontier' – and the aim of the manager is to maintain a portfolio that lies on that line.

The investment mandate is arguably the most important section of the IMA, not only as it sets out the limits of the discretion granted to the manager but also because it includes, in the investment objective, the purposes for which the discretion is to be exercised. This establishes the circumstances in which the portfolio manager is appointed to use its special skills to advance the interests of the Client and is thus required to take decisions in the interests of the portfolio as described in the investment mandate without regard for its own interests or the interest of third parties except, in the latter case, where the Client has given its valid consent. It is therefore the area where, if the manager is a fiduciary, the common law can be expected to provide additional protection against manager misconduct to the Client (and thus to any other investors with indirect interests in the portfolio) to that available under the law of contract (for breach of the IMA). This follows the principle that a feature of a fiduciary relationship should include measures that guard against fiduciary misconduct in circumstances of enhanced risk which may apply however honest and appropriate the fiduciary believes his motive to be. At the same time any profits gleaned from the relationship are due to the principal, absent fully informed consent and regardless of whether the profits could have been earnt by the fiduciary on its own account.

The IMA will also include the other aspects of the relationship that are not directly relevant to the exercise of discretion by the agent manager, but some of which are necessary if the manager is to be in a position to implement change decisions, for example that the portfolio is responsible for all disbursements incurred in the course of providing services. Other clauses will be ‘boiler plate’ and appropriate for any agreement for the provision services. This to an extent explains why many IMAs follow a standard pattern and have very similar clauses, as well as the widespread practice of the first draft document being a standard form, for example as provided and updated by the Investment Association based on legal advice as to what a Court would generally find unreasonable or unenforceable.[78]

If the manager is involved in the collation of investor information on which the investment objective has been based the IMA will contain detailed representations to the effect that the information provided is accurate and complete and the investment objective and that the investor agrees with the conclusions. If the portfolio owner is a retail investor regulation requires that the manager satisfies itself that the investment objective is ‘suitable’ for the investor, with the costs involved in verifying the information a major contributor to the reluctance of investment managers to accept instructions from any person who is not a HNWI.

[78] Investment Association, Model Discretionary Investment Management Agreement (Investment Association and Norton Rose Fulbright 2018).

VII - Inadvertent breach of investment mandate

An inadvertent breach of the investment mandate is a breach for which the portfolio manager is not responsible and thus not a breach of the IMA. An inadvertent breach typically occurs when a portfolio under management contains investments each of which is permitted by the mandate, but which result in portfolio content that, in aggregate, breaches restrictions therein. Common examples include breach that results from differences in the change of value between investments in the portfolio so that, for example, a holding in one security exceeds the maximum percentage of the total portfolio value permitted for a single holding, or exposure because of a combination of the market price of an investment increasing (or decreasing less speedily) than the balance of the portfolio.[79]

A further example is where a result of redemptions by investors reduces the NAV of a CIS and thus reduces the maximum percentage of a class of investment, typically 10% or 25% depending on the sector, that the mandate permits. These types of restriction are normally included as part of the risk management of the portfolio and the issue is what the IMA provides, expressly or implicitly, in terms of the identification of the breach and corrective action required of the manager. For example, if the portfolio is open to retail investors the regulations require the manager to remedy the situation in whatever manner is in the interests of the investors, subject to a maximum of six months within which the breach must be cured.

Even though inadvertent breach is not, of itself, a breach of the IMA will include a duty on the manager to identify any breach and to take appropriate steps to remedy the position. Identification will be an express or implied obligation of the manager by virtue of the manager having a duty to review the portfolio content on a regular and timely basis. The IMA terms will typically permit the manager a period of grace before compliance with the restriction is required if the manager considers immediate correction would not be in the interests of the Client. This might apply where correction, for example, requires the partial sale of a holding in order to fall below the maximum size and in the circumstances

[79] This section is based on the author's experience advising discretionary investment firms in addition to the other sources to which reference is made.

the manager considers an immediate sale would only be possible at a low value due to temporary uncertainty. As a practical matter it is rare for the manager to delay repairing an inadvertent breach in the case of a fund available to retail investors. This reflects that all breaches by a UK based manager must be reported to the FCA, whose practice is to seek an explanation if there are any other than very occasional breaches, to include a report why the breach was not remedied as soon as practicable.

As a result of the time and costs involved in reporting to the FCA and dealing with any questions that may be raised, as well as the risk that the manager may be required by the FCA to meet any losses which would not have been incurred if the breach had been immediately repaired, standard market practice is to cure a breach as soon as practicable notwithstanding that a longer period is permitted. A firm will often impose a 'soft' restriction on its portfolio management teams whereby consent is required from a senior investment officer (who is not a member of the team managing the portfolio) for a holding to exceed a lower limit than the formal restriction - perhaps 4.5% where the limit is 5%. This raises the possibility that, in at least some cases, the manager may be favouring (or accused of favouring) its own interests over those of the portfolio owner (by reducing the risk in the portfolio inappropriately) and thus that the immediate repair of an inadvertent breach is in some circumstances a breach of the duty of loyalty. Investment restrictions are, however, part of risk management and immediate remedy of inadvertent breach by reducing the risk (of a fall in the value of a holding that exceeds the mandate perimeters) can usually be justified as in the interest of the portfolio as a matter of course and whatever the real background to the decision.

If the portfolio is a portfolio being managed for a CIS the portfolio owner will be the CIS if the CIS has independent legal personality and external investors will have rights only against the CIS. Where the CIS has no separate legal personality, the external investors will be collectively the Client and the constitution of the CIS will dictate who and how the ownership rights cane be exercised. Where the portfolio owner is not a CIS open to retail investors the provisions dealing with inadvertent breach will normally be similarly flexible, for example requiring notification of the breach to the Client and allowing delay in its repair where the manager considers this appropriate, perhaps provided the Client is notified of the breach at the earliest practical opportunity. The

Client may even be entitled, under the IMA, to withhold consent to delay or to grant consent either unconditionally or subject to conditions (for example as to time allowed or the breach being subject to a new temporary limit). The issue is a subject for the negotiation of the IMA.

Similar issues arise in connection with investments permitted for regulated funds.[80] These investments are prescribed by FCA regulation implementing EU directives[81] and text from the relevant regulations is often incorporated to at least some extent into the terms of an IMA, with the complete regulations in any event applicable where the portfolio owner is a regulated fund. The drafting of the regulations is in some areas unclear and this has led not only to different interpretations for the purposes of IMAs but also to an investment being treated as eligible by the regulator in one or more EU member states but not by the regulator(s) in others. These differences are typically resolved by a ruling by ESMA,[82] but this may only be decided and made public after the problem has first emerged. The ESMA ruling will accordingly normally specify a grace period within which the ruling must be put into effect by managers of regulated funds without penalty (with the transaction costs met from the portfolio and thus by the Client and thus the investors). The effect is to treat the original analysis, though subsequently deemed an error by the manager, as an inadvertent breach.

The ESMA ruling will not, of itself, have any bearing on the meaning of the term in an IMA with a professional investor, although the manager will likely draw the Client's attention to the ruling and notify the Client that the new interpretation will apply going forward, but not retrospectively. Adopting the same treatment for all portfolios under management not only allows greater efficiencies and thereby reducing costs, but also reduces the risk of internal confusion if the same language has different meanings for different accounts.

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80 The UCITS directives are incorporated into the FCA Handbook: Collective Investment Schemes ('COLL').

81 A list of eligible assets is included in the UCITS Directives: Council Directive 85/611/EEC with further guidance issued by ESMA on an ongoing basis.

82 The European Securities and Markets Association ('ESMA') has an advisory role under MiFID II which provides that its rulings are binding throughout the EEA. ESMA no longer has any authority over the FCA but no amendments have yet been introduced that diverge to a material extent from EU requirements.

In other situations, the manager may be found by the regulator to have been in breach, albeit unwittingly. This could be because the FCA disagrees with the manager's interpretation of the manager's own language in the investment mandate. An example is the interpretation of a fund with 'Europe ex-UK' as part of its title. The manager intended this to signify that the portfolio was to be invested in companies with exposure to economies in Europe but without any material exposure to the economy in the UK. The FCA concluded that the retail investor would consider the phrase to prohibit investment in a company incorporated or resident in the UK, even if the company's client base is entirely outside the UK. The manager, rather than incur the costs and management time involved in arguing the interpretation with the FCA, accepted the FCA position even though disagreeing. This was notwithstanding that the manager was required to recalculate the fund's performance based on exclusion of the relevant investments and to compensate any investor who has received less redemption proceeds or too few shares in exchange for a subscription as a result.[83]

VIII - Investment strategy

The investment strategy is the set of rules, procedures and behaviour that a manager adopts when deciding on portfolio content and, if a decision has been made that change is required, how to implement the change. Factors behind the choice of tactics and strategies will include the investment objective and the skills base and resources available to the manager. Each manager typically uses a series of strategies, which will often include bespoke and confidential elements, to guide its investment decisions.

The traditional divide was and to an extent remains between 'active' and 'passive' management. The former aims to outperform a specified index or benchmark (thereby generating 'alpha'), with a variant the so-called 'absolute return' whereby the target is simply a gross increase in value, sometimes measured in real terms. The calculation of the 'absolute' benchmark may be very different depending on the formula used - and so

[83] There will normally be a *de minimis* exception if the cost of distribution exceeds the sums involved: in practice payments to investors are rare. The example derives from the author's own experience.

this is, in practice, a form of measurement against a benchmark despite its name. The latter seeks to replicate the performance of the specified 'target' through the portfolio content mirroring the content of the benchmark or index (thereby achieving 'beta').This effectively swaps the fees required to have the chance of excess performance (and risk of loss) for the comfort of matching the benchmark or index save only for transaction costs and (materially reduced) management fees, with their aggregate constituting the 'tracking error' – the amount by which performance lags the target. The management fees are much less for passive investment with a major reason that the manager has little, if any, need for the quantitative and analytical skills involved in individual stock selection and risk measurement and management. The passive manager is judged on tracking error and the methodology and complexity required to plan transactions so as to minimise transaction costs while playing 'catch up' in response to benchmark and index changes should not be underestimated. Competition in tracking error is often decided on the basis of a small number of basis points or 'pips', each equal to 0.01% of NAV.

Some passive investment vehicles have no requirement for portfolio management, with the oldest example the Standard & Poor's Depositary Receipt ('SPDR'. commonly called 'spyder') Exchange Traded Fund ('ETF').[84] The ETF issues securities that are listed and traded on a stock exchange but give the holder no rights except to sell the securities at the prevailing market price. Investors can buy and sell shares in the normal way but investment firms who become Authorised Participants ('APs') are entitled to exchange a portfolio of securities matching the index *in specie* for securities in the ETF in substantial minimum lots. If the price of the ETF security (typically a depositary receipt acknowledging its issue was in exchange for the deposit of a portfolio of shares matching the relevant index) falls below the index an AP is able to acquire ETF securities in the market that it then converts into the index constituents shares at the index value, thereby realising a profit. If the market price for ETF securities rises above the index the AP will be able to sell ETF securities for more than the aggregate of the constituent stocks with

[84] 'SPDR' derives from the first ETF with this structure, launched in 1993 as the Standard & Poor Depositary Receipt Exchange Traded Fund and targeting the S&P 500. There are in the order of 140 SPDR funds in issue covering a wide range of indices and commodities, all based in the USA and available to retail investor in the USA and throughout Europe.

the AP thereby also realising a profit.[85] The effect restricts price movement away from parity with the index, so providing the investor with the required 'beta' with only tracking error to be deducted - which is also reduced, as an AP will pay a fee for the opportunity to profit from transactions with the ETF .

The 'no management' structure in the SPDR structured ETF arises because the only transactions involving the ETF are activated by the APs, which are themselves regulated. Another structure sees portfolio management undertaken by a computer applying one or a series of algorithms, with human involvement restricted to general overview. Both structures leave little room for analysis in terms of a possible relationship involving fiduciary status for the 'manager' owing duties to the investor and scrutiny of the motive behind decisions. It is difficult to assign a motive to a computer when its role is to evaluate alternatives and decide, on the basis of the algorithms with which it is programmed, which is to be preferred.[86] In contrast other strategies that aim to remove the need for individual business research, for example 'asset rotation'[87] under which the portfolio consists only, or predominantly, of passive investment funds with the holdings changing in reaction to macroeconomic developments, are, from a regulatory and legal perspective, no more than a version of the 'fund of funds' model.

ETFs are part of an increasing range of Exchange Traded Products ('ETPs') which share the common factor that there is no portfolio management. Examples include Exchange Traded Commodities and Currencies ('ETCs') and Exchange Traded Notes ('ETNs'), the latter being based on a note issued by a bank and listed on an exchange, with the holders of the Note due to receive a fixed sum when the note matures. A further variant is a portfolio combining passive and actively managed investments holdings. This is not unusual for IFAs providing discretionary portfolio management primarily to a retail investor client base, when a factor may be that the reduced management fee at the

[85] Both examples assume that the AP will have 'hedged' the risk of market movement in the index so that the AP is unaffected by the index price rising or falling.

[86] Or is the entity responsible for the computer also responsible for the results, including if these indicate the software is producing inappropriate preferences? Simon Degeling and Jessica Hudson, 'Financial Robots as Instruments of Fiduciary Loyalty' (2018) 40 Sydney Law Review 63.

[87] Matthew P. Erickson, *Asset Rotation: The Demise of Modern Portfolio Theory and the Birth of an Investment Renaissance* (Wiley 2014).

portfolio level increases the manager's profitability as the reduction is not reflected in any change in the fees paid by the retail investor.

This last category is referred to as 'smart beta' and seeks to add value through strategic decisions on weighting and rebalancing the holdings within an index based on objective factors, in the main statistics derived from publicly available data. Traditional indices base the weighting of a holding based on relative market capitalisation. As a result, holdings in large companies have a larger slice of the index even if the company is considered, whether by a manager or generally, to be over-valued, that is to the market price exceeds what the manager or managers consider to be the intrinsic price. Another example is that small companies have a smaller slice of the index even though their characteristics indicate the potential for rapid growth. Smart beta seeks to overcome this 'size bias' by using objective criteria to calculate different weightings for each constituent in the index.

The ability of computers to calculate the resulting weightings for a specific index almost instantaneously means the manager is not involved in individual stock selection decisions, so significantly reducing the research and analysis involved and thus the level of 'management fee' required to generate a profit. Since the first smart beta fund was launched in 2003 smart beta's share of the total ETP market in Europe has increased from less than 1% in 2005 to approximately 6% in 2020. By the end of 2020, the number of ETPs reached 160 and the total AUM in ETPs had reached EUR63 billion.[88]

The traditional active manager combines fundamental and quantitative analysis to assess the 'intrinsic value' of an investment and then compares this to the market price - and seeks to take advantage of any material difference. This might, for example, be by way of the investment having a greater or lesser weighting in the managed portfolio than in the mandate's reference benchmark or index. An active manager may, in contrast, choose to invest in a company that is not in the index, but which the manager's research indicates has the potential to outperform - and thus add value and provide alpha - to the portfolio performance. The research will typically involve an element of objective

[88] Bruno de Saint Florent, 'Will smart beta ETFs revolutionize the asset management industry?', Performance Magazine 36, September 2021.

statistical analysis based on publicly available financial information combined with research based on human study of the company, its competitors and the current state and prospects of its sector. The fact that objective statistical analysis can rely on computers to a greater extent than research, which relies on human capital, means that the costs involved in the latter are significantly greater. This explains in part why there is a growing tendency to opt for passive or hybrid management, with the reduced fees compensating for the loss of the opportunity to achieve excess performance while also reducing, if not eliminating, the risk of loss exceeding tracking error.

IX - Agency role and 'best execution'

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The strategic asset allocation and model portfolio components of the first two management stages, together with the evaluation analysis of the third can fairly be compared to what is commonly referred to as the manager's 'stewardship' role. The role does not extend to the manager acting as agent, in the sense of a person who has received the power to act on behalf of another thereby binding that other person to a contract as if he or she were themselves making the decisions, but rather describes the process whereby the manager makes decisions as to portfolio content, including a decision not to take action, that could otherwise be taken by the Client but which have been delegated to the manager under the terms of the IMA. The portfolio is kept under regular review and the need for change identified in light of developments both within and external to the portfolio. The manager is not the legal owner of the portfolio but the agency with discretion role provides the power and the obligation to control its content by instructing the custodian to complete contracts entered into by the manager as agent for the Client.

If the review process leads to a decision to change portfolio content the manager then faces another decision - how to implement the change. The obligation is to obtain 'best execution'. This is the legal principle that an agent executing an order for his principal must provide the most advantageous transaction that the prevailing circumstances permit. The principle is, as the FCA has set out in guidance, 'relevant to all firms which execute, receive and transmit or place orders for execution, including portfolio managers'.[89] The effect is that the manager, when deciding how to implement the change, must seek to obtain the best price for the portfolio taking into account all the associated transaction costs and circumstances, as well as the price actually achieved. This was further described as requiring that the firm 'take all reasonable steps' to obtain the best possible result for the client, taking into account price, costs, speed and likelihood of execution and settlement, size, nature or 'any other consideration relevant to the execution of the order', which include the opportunity to get a better price than what is currently quoted, for example on another trading venue. When a suitable offer is identified the execution process will involve the manager entering into contracts as agent for the portfolio owner in the 'agency role'.

That price is not the only issue relevant to best execution can be illustrated by example. If a manager wishes to acquire shares and is offered a price by one broker that is less than offered by another the transaction would not satisfy best execution if the fees of the first broker exceeded the fees of the second by an amount greater than the price differential. If the transaction costs of dealing with the first broker were less than those of the second, for example because the second had access to a different trading venue, then this would also be an issue to be taken into account. A further factor to be taken into account before deciding which option to choose would be if the second venue was less liquid than the first so that the probability of successfully executing an order of the relevant size was less. The underlying problem is that the implementation decision is taken before implementation and it will be impossible to ascertain, except possibly but not certainly with hindsight, whether a 'better' deal for the investor could have been obtained.

Other more complex risks include obtaining a beneficial price on one transaction leading to the market price rising, perhaps because the initial transaction and the enthusiasm it indicated for the issuer in an otherwise dull (low volume) market for the subject shares leads to an upsurge in demand and an increase in price for other pending orders. If a large order is split into its smaller parts with the instructions divided between brokers and speedily given the result may be similar, although if the order had been

[89] Financial Conduct Authority, 'Investment managers still failing to ensure effective oversight of best execution' (FCA, March 2017).

spread over time a better result may have been achieved (as could have a worse result, for example if bad news concerning the issuer was made public in the interim). There is also a dilemma for the manager if separate clients are seeking to buy and seeking to sell, though an 'agency cross' at the prevailing market price will often, if not always (as further explained in Chapter 3), provide a solution with transaction costs reduced and the uncertainty that an independent counterparty cannot be found removed.

In practice 'best execution' can only be monitored *ex post*, with future implementation policy taking into account to the greatest extent possible evidence of past performance. With study of appropriate data, a preferred execution method for a trade that is similar to a trade previously executed should emerge, though this will always be subject to market conditions, while portfolio objective and benchmark may also be relevant. While it is difficult to identify a failure to achieve best execution, let alone specify how it can be achieved, it seems clear that without evidence as to past results measurement is not just difficult but impossible.

ESMA conducted a review of best execution in Europe in 2015 and concluded that the level of implementation of best execution provisions, as well as the level of convergence of supervisory practices by regulators in the European Union, was relatively low.[90] The review led to new regulatory requirements being introduced from January 2018 as part of MiFID II.[91] These substantially expand the processes that 'best execution' requires, in particular the records that must be kept and made available to the FCA, the need for these to include methods for measurement so that differing options can be compared and the need for flexibility. The methods used for measurement must be reviewed on regular basis and where necessary updated to take into account technological advance and changes in market practices. This is not least so that the charges that portfolio owners are required to meet can be justified: it is difficult to justify a decision to implement an order in a particular manner if the manager is unable to refer to data supporting the choice.

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[90] European Securities and Markets Association ('ESMA'),'Peer Review Report on Best Execution under MiFID' (ESMA, 2015/494).

[91] The reporting obligations are extensive and are summarised in the tables contained in the regulations MIFIR Reporting, MiFID Commodity Position Reporting, EMIR Reporting, MIFIR Trade Publication and MIFIR Reference Data Reporting, all published by ESMA and referred to collectively as 'MiFID II'.

While the legal obligation to provide 'best execution' is clear what is required to satisfy the obligation is less so. This results in grave difficulty in establishing a failure, let alone a causal link between a manager's implementation of a decision to change portfolio content and loss to the portfolio. The newly enhanced reporting obligations and the possibility of regulatory enforcement may assist the protection of the investor by highlighting methods for reducing unnecessary or inappropriate transaction costs. ESMA recognised this and issued guidance that the overreaching requirement should not be interpreted to mean the best possible results.[92]

The underlying problem is that the implementation decision must be taken before implementation and it will be impossible to ascertain, except possibly but not certainly with hindsight, whether a 'better' deal for the investor could have been obtained. The legal issue is thus whether the manager had applied the appropriate level of knowledge and skill to the decision how to implement the order, a subject discussed in Chapter 4.

X - The IMA: principal terms

This section contains a description of the principal terms that will be contained in an IMA with particular reference to the potential status of the manager as a fiduciary, the reasons for their inclusion and their intended effect. The emphasis is on those terms that are directly relevant to the agency role and the strict fiduciary principle that the manager, as a fiduciary, has a duty to exercise discretion solely in the interests of its principal subject only to such amendment and dilution of the principle as has received the fully informed consent of the principal.[93]

Many regulatory provisions have, in practice, been incorporated into IMAs with the result that the strict fiduciary principle that would otherwise apply is diluted by the contractual terms. In the oft quoted words of Mason J*:*

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[92] ESMA Level 111, Investor Protection 1. Best execution, Question 1 (October 2019).

[93] The contents of this section are based to a significant extent on the author's experience drafting and negotiating IMAs during 35 years as a solicitor in the City of London and New York but are also based on the commentaries and standard forms to which reference is made in this and other sections of this Chapter.

'That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations, it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties'.[94]

A regulatory requirement that an authorised investment manager provides a written statement of the material terms and conditions of the appointment to each of its clients was first introduced as part of the original conduct of business rules that came into effect in 1988 under the auspices of the Investment Management Regulatory Organisation ('IMRO'). IMRO was one of the self-regulatory organisations - or 'SROs' - introduced pursuant to the FSA 1986 and was subsequently absorbed into the Financial Services Authority in 2001 as part of the changes introduced by FSMA 2000.[95] Since then the similarity in the content and format of IMAs, as well as the growth in prescriptive regulation, has led to the development of 'standard terms and conditions' that form the basis for the vast majority, if not all, IMAs to which a FCA authorised discretionary portfolio manager is a party and which are, for practical purposes, 'different but very much the same'.[96] The issuers of standard terms range from individual groups to industry bodies, with the most prominent in the UK the Investment Association (formerly the Investment Management Association), the trade association for UK based investment managers.[97]

One result is that IMAs typically follow a standard pattern even if, in practice, the language, clause titles and order may differ depending on the specific discretionary

[94] Per Mason J in his oft quoted dissenting judgment in *Hospital Products Ltd v U.S. Surgical Corp* (1984) 156 Commonwealth Law Reports 41 at 97, 55 ALR 417 at 454/5; *Kelly v Cooper* [19993] AC 205 at 215; *Hilton v Barker Booth & Eastwood (a firm)* (2005) 1 All ER 651; (2005) 1 WLR 567 at 30; *F&C Alternative Investments Ltd v Barthelemy (No. 2)* [2012] Ch 613 at 224; M Leeming, 'The Scope of Fiduciary Obligations: How Contract Informs, But Does Not Determine, the Scope of Fiduciary Obligations', (2009) 3(3)Journal of Equity 181.

[95] The FSA was split into the FCA and the Prudential Regulatory Authority (the 'PRA') in 2013 as part of reforms introduced after the Global Financial Crisis ('GFC') in 2007/8.

[96] Model Discretionary IMA (n 78), introduction.

[97] Ibid.

manager or group and the other services provided by the manager's associates. This section describes a number of terms that can be expected in any IMA, with the only major difference being between an IMA involving retail investors, directly or indirectly through a holding in a CIS, and an IMA for a professional investor, or investors (including through a CIS). The relatively few retail investors who are party to an IMA will almost invariably use a standard form provided by the manager and this or a modified version will also be the case for a majority of professional investors.

Investors with substantial assets or linked to a public body, for example a pension fund for public sector employees, may provide and insist upon their own standard form template. This will also be the case where an investor has opted for 'fiduciary management'. This is an arrangement, initially introduced in the Netherlands, whereby an investor delegates all investment decisions to a 'fiduciary manager' that then designs a model portfolio and appoints portfolio managers to manage specific segments. In the UK fiduciary management is currently restricted mainly to insurance companies and pension funds because their future liabilities are easier to identify, thereby enabling actuarial valuation to inform and guide decisions as to changes in investment objectives and calculations as to the extent that additional funds may need to be provided in the short to medium term to reduce the risk that the assets in the portfolio will be insufficient to meet future liabilities. Similar issues tend to be the subject of negotiation, although negotiation, except on the level of the manager's fees, is less common where the client includes, directly or indirectly, retail investors.

For a CIS to be eligible to accept retail investors the CIS must either be a UCITS or otherwise approved by the FCA for retail investment, either, if open-ended[98] as a Non-UCITS Retail Fund (or 'NURS') or if closed-ended[99] by its securities being listed on the London Stock Exchange. The open-ended funds available to the retail investor are

[98] An open-ended scheme gives an investor the right to redeem its investment from the scheme's portfolio at a price based on its proportionate interest: a closed-ended scheme investor may only be able to realise at a secondary market price.

[99] A closed-ended scheme will be an Alternative Investment Fund, or AIF, regulated under the AIF Marketing Directive ('AOFMD') within the EU. Although structured as a company the closed-ended vehicle for retail investors in the UK is referred to, for historical reasons, as an investment trust.

commonly referred to as 'regulated funds'[100] although all regulated and many unregulated funds will have an IMA with the investment manager that will follow the standard format described in this section. Whether a CIS that is restricted to investment by professional investors will be party to an IMA will depend on the structure and jurisdiction chosen for the investment vehicle. This is a specialist subject outside the scope of this thesis but there may be occasions when such a vehicle appoints a portfolio manager and thus the contractual nexus includes an IMA. Other structures may not require an IMA, for example if investment decisions are taken by the general partner of a limited partnership or a specified member or members of a Limited Liability Partnership, or by a committee nominated by the participators. These cases are strictly proprietary investment but may include an investment advisory agreement. A feature of the industry is that a number of jurisdictions have introduced investment structures into their domestic law designed specifically to encourage use by international investors and as a result provide local employment in fund administration as well as advisory and management roles.[101]

A further complication where the IMA client is a CIS is that the CIS may or may not have separate legal personality. Where the CIS is a legal entity it will be the Client and the entity to which the contractual duties, fiduciary or otherwise, are owed: alternatively, the investors in the CIS may be collectively the client. In the UK and other jurisdictions the client may well be a trustee - the unit trust is the most common example, with the trustee the legal owner of the portfolio and the investors holding units that provide rights set out in the Trust Deed and holding, on a collective basis, the beneficial interest in the portfolio.[102] The network of relationships within the unit trust structure is complex as the portfolio manager is party to an IMA with the trustee, which is typically an associate

[100] Strictly speaking regulated funds include funds regulated by another regulator within the EEA but recognised by the FCA under s.264 FSMA and funds regulated by a regulator outside the EU but recognised by the FCA under s.272 FSMA, in each case as satisfying the criteria for eligibility for direct investment by retail investors.

[101] Recent vehicles introduced with a design specifically designed to attractive collective investment include the Irish Collective Asset-management Vehicle or ICAV, introduced in March 2015 under the Irish Collective Asset-management Vehicle Act 2015 (the 'ICAV Act') and the introduction of the Singapore Variable Capital Company ('VCC") under the Variable Capital companies Act 2020.

[102] In the UK an authorised (by the FCA) unit trust is a 'regulated fund' eligible for direct investment by retail investors, with unauthorised unit trusts used by some non-retail investors, often by charities though many now prefer the simpler FCA authorised Charitable Authorised Investment Funds ("CAIFs")

of the manager, owing fiduciary obligations, as the trustee, to the investing unit holders (who are the beneficiaries of the trust).[103] In the latter case the obligations of the trustee will include seeking redress against the portfolio manager for breach of the IMA if the trustee considers that this is in the best interests of the investors.

An IMA will contain, normally close to the beginning, a statement that the Manager will provide discretionary investment management services in accordance with the investment mandate, as well as provide any other appropriate ancillary services, including those that fall outside the agency discretion. The range of contracts that the Manager is authorised to enter as agent for the Client will also be specified.[104] This is typically wide ranging and normally ends with a 'catch-all' provision that authorises the manager 'generally to enter into any kind of transaction or arrangement' that the manager considers appropriate or necessary to carry out its role. It is also likely that there will be an express statement that the Manager may provide information to the Client, including investment research and financial analysis, but this will in no circumstances constitute investment advice.

The list of authorised actions will then be followed by a series of orders and instructions that the manager is authorised to give as agent, including to the party responsible for safe keeping of the Portfolio (the 'custodian'). Financial assets in the form of contracts do not need completion by the custodian, but this may be required by the Client and will in any event require notification to the custodian so that it can maintain accurate records of portfolio content and activity. The contracts that the manager may enter on behalf of the Client will also extend to ancillary agreements necessary to achieve certain types of transaction, for example to permit investment in derivatives or to deal in overseas markets. There will again be a catch all final section, typically permitting the manager to take any action that the manager 'reasonably considers to be necessary, desirable or incidental to carry out the services specified under the IMA'

[103] *Barclays Wealth Trustees (Jersey) Limited & Another v Equity Trust (Jersey) Limited & Another* [2014] Jersey Royal Courts 102D holds out the possibility that in some circumstances the manager might owe fiduciary duties to the unitholders despite the lack of any contract between them, but the case concerned an unsuccessful application to strike out a claim at a preliminary hearing and any duties would be outside the manager's role as an agent with discretion – and thus outside the scope of this thesis.

[104] Model Discretionary IMA (n 78) cl 5.

The standard of care, the level of knowledge and skill that the Manager is obliged to apply in the stewardship and agency roles,[105] will be expressly described. This is primarily in order to prevent any argument that the duty extends beyond the duty that the manager considers applicable, for example to include a special skill or level of knowledge to which the manager has not agreed.[106] In some contrast to the regulatory duty to act honestly, fairly and professionally in the best interests of the client,[107] the IMA will normally include an express duty to act in good faith that applies only when providing portfolio management services and does not extend beyond the exercise of the managerial discretion. This obligation to act reasonably within the duty of care is, however, the means by which the FCA regime of rules and guidance is incorporated into the IMA.

The existence of regulations or a code of conduct applicable to those carrying on a business does not, of itself, create a common law duty of care where none otherwise exists.[108] Where a party provides professional services and owes a duty of care as a result, however, the duty can be expected to include compliance with the regulations applicable to the provider.[109] The Courts can also be expected to 'attach considerable weight' to the content of Codes drafted by those concerned with the maintenance of proper standards.[110] Compliance with FCA regulation is mandatory while FCA guidance describes what the FCA considers to be 'best practice' and thus compliance will represent, albeit not exclusively, what it is reasonable for an investor to expect in the ordinary course, that is absent unusual or exceptional circumstances.

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[105] The duty is to perform 'reasonably' in the absence of an express description in the IMA Sale of Goods Act 1982, s.13.

[106] Model Discretionary IMA (n 78) cl 6.

[107] FCA Handbook COBS 2.1.

[108] *Green v Royal Bank of Scotland* [2013] EWCA Civ 1197, [2-14] Bus LR 168.

[109] *O'Hare v Coutts & Co.* [2016] EWHC 2224 (QB).

[110] *Gorham v British Telecommunications* plc [2000] EWCA Civ 234, (2000) 1 WLR 2129.

The potential for clash between regulation and the common law has been an on-going topic for debate, though rarely addressed in judgments.[111] The contrast is between regulation that specifies what outcomes the investor is entitled to expect and the common law duty of care that considers what the reasonable manager can be expected to provide. The Law Commission was asked to examine the relation between regulation and fiduciary duty as early as April 1990.[112] Its preliminary conclusion was that statute should be passed providing for the Courts to have regard to regulations when assessing fiduciary duties, though at the time a major issue was the status of rules made by Self-Regulatory Organisations which were not public bodies.[113] This recommendation was dropped in the final report[114] after the Privy Council upheld the principle that terms could be implied in a case concerning Bermudan estate agents in a judgment in which made specific reference to stockbrokers being permitted to receiving information from a client that was kept confidential from other clients without any express term allowing this.[115]

The lack of legal precedent reflects that complaints by retail investors rarely reach the Courts. They are instead settled by the FOS on a basis of what is 'fair and reasonable,' with the law to be taken into account but not binding.[116] Another factor is that the Statutory Claim is available only to retail investors, with the implication that such a breach does not give a professional investor a cause of action. The comment, in a 2001 judgement in a case concerning limitation periods,[117] that, following the Financial Services Act 1986, a financial practitioner could be found to have been negligent notwithstanding many practitioners would have provided a similar standard of advice, seems premature. It was suggested, in the subsequent Parliamentary enquiry, that the

[111] See e.g. Jenny Hamilton, 'Negligence in the corridor? Interaction between "separate rooms" of regulation and the common law in financial services' (2007) 23(3) Tottels Journal of Professional Negligence 134; Julia Black 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilis Ferran and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015), ch 8.

[112] Law Commission, 'Fiduciary Duties and Regulatory Rules' (Law Com No 236, 1995), para1.1.

[113] Law Commission, 'Fiduciary Duties and Regulatory Rules'(Law Com CP No 124, 1992).

[114] Law Commission, 'Fiduciary Duties and Regulatory Rules' (Law Com No 236, 1995).

[115] Lord Browne-Wilkinson in *Kelly v Cooper* [1993] AC 205, 214.

[116] Financial Services and Markets Act 2000, s.228(2).

[117] *Loosemore v Financial Concepts* [2001] Lloyds Rep PN 235.

failure of the managers and brokers involved in the split capital investment crisis to warn investors of the risks of contagion if the trusts were heavily invested in each other was not negligent when few if any advisers had identified the risk, either at all or as worthy of disclosure.[118] This may well have contributed to the FSA agreeing to a settlement with the principal managers and brokers involved on the basis of no finding of fault but the voluntary establishment of a fund to compensate investors, even though estimates of the losses involved were a multiple of the fund. The position is probably best summarised in a judgment which accepted that common law duties are not necessarily co-extensive with duties owed under the regulatory regime but regulations provide strong evidence of what is expected of a competent adviser in most situation.[119]

There is then likely to be a clause that clarifies that breach of the restrictions in the investment mandate for reasons outside the control of the Manager, that is 'inadvertent' breach as discussed in section VII, is not a breach of the IMA. There will also be an express statement to the effect that the Manager gives no warranty, assurance or undertaking as to any aspect of the performance of the portfolio, including the achievement of the targets or investment objectives included in the mandate. The manager is thus responsible the way decisions are taken and the level of skill and knowledge and skill applied but not the value of the portfolio that results.[120]

There will be a selection of clauses dealing with the power of the manager to contract as agent for the portfolio owner, including to enter into contracts ancillary to, but necessary if the manager is to be in a position to undertake, the role of agent. This might, for example, include the manager appointing an overseas agent to act on the Client's representative on an overseas exchange, to include making regulatory returns. This essentially acknowledges that the Client is responsible for the consequences of the manager complying with the rules of any exchange and market practice even if the portfolio suffers loss as a result. The same applies as long as the manager complies with

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[118] Andrew Adams, *The Split Investment Trust Crisis* (Wiley 2004), 135.

[119] *Seymour v Ockwell* [2005] EWHC 1137 (QB); *SPL Private Finance (PF1) IC Ltd v Arch Financial Products LLP, SPL Private Finance (PF2) IC Ltd v Farrell*[2014] EWHC 4268 (Comm).

[120] Model Discretionary IMA (n 78) cl 7, schedule 2.

its written policy for the execution of orders where more than one managed portfolio is engaged in a similar transaction, as described in chapter 3.[121]

The suspension of Halliday Simpson from the London Stock Exchange, in July 1981, after an investigation indicated that the firm had allocated transactions to clients on a preferential basis, was a precursor to regulation designed to prevent such action being undetectable.[122] The clause will also provide that the manager is not responsible for a counter-party default unless the choice of counter-party was negligent; and that the Client will meet the costs incurred by the Manager seeking to ameliorate the result of such a default, although this will not extend to the Manager commencing litigation on the Client's behalf, which is typically covered in a separate clause.

There will normally be express permission for a breach of the investment mandate to be cured by a transaction in which the manager deals as principal (i.e. the manager acquires the offending investment(s) as principal, known as a 'reverse trade').[123] There will also be reference to the circumstances in which a transaction as agent for the client will need to be disclosed, for example as part of mandatory transaction reporting under the MiFID 11 or FCA rules; and a requirement for the Client to provide its Legal Identity Identifier ("LEI") so this can be attached to orders. The LEI is a relatively new development and is designed to enable regulators to identify parties to suspicious trades more easily as part of the shift to transparency after the GFC. The FCA rules also provide that some transactions must be made public[124] and there will be an acknowledgement in this clause that the manager will comply with this obligation even if the client wishes to retain anonymity, with the manager's duty of confidentiality amended accordingly.[125]

The duty of confidentiality and its relationship to fiduciary duty has been a source of debate for many years, although the modern view is, at least for the purposes of English

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[121] Ibid cl8, 9 and 10.

[122] Julian Franks and Colin Mayer, *Risk, Regulation and Investor Protection* (Clarendon Press1989), 107.

[123] Model Discretionary IMA (n 78) cl 10.6.

[124] FCA Handbook: Code of market conduct ('MAR') 7.2.

[125] Model Discretionary IMA (n 78) cl 10.7, 10.8.

law, that confidentiality obligations are better analysed as arising separately from fiduciary duty.[126] The reason is that this is not a duty restricted to fiduciaries,[127] even though fiduciaries will generally owe such a duty, with the duty better analysed as based on good faith rather than proprietary or contractual rights.[128] Other differences include the survival of a duty of confidence until information is no longer confidential,[129] potentially many years after the fiduciary relationship has ended - and the reason why a number of the past clients of the author are not identified in this thesis. What seems clear is that a duty of confidentiality can arise in circumstances where the relationship between the parties is not fiduciary in nature,[130] although this of itself does not preclude a different, for example enhanced, level of duty owed by a party who is a fiduciary, or a duty breach of which may make certain 'equitable remedies' available against a defendant that is a fiduciary which are unavailable against a defendant that is not.

The next clause will also concern payments by, directly or indirectly, the Client, including by deduction from the portfolio.[131] The management fee will often be described in a separate schedule[132] with only a brief mention in the main IMA text. This is all but invariably the case if the fee includes a performance element as the drafting of a performance fee formula to cover every eventuality means the less complex the formula the greater the chance that a market movement will not be catered for unambiguously. The existence of a separate schedule often reflects that negotiation of the management and 'performance' fee will be a significant part of the pre-contract discussions, with the terms and formula often negotiated and drafted separately - and provided to the legal advisers at a late stage in the negotiating process.

[126] *Arklow Investments Ltd v Maclean* [1999] UKPC 51, [2000] 1 WLR 594, 598

[127] *Douglas v Hello! Ltd (No. 6)* [2005] EWCA Civ 595, [2006] QB 125.

[128] *Fraser v Evans* (1969) 1 QB 349, 361.

[129] M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart 2011) p 241 et seq.

[130] Ibid ch 9 iiiB.

[131] Model Discretionary IMA (n 78) cl 12.

[132] Ibid schedule 3.

This clause will set out that the Client shall 'also' (i.e. in addition to the management fee) bear (i.e. pay by deduction from the portfolio) (i) all costs incurred by the manager in the course of providing services to, and acting as agent of, the Client including all direct and indirect costs of any and all transactions for the account of the portfolio; (ii) all costs and fees payable in connection with arrangements associated with restructurings or similar arrangements affecting investments in the portfolio (typically incurred following a default on a debt instrument); (iii) all costs and expenses incurred in litigation that fall within the clause covering litigation (see below); and (iv) any costs relating to the termination of the IMA, again as described in the relevant clause (see below). This is an area where there are frequent suggestions that the costs of discretionary portfolio management are not fairly disclosed as the clauses are generalised rather than specific and thus the amount that is deducted from the portfolio for costs is often difficult to discern or to compare, in particular for retail investors. Following a review in 2019, the FCA introduced new regulations which include a requirement to provide investors with an annual statement of costs on demand.[133]

There will also often be a reference to custodial and banking fees being invoiced separately, which is designed to keep the manager as far as possible independent of any disagreement between client and any bank or custodian that does not involve the exercise of discretion by the manager. A provision, introduced under MiFID II,[134] specifies that the manager will provide the Client with the information on costs and charges specified in MiFID II separately from information on any other fees, expenses or charges and in a manner consistent with the relevant regulations.

A clause detailing the relationship between manager and the custodian will follow.[135] This will provide that the manager is not at any time to hold (i.e. be the legal owner of any) assets in the portfolio nor to take responsibility for the acts or omissions of the custodian; that the Client is to instruct the custodian (i) to act in accordance with instructions from the manager, (ii) to provide the manager with portfolio statements and

[133] FCA Handbook: COBS 6.4.3.

[134] MiFID 11, Article 24.

[135] Model Discretionary IMA (n 78) cls 13 and 18.

access to the custodian's records concerning the portfolio, (iii) to give the manager or any third party agent the manager has instructed for the purpose (such as a third party voting agent) warning and details of the potential to exercise voting or other rights attached to investments in the Portfolio, (iv) to comply with the instructions of the manager when notice to terminate the IMA has been given – the subject of paragraph 10.18 below, (v) to advise the manager as soon as practical of any withdrawals, debits, additions or credits to the portfolio, and (vi) to pay fees, costs and expenses in accordance with instructions of the manager. A common feature is for professional investors to require that fees payable to the manager or any associate receive the Client's prior consent.

The clause will then clarify that the books and records kept by the custodian are the official records of the client, with the consequence that the records kept by the manager are the property of the manager with no right of inspection for the client, only the right to information expressly specified elsewhere in the IMA. This is an important clause has it establishes that the role of agent in contracting for the portfolio owner is achieved through the instructions given by the agent to the custodian to complete the transactions which the manager has entered into as the agent of the portfolio owner. The records as to the exercise of the manager's discretion are the records kept by the custodian, which has control over the portfolio and records the changes in portfolio content and the transactions required to achieve this. The clause represents a modification of the fiduciary's duty to account which would include, absent agreement to the contrary, the right to inspect the records that the fiduciary would be required to keep of its actions taken in the fiduciary capacity.[136]

There is thus no right for the Client to inspect, for example, the records of the manager kept in accordance with FCA regulations, which will accordingly not be released until a dispute reaches the discovery stage of litigation. The practical consequences are well illustrated by the only significant settlement involving a claim by a split capital investment trust against its manager in the course of the split capital investment crisis. A settlement involving the manager paying £49.7 million was announced less than ten days after announcement of the Court of Appeal decision that internal documents shared with

[136] *Khouj v Acropolis Capital Partners Ltd* [2016] EWHC 2120 (Comm).

the then FSA as part of an FSA investigation into possible misconduct were disclosable in the litigation that had been proceeding for a number of years.[137]

This provision also means that the manager has no responsibility for the accuracy of the 'official records' or for any periodic reconciliation, for example for audit purposes.[138] Further provisions deal with an obligation on the Client to give 'reasonable prior notice' to the manager of any pending change of custodian. This reflects that a change of custodian is often a complex logistical matter, particularly if the portfolio holds investments in multiple jurisdictions. Finally the manager will want to include a clause to the effect that any exercise of voting or similar powers is undertaken on the basis of the information sent to it in its capacity as holder of the relevant information and not on the basis of any other information of which the manager may be aware (for example confidential information received from or when acting for another client) or could obtain by further investigation. The express term removes any need to rely on terms that might otherwise have to be implied.[139]

Clauses will then set out that the manager is not responsible for the selection of any entity with which cash is deposited absent agreement to the contrary and any borrowing powers included within the agency authority, although borrowing to gear the portfolio will normally be specifically covered in the mandate.[140] The clause will typically deal only with borrowing for short term liquidity, for example where there is a transaction mismatch or completion is delayed or fails and it takes time to sort out (between the brokers or other agents for the two counter-parties) and any 'unforeseen circumstances consistent with the efficient management of the portfolio' although this is

[137] *Real Estate Opportunities Ltd v Aberdeen Asset Managers Jersey Ltd* [2007] EWCA Civ 197, (2007) 1 Bus LR 971; see also *Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2015] EWHC 1557 (Ch), (2016) 1 WLR 361.

[138] Values of assets and liabilities shown in books will often differ from the values when calculated for accounts or audit purposes, for example because of provisions for bad debt and differences between the due date for payment and the date of actual receipt.

[139] *Kelly v Cooper* [1993] AC 205; *Rossetti Marketing Limited & Another v Diamond Sofa Company Limited* [2012] EWCA Civ 1021, [2013] Bus LR 543.

[140] Model Discretionary IMA (n 78) cls 14 and 15.

subject to negotiation and a client may require, for example, notice of any such circumstance as soon as 'reasonably practical'.

If the manager is to be permitted to use derivatives the detailed provisions will be included as a separate schedule, if only for administrative convenience given the complexities and ancillary contracts such dealings involve, the requirements for collateral and the possibilities that losses on a derivative transaction may exceed many times the initial sums invested and that the counterparty may default. The schedule will likely also contain details of any arrangements for securities lending which involve the manager, including any limits on the proportion of any specific security that may be lent (and thus exchanged for a secured obligation to 'return' an equivalent security at a specified time or on demand), a topic discussed further below. There will also be a cross-reference in the investment mandate as these provisions effectively include investment restrictions.[141]

There will be provisions dealing with the exercise of voting rights that arise in respect of any of the holdings in the portfolio, for example that the manager may exercise these at its discretion unless the Client orders otherwise. The manager will be authorised to bind the Client to any corporate action that is a consequence of any vote, while also expressly acknowledging that the manager has no liability for exercising or failing to exercise voting rights and may be unable to verify whether the custodian has passed on details of any exercisable voting rights to the Manager or any third party in a timely manner.[142]

The argument that shareholder participation is in the public interest is an example of the interests of the Client being potentially prejudiced in the interests of investors as a whole, in effect the public interest. Concerns raised in the aftermath of the GFC led to the introduction of the UK Stewardship Code, published by the Financial Reporting Council, which calls upon asset managers to ensure the exercise of voting rights attached to securities in their managed portfolios. The Code sees this as part of the manager's role of 'enhancing and protecting the value [of the holding] for the value of the ultimate

[141] Ibid cl 16, 17 schedule 4.

[142] Ibid cl 19.

beneficiary' but makes no mention of achieving or maximising 'shareholder value'. The Code is not compulsory, although an investment manager is required to include a statement whether or not it complies with the Code on its website and an explanation of the reasons if it does not. This notice will also be referred to in the IMA, with the combination presumed to constitute the client's consent to compliance with the Code notwithstanding the argument that the Client's best (financial) interest would be served by the manager taking no action or abstaining (so preserving resources that might be used to improve portfolio performance).[143]

Environmental, Social and Governance are commonly referred to as 'ESG' factors in investment decision-making and are an interesting example of the uncertainties surrounding fiduciary duties and the extent to which social goals should be considered as part of the duty. ESG describes a series of criteria against which socially conscious investors measure a company's operations when deciding whether or not to invest. Environmental criteria consider a company as a steward of nature. Social criteria examine relationships with employees, suppliers, customers and the communities in which it operates. Governance deals with a company's leadership, executive pay, audit and internal controls and shareholder rights. In the past ESG investing was, and sometimes still is, referred to as sustainable investing, responsible investing, impact investing, or socially responsible investing.

A concern was that, in taking ESG into account, the investor was, intentionally or not, running the risk of eliminating profitable investments that did not satisfy the investor's non-financial goals. While this is a matter of choice for the investor, the issue becomes more difficult when taking decisions for third parties as fiduciary duty requires that financial returns be the objective unless the portfolio owner had given 'fully informed consent' to an alternative.

The uncertainty, in English law, is in part the result of an absence of cases since the 1985 judgement of Megarry VC in *Cowan v Scargill*[144] with the decision – that the key

[143] Ewan McGaughey, 'Does corporate governance exclude the ultimate investor?' (2016) 16(1) Journal of Corporate Law Studies 221.

[144] [1985] Ch 270.

to satisfying fiduciary duty is the objective pursuit of financial returns, although this is not necessarily paramount – given an importance that Megarry himself questioned as early as 1989.[145] His view was reinforced by Lord Murray in *Martin v City of Edinburgh District Council*, who strongly disagreed that trustees have 'an unqualified duty simply to invest trust funds in the most profitable investment available'. [146]

The continuing absence of any clear authority or specific prescriptive regulation overruling the judgment in *Cowan* has led some advisers to continue to caution against taking ESG into account unless a direct relationship can be shown between the ESG factor and the financial performance of the investment. This might include the risk of an oil spill causing damage to an oil company;[147] or the risk that a ban or restriction on fossil fuel extraction might lead to a write-down in the value of the assets within which the unextracted fuel is held.[148]

In practice the issue, in the context of discretionary portfolio management, is almost invariably settled by a suitable disclosure of the role that ESG will play in the manager's analysis of investments, both potential and already in the portfolio. If ESG analysis would breach the fiduciary duty a suitable inclusion in the IMA evidences the portfolio owner's consent, with fully informed consent required only if the provision is included after the fiduciary relationship has commenced.[149] If fiduciary duty is not an issue the IMA term simply reflects what the manager has agreed to undertake as part of managing the portfolio. The uncertainty is thus confined, in practice, to the increasingly rare case where the manager is appointed to manage the complete portfolio of a pension

[145] Sir R Megarry, 'Investing Pension Funds: The Mineworkers Case' in TG Youdan (ed) *Equity, Fiduciaries and Trusts* (Carswell 1989) 115.

[146] [1989] PLR 10, [1988] SCLR 90 at 134.

[147] For example, the Deepwater Horizon oil spill in 2010 led to substantial losses for BP and a significant fall in its share price.

[148] See e.g. T Dordi and O Weber, 'The Impact of Divestment Announcements on the Share Price of Fossil Fuel Stocks', (2019) 11 Sustainability 3122, at www.mdpi/com/journal/sustainability (accessed July 25, 2021).

[149] P.105 et seq.

fund or trust and therefore takes on the fiduciary duty of the trustees.[150] Not least this reflects that expressions such as 'fiduciary duty', 'fiduciary standard', and 'fiduciary principle' are often used interchangeably and the meanings differ depending not only on context but also the applicable jurisdiction.[151]

Furthermore the increasing evidence of extreme weather events linked to climate change and the growing acceptance of the potential financial consequences in both the short and longer term mean that environmental issues are increasingly relevant to investment decision making. ESG AUM is estimated to have reached $37.8 AUM but the end of 2020 with this seen as likely to continue to grow.[152] Regulation has also intervened, with the FCA requiring managers of retail investment funds to consider ESG factors material to the fund's financial performance as well as to consider non-financial issues that present financial risk or are important to the beneficiaries.[153] The FCA has not provided a definition of ESG, however, on the basis that this will evolve over time, with firms no longer allowed to ignore the concept.[154]

The regulatory landscape has moved on from the requirement, introduced in 2005, to include 'the extent (if at all) to which social, environmental or ethical considerations' are taken into account in investment decisions in a pension fund's investment decisions.[155] Subsequent developments include Professor Kay's 2012 report after he was asked by the government[156] to review whether the equity markets gave

150 The fiduciary 'best interests' duty can be satisfied based on analysis of the aggregate portfolio, with different mandates and risk profiles provided for the separate portfolios as set out in the relevant IMAs.

151 See for example, John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making (HM Government, July 2012); European Commission Press Release March 9, 2019; and the United Nations Environment Programme Finance Initiative (UNEP FI), 'Fiduciary Duty in the 21st century Final Report' (UNEP FI, October 2019).

152 Bloomberg business, 'No niche $50 trillion in ESG assets', press release February 23, 2021.

153 FCA Handbook SYSC 3.2.23 for investment firms, 4.1.15 for pension funds.

154 FCA, 'Independent Governance Committees: Extension of Remit – Policy Statement', FCA 17 December 2019.

155 Occupational Pension Schemes (Investment) Regulations 2005, Cl 3(b)(vi).

156 The Secretary of State for Business, Innovation and Skills.

sufficient support to the developing the businesses of British companies.[157] This included his conclusion that investment management decisions were too often based on short term objectives whereas the interests of business were dependent on long-term objectives and a call for the Law Commission to consider whether change and clarification of fiduciary duties could achieve this. The Law Commission subsequently concluded that, while this might be possible through legislation, it would conflict with the freedom to define investment policy enjoyed by the investor and granted to pension fund trustees by legislation.[158]

Similar suggestions have included that exercising shareholder rights and taking ESG issues into account should form part of an investment manager's 'fiduciary duty' in light of the importance of governance to corporate behaviour and the potential impact of ESG factors on the individual investor as a member of society and not only in financial terms, with regulations to make taking ESG factors into account compulsory for portfolio managers muted at the European level.

The Government's most recent position is that planned new governance duties, which relate to compliance with the Task Force on Climate-related Financial Disclosures ('TCFD') and require pension fund trustees to be able to understand disclosures by investee companies and advice given in relation thereto, will not supersede fiduciary duty. The Government is seeking 'to ensure [pension fund] trustees are able to carry out their duty to deliver returns for their members. Without effective governance of climate-related risks, the retirement incomes of millions of savers are in unnecessary danger. It remains our policy that consideration of investment impacts on the planet, or other environmental impacts are only required to be taken into account by trustees insofar as they are a financially material risk to the scheme'.[159]

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157 The Kay Review (n 151).

158 Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No 350. 2014); Christopher D Stears, 'Will a "fiduciary standard" Assist in Delivering Better Stewardship and Engagement?' (2014) 36(3) Comp Law 71 -76.

159 DWP, 'Consultation Outcome, Taking Actions on climate risk: importing governance and reporting by occupational pension schemes' (Department of Work and Pensions,21 July 2021).

Perhaps the best summary remains that contained in the 2015 CFA report which concluded that including ESG factors within investment analysis would not, of itself, breach fiduciary duty.[160] At the same time, as including ESG factors in investment mandates become increasingly common it may not be long before this becomes industry practice, with ESG analysis, however described, coming to be seen as a feature that a reasonable manager would be expected to employ, at least absent agreement by the portfolio owner that this should not be the case. It is also fair comment that not only is ESG a rapidly developing field,[161] but also a major concern of investment managers in the context of ESG is the costs involved in satisfying the detailed requirements of the differing disclosure regimes being introduced around the world.[162]

Reference has already been made to the provisions concerning conflicts of interests and the modification of the prohibitions on conflicts of interests and unauthorised profits. This topic is considered in detail in the subsequent chapters. The effect is, in broad terms, to modify the fiduciary principle to permit conflict of interests provided the manager takes reasonable steps to treat the Client fairly, with the relevant regulatory provisions evidence of, but not conclusive as to, the steps that a Client might reasonably expect the manager to take, although in some circumstances variation is potentially permissible. The reasons why the IMA uses this variation of the duty of care rather than incorporate the FCA regulations include to prevent a minor breach of the rules taking the manager outside the waiver of the strict fiduciary prohibitions and thereby allowing the Client to argue that the result is a breach of fiduciary duty and thus of the IMA even if the Client has suffered no loss.

Breach of the FCA regulations may also lead to enforcement proceedings and provide a retail investor with a claim for damages[163] to which causation and remoteness principles will apply, but it will not, of itself be a fiduciary breach. FCA guidance also

[160] U Hayat CFA, M Orsagh CFA, CIPM, *CFA Institute Guide for Investment Professionals*(CFA October 2015).

[161] Iris Chiu, 'Investor stewardship and ESG at companies- new developments', (2020) 41(6) Company Lawyer.

[162] See e.g., David Ricketts, 'Asset managers should brace for enormous risks of ESG costs', *Financial News* (16 March 2021), at <https://www.fnlondon.com/articles/asset-managers-should-brace-for-enormous-risk-of-ESG-costs-20210316> (accessed .2021).

[163] S.138D Financial Services and Markets Act 2000 (as amended).

specifies that there is no conflict if there is no risk of loss to the Client, but this is also only guidance, albeit the Courts would likely take this into account, while not being bound, when deciding whether a conflict of interest had arisen in the context of investment management.[164] The reference to taking reasonable steps to treat the Client fairly rather than treating the Client fairly reflects that views will often differ as to what is 'fair', which is often a subjective rather than objective judgment and thus difficult to judge. Whether steps that a manager has taken are reasonable is, in contrast, an objective test which is common legal practice.

The prohibition on unauthorised profits that is the second limb of the legal form of the fiduciary principle is severely diluted by the clause providing that the manager is not liable to account for any profit or commission made in relation to any transaction undertaken for the portfolio or any connected transaction unless the FCA rules so require. The provision is typically extended to exclude any obligation to provide information relating to any such transaction in the absence of any FCA requirement, but professional investors sometimes require disclosure of details of specified transactions (for example investments in funds managed by the manager or associates of the manager, where fees would typically be restricted to the higher of the two fees). The practicalities of financial services mean that the manager will not receive fees, other than the management fees set out in the IMA, without the Client's written and fully informed consent.

The conflict involved if associates are engaged to provide services to the portfolio is also diluted, with such appointments permitted provided that the manager takes reasonable steps to ensure fair treatment. A general disclosure permitting associates of the manager to provide services in connection with the portfolio is a normal provision even where the manager is an independent company and not part of the group. This means that a merger or acquisition will not necessarily require wholesale amendment of the terms of business of the formerly independent manage. Associates is also defined to include not only companies but also partners in partnerships and similar structures, employees, officers and appointed representatives. The permission is based on the manager taking steps to confirm that an independent service provider could not provide

[164] Model Discretionary IMA (n 78) cl 20.

a better service considering not only price but also the overall efficiency in the portfolio management processes that result.

A clause will follow containing the normal warranty that the Client has the power and authority (to appoint the manager) and specific acknowledgement by the Client that the various disclosures and warnings referred to in the IMA, as well as those separately notified to the client in the course of the IMA negotiation (and, where the client is a retail investor, suitability exercise) have been read and understood. Finally, there will be an acknowledgement that the manager has made no other representation nor given any advice (unless required by FCA rules).[165] It follows that any item mentioned in discussions as to what the manager may or may not undertake is not part of the IMA unless specifically included in the express terms.[166]

A clause concerning 'liability' will follow.[167] In practice the purpose of the clause is to limit the liability of the manager for breach of the IMA. An attempt to exclude liability for negligence if the Client is a retail investor will be invalid considering the statutory liability of the manager for damages caused by breach of the FCA rules and the need for any limitation to satisfy the reasonableness criteria in the Consumer Rights Act 2015. A similar exemption will only be valid against a professional investor where the exclusion is reasonable, which in practice is restricted principally to cases where the Client is a professional investor and the clause is the result of a negotiated agreement between the manager and the Client as to which will bear the cost of damage suffered because of breach by the manager that is not the result of a deliberate act.

The clause will accordingly restrict liability, in most cases, to 'negligence, wilful default or fraud', with the main, if unusual, alternative a restriction to 'wilful default or fraud'. The latter might apply if, for example the manager is small, perhaps a 'start-up' by an individual who has invested successfully for the Client when an employee of a substantial firm and is starting an independent business, when the insurance premium

[165] The FCA rules impose an obligation to assess suitability in all cases where the Client is a retail investor FCA Handbook: COBS 9 A. 2.

[166] Model Discretionary IMA (n 78) cl 21.

[167] Ibid cl 23.

to cover negligence would make the appointment uneconomic (as the manager's costs would be too high for viability). The use of the phrase 'gross negligence' in an IMA is, in practice, unusual because of uncertainty as to its meaning, although in some cases may appear because of negotiation. In such a case the Client will be a professional investor and the compromise may be that its remedy for (only) negligence is limited to terminating the IMA.

On those occasions where there are negotiations the parties may not fully understand the extent to which the difference between 'wilful default' and 'gross negligence' is uncertain. The exact meaning of 'wilful default' has been reviewed in a number of cases which are not entirely consistent.[168] It is, however, clear that the phrase will be interpreted very much in light of the particular circumstances. The manager would have to act deliberately, that is to say with knowledge that the action or omission was, or at least could be, in breach of the IMA. A number of cases add a requirement that the manager was either (i) aware that the act or omission could cause the Client loss but nevertheless decided to proceed or (ii) indifferent as whether loss would result. This additional requirement appears to stem from the judgement of Millett L J in *Armitage v Nurse* , where the Court of Appeal held a clause exempting a trustee from fraud was valid but then defined fraud to include dishonesty that involved recklessness in the terms described above.[169]

As any investment decision, including not to change portfolio content, raises the possibility of loss, these requirements would seem satisfied in every case of deliberate breach by a manager, with negligence restricted to honest incompetence or, perhaps, a reckless failure to consider compliance with the IMA terms (which would seem likely to require very exceptional circumstances).The judgement also upheld as valid an exemption of a trustee for liability for gross negligence, a result that has not escaped

[168] Peter Rother, 'The notion of "wilful misconduct" and its impact on the scope of limitation of liability clauses' (2018) 6 International Business Law Journal 529; *TNT Global SPA v Denfleet international Ltd* [2007] EWCA Civ 405, (2008) 1 All ER (Comm) 97; *De Beers UK Limited v Atos Origin IT Services* [2010] EWHC 3276 (TCC); *National Semiconductors (UK) Ltd v UPS Ltd and Inter City Trucks* (1996) 2 Lloyds Rep PN 212.

[169] *Armitage v Nurse* [1997] EWCA Civ 1279, [1998] Ch 241, 251.

criticism but has received support in the Privy Council, albeit in a case concerned with Guernsey rather than English law.[170]

The meaning of 'gross negligence' is also the source of uncertainty, even if the debate has been described as 'somewhat sterile and semantic'.[171] The traditional approach of English law was to see 'negligence' and 'gross negligence' to be the same, with gross merely a 'vituperative epithet'.[172] As late as 1997 Millett LJ held, also in *Armitage v Nurse*, that no line could be drawn, for the purpose of an exclusion clause, between gross negligence and negligence.[173] In the same year, however, the modern approach began to emerge, with Mance J holding, at first instance, that gross negligence appeared to be capable of embracing 'conduct undertaken with actual appreciation of the risks involved, but also serious disregard or indifference too an obvious risk'.[174] The position remained uncertain and a Government Report in 2007 summarised the position as the term 'not having been developed by the Courts as a concept distinct from negligence'.[175] Four years later the Mance J approach received supported in a judgment that gross negligence required more than mere negligence.[176] This has been supported in a series of subsequent cases,[177] although there remains no established definition and in some cases the use of 'gross negligence' risks being 'linguistic overkill' in the absence of a clearly drafted definition.[178]

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[170] *Spread Trustee Co. Ltd v Hutcheson* [2011] UKPC 13; CF Loi, 'Gross negligence and trustee exemption clauses in the Privy Council: Spread Trustee v Hutcheson' (2011) 6 Conveyancer and Property Lawyer 521, note 2.

[171]Aikens LJ in *Springwell* (n 66) [193].

[172] Baron Rolfe in *Wilson v Brett* (1843) 152 ER 737.

[173] *Armitage* (n 169).

[174] *Red Sea Tankers v Papachritidis (The Hellespont Ardent)* (1997) 2 Lloyd's Rep 547,586.

[175] *Davies Review of Issuer Liability: Final Report* by Professor Paul Davies QC March 2007 published by HM Treasury.

[176] Andrew Smith J in *Camerata Property v Credit Suisse* [2011] EWHC 479,161.

[177] *Winnetka Trading Corporation v Julius Baer International Ltd*[2011] EWHC 2030(ch); *Marex Financial Ltd v Creative Finance Ltd* [2013] EWHC 2155 (Comm), (2014) 1 All ER (Comm) 122; *Torre Asset Funding Ltd Royal Bank of Scotland Plc* [2013] EWHC 2670 (Ch); *Singularis Holdings Ltd (In Official Liquidation) v Daiwa Capital Markets Europe Ltd* [2017] EWHC 257(ch) [2017] Bus LR 1386.

[178] Lewison LJ in *Interactive E-Solutions v O3B Africa* [2018] EWCA Civ 62, [2018] Bus LR 1034, [24].

In the absence of any cases relating directly to portfolio management the uncertainty is even greater, at least in the absence of a clear definition in the IMA. The argument might be that, based on the *Red Sea Tankers* line of cases, ‘gross’ implies negligence that involves both awareness of the risk involved and knowledge that it is unreasonable to take the risk and thus conduct by a manager undertaken with actual appreciation of the risks involved combined with serious disregard or indifference to the risk. The similarities, in the context of discretionary portfolio management, with ‘wilful default’ make it difficult to distinguish between them, with this potentially only possible by way of clear definitions in the IMA.[179]

In contrast fraud is easier to define as it connotes deliberate deception or dishonesty with intent to cause loss or disadvantage to the counterparty.[180] It would take very clear language for fraud to include ‘equitable fraud’, that is failure to perform an equitable duty, for example fiduciary duty, where motive is not relevant and even innocence or acting in good faith is no bar to liability. Not least is the inherent contradiction if the parties have agreed that liability is to attach only where the manager had acted deliberately, so the contract would very careful and detailed drafting to clarify this is what the parties understood and intended.

The clause will continue with a list of express exclusions for damages not caused by manager default as well as exclusion of liability for indirect, special or consequential losses. The effect is that damages are limited to the loss in the value of the portfolio resulting from breach, although liability for ‘opportunity costs’[181] may be expressly excluded. The clause will conclude with a reference to the manager not being liable for losses after the termination of its appointment unless the loss could be shown to be the direct result of acts or omissions before termination; and a final statement that nothing in the clause excludes or restricts any duty or liability that the manager has under FSMA, or, in the case of pension fund investors, the Pensions Act 1995. Case law suggests that the exclusion of equitable remedies for fiduciary breach is valid, though only if suitably

[179] Christopher J Arnott, ‘A sterile and semantic debate about negligence’ (2020) 36(1) Pension News 19,32.

[180] *Smith New Court Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1996] UKHL 3, [1997[AC 254.

[181] The loss of the opportunity to make gains from the investment of money wrongly invested.

worded and in an IMA with a professional investor.[182] The exclusion would, however, be invalid under the CRA 2015 where the investor is a retail investor or otherwise protected under the CRA or the Unfair Contracts Terms Act 1977.

The manager will seek, and will normally obtain, an express statement that it and any delegate is entitled to be indemnified to the extent of any expenses or costs incurred in the performance of duties under the IMA unless and to the extent that the cost or expense is the result of the manager's negligence, wilful default or fraud, with the proviso that this, to the extent it is a limitation, will not apply to limit any indemnification available to the manager as a matter of applicable law.[183] The manager will also normally require a clause to the effect that its role does not extend to taxation or accounting advice and that, unless specified within the mandate (which may be the case for an professional investor), the tax status of the client is not a factor to be taken into account in the exercise of the manager's discretion under the IMA. The manager will also include an express statement that it will provide the information and documents that are requested by any tax authority in respect of the client.[184]

A clause will then provide that the manager is entitled to assume any instruction that the manager reasonably believes to come from a party authorised to instruct the manager by the Client but may (or perhaps will) promptly advise the Client if concerned that the instruction is ambiguous, invalid, not practical or might breach the IMA.[185] The manager will also expressly exclude any obligation to become involved in litigation other than to consider any reasonable request to disclose information, though this will not extend to breach of any confidentiality obligations and will be made only on the basis of the Manager being fully indemnified for the consequences of any disclosure.[186] This is standard industry practice and does not prevent personnel volunteering or being

[182] *Fujitsu Services Ltd v IBM United* [2014] EWHC752 (TCC).

[183] Model Discretionary IMA (n 78) cl 23.

[184] Ibid cl 24.

[185] Ibid cl 25.

[186] Ibid cl 26.

required to appear as witnesses in contested litigation whether or not the manager is a party.

Where the investment mandate includes potential investment in debt instruments there is likely to be a clause providing that any involvement of the Manager or any delegate in rescheduling or similar arrangements or negotiations is not within the services provided under the IMA.[187] Involvement will only take place on the basis of the manager or delegate being fully indemnified and that, to the extent that any such activity leads to the manager, any delegate or an associate of either receiving a fee, the fee is in addition to fees due under the IMA and thus authorised profits - and thus not prohibited under fiduciary principles notwithstanding the argument that they derive from the appointment as manager.

Termination of an IMA is not as straightforward as might at first appear, particularly if, as will often be the case where the Client is a CIS, an associate of the manager is acting as the administrator and opts to resign at the same time or as soon thereafter as is permitted under its agreement with the Client. The practical difficulty is the need to ensure that termination does not result in any hiatus, however brief, not only in the investment management process but also in the various ancillary activities that accompany the investment decision process. Furthermore, if the change of manager reflects a change of investment strategy, or even if the strategy remains unchanged, there is likely to be a need to change, potentially significantly, the portfolio content before the new manager is willing to be associated with the portfolio performance.

As a result the normal practice will be, whatever the reason for the termination, for the current manager to lose its discretion to make investment decisions at an initial stage and be authorised only to acquire and to sell investments as instructed by the replacement manager, as the delegate of the Client under the existing IMA. If the instructions extend to implementation of an investment decision the manager would be released from any best execution obligation, but in practice it is normal to leave best execution as the responsibility of the manager until the IMA is terminated and replaced by a new IMA with the replacement. During this period the existing valuation and risk

[187] Ibid cl 27.

management calculations will continue uninterrupted until the process of feeding the portfolio content and associated data into the computer and related systems operated by the new manager is completed. There would then be a period while both systems operate in tandem so any differences in statistical measurements or results are identified and as far as possible eradicated or the consequences noted and taken into account. When the period of dual running is completed the initial IMA will then formally terminate and the IMA with its replacement will become fully operational. The replacement new IMA is often a standalone agreement with an interim agreement with the new manager covering its actions prior to the termination of the old IMA or there may be a side letter setting out which provisions do not apply in the interim period.

It follows that a termination of an IMA in favour of a replacement manager relies on cooperation between the departing manager and its delegates and their replacements and industry practice, in compliance with applicable regulations, is to provide this 'in the interests of the client' even where there is an ongoing dispute between departing manager and Client. The clause detailing termination will accordingly set out in some detail the process and responsibilities of the parties in addition to the provisions setting out the minimum period of notice, which is typically no more than 90 days for termination by the manager, the notice period giving the Client time to instruct a replacement, and termination permitted without notice if by the Client whether or not breach by the manager has been alleged.[188] The replacement manager will normally, as a condition of taking on the new appointment, specify to the Client the period necessary, in its opinion, for the transition to take place in an orderly fashion. The period will depend on the complexity of the associated arrangements, for example whether new arrangements must be put in place in multiple jurisdictions and the existence of investments that cannot easily be valued based on current market prices. Often the custodian remains unchanged as if this is not the case the logistical complications increase and the transition period is likely to be lengthened.

The IMA will also provide that termination may occur without notice, for example if the manager becomes insolvent or loses its authorisation from the FCA; or if a party is

[188] Ibid cl 28.

in material breach and, if remediable, this is not cured within a period, normally no more than 28 days, of notice; or if force majeure that prevents services being provided extends for a similar period; or applicable law requires termination. These events are difficult to cater for before they occur and the assumption is that the FCA would be available to arrange any measures necessary to minimise disruption, including suspending some regulatory requirements as necessary to accommodate the circumstances before a new manager could assume the role, together with ancillary service providers as necessary, first under an interim IMA and then subsequently under a new negotiated IMA.

The termination clause would normally provide for the manager to receive fees and disbursements for services until termination and possibly to retain a sum from the portfolio to cover these if the amount is not agreed before termination. Termination would not affect accrued rights, for example any outstanding claim against the manager by the Client, although in normal circumstances termination will often be marked by the Client and manager signing an agreement to the effect that as of termination neither had any outstanding claims against the other. This may, however, only follow once any outstanding disagreements are settled - or never take place, notwithstanding that no formal claim for damages is ever formally made within the six-year limitation period.[189]

Whether a duty of confidentiality is capable of being a fiduciary duty rather than a duty that is owed not only by fiduciaries is a subject for the next chapter. However the IMA will include a clause that specifies that each party owes the other a duty to keep information received or developed in the course of the contractual relationship confidential, but will include exceptions to the confidentiality obligation, typically in some detail and providing information as to what is stored and when disclosure is required by third parties and ending with a statement that both parties agree that damages is not an adequate remedy so assisting any application for an injunction, with any subsequent breach the criminal offence of contempt of Court.[190] There will also be a clause providing that either party may record telephone conversations with the other and

[189] Limitation Act 1980.It is unusual, if not unknown, for an IMA to be executed as a deed, with the limitation period extended to 12 years as a result. The parties may also agree a shorter period, although this would be unusual.

[190] Model Discretionary IMA (n 78aget) cl 29.

that the manager may monitor other communications with or by the Client and setting out the permitted uses for this data.[191]

The IMA will also include a series of 'boiler plate' clauses that cover matters common to most commercial contracts for services. 'Assignment' will permit assignment to an associate of the manager but not otherwise unless the parties agree and may include a reference to the manager's plans after the UK has ceased to be a member of the EU, for example assigning to an EU associate which will then delegate certain duties 'back' to the manager. 'Rights of third parties' will exclude third parties (including investors in a CIS that is the client) from making claims in relation to breaches of the IMA except as specified under the Contracts (Rights of Third Parties) Act 1999, for example the beneficiary of any indemnity contained in the IMA, e.g. an employee of the manager acting in the course of providing services to the Client. There will also be clauses providing how the Client may complain and describing any rights the Client may have to compensation from the Financial Services Compensation Scheme in the event of the manager's insolvency.[192]

Following custom the final clause will set out that the governing law is English law and may also provide for arbitration rather than litigation as the chosen system for dispute resolution where the Client is a 'professional investor'.[193] The reasons include the availability of arbitrators experienced in portfolio management and that any award that results is confidential, while the availability of the FOS to settle retail investor complaints explains the absence of arbitration clauses in IMAs with retail investors. The subject is further considered in Chapter 4. Where there is an arbitration clause the most common choice is to opt for the London Court of International Arbitration ('LCIA') even where the Client is based overseas. A formal appointment of a process agent within English jurisdiction would also be included and the clause would refer to the substantive laws of England and Wales in accordance with LCIA rules.

[191] Ibid cls 30 and 31.

[192] Ibid cls 32 - 41 (inclusive).

[193] Ibid cl 42.

As the manager is based in the UK and subject to UK regulation providing for a non-UK governing law is highly unusual, though there are cases where commercial pressures may lead to the Manager agreeing to an overseas jurisdiction. These typically involve inexperienced clients who are subject to domestic legal requirements, perhaps under pension or insurance regulation, but choose not to take external legal advice. The result is a potential for considerable confusion but in practice both parties would strive to settle any dispute without incurring the legal expense necessary to untangle what could raise some very complicated conflict of laws issues, not least that the law concerning fiduciaries, agent duties of loyalty and asset managers differs materially between the commonwealth jurisdictions, is statute based in the USA and is approached differently in civil jurisdictions.

The signatures of the duly authorised representatives and the dates of signature and the Agreement becoming effective will follow. The Schedules follow primarily for convenience as they are the most likely to alter during the course of the relationship and this location facilitates replacement in the relevant filing and computer systems. There are typically four: authorised persons and instructions; Guidelines; Fees; and Derivatives. None are directly relevant to the fiduciary status of the manager.

XI- Summary

This chapter has provided an overview of discretionary portfolio management under English law. The principal role of the portfolio manager is the exercise of discretion to control the assets in the portfolio under management within portfolio the limits and for the objective set out in the investment mandate. This role raises the issue whether and how the Client and those investors with indirect interest in the should be protected against manager misconduct, not least given the limited ability of the Client to oversee the manager's activities. Regulations and their enforcement by the FCA provide protection, but the thesis is concerned with whether fiduciary law supplements this or has been, in practice, overtaken by a combination of regulation and market practice that does not just modify but effectively renders obsolete the additional protection that equitable remedies provide a principal who suffers a breach of fiduciary duty.

Chapter Two: fiduciary duties and the discretionary portfolio manager

I - Introduction

The basis for the fiduciary principle lies in the series of relationships where the role of one party is perceived to include serving the interests of the other and public policy requires, whether based on grounds of relationship integrity or economic efficiency (or both), that the role be carried out in a 'loyal' manner. The serving party, the fiduciary, is not permitted to take advantage of any opportunities the relationship provides to serve the interests of any person other than the second party, the beneficiary, whether the interest so served is the interests of the fiduciary or any other party.[1]

Fiduciary duties owe their origins to late medieval and early modern legal rules that required co-owners to pay due regard to each other's interests when dealing with the shared property, so seeking to prevent agents and bailees to prioritise the interest of their principals when dealing on their principal's behalf.[2] . The expression 'fiduciary duty' now refers to the duty of loyalty owed by a party who falls within the fiduciary category, as a matter of English law, by assuming a position of trust and responsibility as a result of which the party is obliged, when acting in the fiduciary capacity, to serve only the interests of the beneficiary, ignoring both the interests of the fiduciary and the fiduciary's duties to third parties, unless the beneficiary has given fully informed consent.

The starting point is that the fiduciary is under a duty to take decisions, when acting in the fiduciary role, on a basis that takes into account solely the interests of the beneficiary. The risk of fiduciary misconduct and the problems involved in detecting the state of an individual's mind and thus motive resulted in the common law providing additional protection for the beneficiary. In terms of legal doctrine this has become, or perhaps come to include two overlapping proscriptions. A fiduciary (a) cannot use the knowledge or opportunity obtained by reason of the position to his own or a third party's

[1] Paul Finn, 'Contract and the Fiduciary Principle'(1989) 12 UNSW Law Journal, 76, 84; Lionel Smith, 'Fiduciary Relationships: Ensuring the Loyal Exercise of Judgement on behalf of Another' (2014) 130 LQR 608; Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart 2011); Tamar Frankel, Fiduciary Law (OUP 2011).

[2] Joshua Getzler, 'Rumford Market and the Genesis of Fiduciary Obligations' in A Burrows and A Rodger (eds), *Mapping the Law: Essays in Memory of Peter Birks* (OUP 2006), 577

possible advantage or to the beneficiary's possible disadvantage and (b) cannot, in any matter within the scope of the position, have a personal interest or inconsistent engagement with a third party, unless in either case this has the freely given consent of the fully informed beneficiary or is authorised by law.[3]

This chapter reviews how the fiduciary doctrine operates in terms of consequential obligations of the fiduciary under English law, breach of which gives the principal potential access to certain equitable remedies in addition to compensatory damages for breach of the contract. Peter Birks described the fiduciary relationship as 'a relationship analogous to that between express trustee and beneficiary' and continued that 'a fiduciary obligation is a trustee like obligation exported by analogy… to export the incidents of the express trust to new situations'.[4] The trust analogy has received less attention in recent years as fiduciary law has developed into something of a separate 'fiduciary' area of the law, with broader usage and less stringent controls.[5] This has resulted in there being many competing and to some extent conflicting analyses of fiduciary doctrine, with both judges and legal scholars continuing to struggle to explain precisely when and how fiduciary concepts apply and what the practical consequences are.[6] The confusion is not helped by the analyses and results differing between jurisdictions.

There is, however. general consensus that there is a small group of well-established relationships, which include trustee and beneficiary[7], lawyer and client [8] and principal and agent,[9] where the fiduciary duty of loyalty can be expected to arise as a

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[3] Deane J in *Chan v Zacharia* (1984) 154 CLR 178.

[4] Peter Birks, 'The Content of Fiduciary Obligation' (2000) 34 Israel Law Review 3.

[5] Francis Reynolds, Peter Watts and William Bowstead, *Bowstead & Reynolds on Agency* (21st ed., Sweet & Maxwell 2017), 6-036.

[6] For a description of the principal theories see Evan J Criddle, 'Liberty in Loyalty: a Republican Theory of Fiduciary Law' (2017) 95(4) Texas Law Review (2017) 993.

[7] *Re Diplock* [1948] Ch 465.

[8] *Nocton v Ashburton* [1914] AC 932 (HL); *Clarke Boyce v Mouat* [119] UKPC 34, (1993) 3 WLR 1021; *Hilton v Barker, Booth & Eastwood (a firm)* [2005] UKHL 8, (2005) 1 All ER 651.

[9] Dick Frase, "Conflict of Interests'(2012) 97(Jun) Compliance Officer Bulletin 1, para 1.2.4 ; Deborah A, DeMott, 'Fiduciary Principles in Agency Law' in Evan J Criddle, Paul B Millerand Robert H Sitkoff. (eds),*The Oxford Handbook of Fiduciary Law* (OUP 2019); Alistair Hudson, *Equity and Trusts* (7th ed, Routledge

matter of course.[10] In these relationships the issue is less whether the relationship is 'fiduciary' than the practical consequences of that relationship in the particular circumstances. The considerable similarities between the role of a trustee exercising the power to invest assets in the trust fund and the role of a manager providing portfolio management services under an investment management contract ('IMA') make the Birks analysis pertinent to the relationship between manager and portfolio owner(s).

The next section outlines the content of fiduciary duties and the uncertainties arising as to their scope without delving deeply into analysis as to when, why and how a relationship has fiduciary characteristics. . Section III reviews these duties in the context of portfolio management and the modifications to the fiduciary duties that would otherwise apply to the relationship between a discretionary investment manager (a 'portfolio manager' or 'manager') and a client (the 'Client') that owns a portfolio under the management of the manager pursuant to the terms of an Investment Management Agreement governed by English law (an 'IMA'). This raises the issue whether the modifications represent, in practice, mere dilution or complete exclusion, which is considered in the final chapter.

II - Fiduciary duties

The duties of a fiduciary attract almost as much academic debate and disagreement as the definition of a fiduciary. The basic concept is relatively straightforward. There is a class of persons commonly referred to as 'fiduciaries' who have been entrusted with powers the exercise of which is intended to benefit one or more third parties, which may include the entruster. In that exercise they are obliged to act honestly in what they consider to be in the best interests of those third parties. A common feature is that when exercising its power, the fiduciary is not under the direct and immediate control of the third party to whom the duty is owed and therefore equity intervenes to supervise the exercise. The precise nature and scope of the fiduciary's duty

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2013),para 14.3;Mason J in *Hospital Products Ltd v U.S. Surgical Corp* [1984] 156 Commonwealth Law Reports 41, 97; *Lowther v Lowther* (1806) 13 Ves 95; *Boston Deep Sea Fishing Co v Ansell* (1888) 39 Ch D 389; *FHR European Ventures LLP v Cedar Capital Partners LLC* [2015] AC 250.

[10] Bowstead, (n 4) 6-033.

will, however, depend on the circumstances of the relationship between the fiduciary and the third party or parties to whom the duty is owed.[11]

The starting point for analysis of the scope of the fiduciary duty, at least as far as English law, is the judgment of Millett L J in the Court of Appeal in *Bristol & West Building Society v Mothew*[12]:

> 'a fiduciary must act in good faith; he must not make a profit out of his trust: he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third party without the informed consent of his principal.... [if] the fiduciary deals with his principal, he must prove affirmatively that the transaction is fair and that in the course of negotiations he made full disclosure of all facts material to the transaction.'

In its 2014 Report[13] the Law Commission, which had divided the duty of loyalty into four categories in its 1992 Consultation Paper[14] (which preceded the 1998 *Mothew* judgment[15]), considered the duty to have two themes: the 'no conflict' rule and the 'no profit' rule. The former was described as providing that a fiduciary must avoid acting, unless the principal has given fully informed consent, where there is a conflict between its duty and its interest and where there is an actual or potential conflict between its duties to multiple principals; and the latter that a fiduciary must not make an unauthorised profit by reason or by virtue of the fiduciary office or otherwise within the scope of that office, again absent the principal's fully informed consent. These descriptions beg a number of questions, which include the scope of the potential conflicts to be avoided, the scope of 'by reason or by virtue' of the appointment and whether the two rules are, in fact, only one ,or two rules that often overlap.[16]

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[11] Paul Finn, *Fiduciary Obligations 40th Anniversary Republication with Additional Essays* (The Federation Press 2017) para 6.

[12] *Bristol and West Building Society v Mothew* [1998] EWCA Civ 533, [1998] Ch 1.

[13] Law Commission, 'Fiduciary Duties of Investment Intermediaries' (Law Com No 350, 2014).

[14] Law Commission, 'Fiduciary Duties and Regulatory Rules' (Law Com CP No 124, 1992), para 2.4.9.

[15] *Mothew* (n 12).

[16] Lionel Smith (n 1) 619; cf. Conaglen (n 1) 113-125.

Whether there are one or two rules is by no means the only area of fiduciary law that is 'murky if not inconsistent'.[17] The issue emerges in part as a result of the House of Lords judgments in *Boardman v Phipps*[18] (the case is analysed in some depth below) and the emphasis placed on the earlier case of *Regal (Hastings) v Gulliver*.[19] The latter has been described as 'the apotheosis of a strict no profit rule which is not dependent on a conflict requirement'.[20] While the description is consistent with the judgements in the House of Lords, study of the underlying facts makes clear that the five defendants faced multiple conflicts of interests. One defendant, the claimant company's solicitor, was found not in breach because he had his client's valid fully informed consent (provided by the other four defendants as the directors of the claimant). Another avoided liability because he realised no profit (and the claimant company incurred no loss).The other three were held liable to account to the Company for profits arising on the sale of the acquired shares on the basis the profits had arisen as a result of their appointment as directors and thus fiduciaries.

Not least amongst the intriguing features of the case, first reported in 1942, is that the House of Lords judgments only appeared in the law reports a quarter of a century later, after the publication of the House of Lords judgments in *Boardman*. As Richard Nolan has pointed out,[21] the skewed course of the proceedings in *Regal,* with common law issues badly presented at first instance and before the Court of Appeal and equity becoming involved only in the House of Lords, has had some significant and enduring consequences, albeit principally restricted to 'business opportunity' cases.[22] The controversy will not, however, be examined in any further depth as its relevance to portfolio management is limited. As the next section will explain, the IMA reduces the rule, in the context of portfolio management and in practice, to compliance with FCA

[17] Shue Sing Churk, 'Just Abolish the No Profit Rule' (2015) 26(7) International Company and Commercial Law Review 244.

[18] *Boardman v Phipps* [1967] AC 46.

[19] *Regal (Hastings) v Gulliver* (1967) 2 AC 134.

[20] EV Ferran, *Company Law and Corporate finance* (OUP 1999), 190.

[21] Richard Nolan, '*Regal (Hastings) v Gulliver*' in Charles Mitchell and Paul Mitchell (eds), *Landmark Cases in Equity* (Hart 2014).

[22] *Bhullar v Bhullar* [2017] EWHC 407 (ch).

rules. This, in turn, restricts its potential application to situations where there is a conflict and the Client is at risk of loss, including a reduction in gain. For the sake of convenience and in common with many textbooks, this thesis refers to the 'no conflict' and the 'no profit' rules.

There are, in practice, few aspects of fiduciary duty about which there is general consensus, but one is that the 1726 case of *Keech v Sandford* has a significant place in the history of fiduciary doctrine.[23] Indeed it is often contended that it is from this case that the 'no conflict' and 'no profit' rules derive, although some suggest the use of 'rule' is misleading as the concept is not that a fiduciary must avoid conflicts of interest but rather that if a conflict is identified any transaction to which it is relevant is liable to be set aside.[24] Others have suggested that the *Keech* judgment relied on the then prevailing expectation that a tenant would have a lease renewed and thus has been given a prominence which it does not deserve.[25] As already mentioned, others consider the fiduciary principle can be traced back well be before 1726 and that trust law was, in a sense, a development of the underlying principle.[26] Nevertheless, the importance of the case has long been accepted and this seems unlikely to change.

The case involved a fixed term lease of a property in Rumford market, in Essex. The lease was transferred to a trustee, Sandford, to hold for an infant, Keech. The lease was renewed, but in favour of the trustee absolutely rather than in his capacity as a trustee for the infant beneficiary. Lord Chancellor King held that Sandford held the lease as trustee for Keech. The danger, human nature being what it was (and remains), that the trustee might be tempted not to use his best efforts to seek to renew the lease for the benefit of the beneficiary required that the temptation be removed. This could only be achieved if the trustee was prohibited from taking a renewal of the lease in his own name. There was no finding that Sandford had acted dishonestly, but the issue was irrelevant:

[23] *Keech v Sandford* [1726] EWHC Ch J76, (1726) Sel Cas Ch 61.

[24] Charles Mitchell, 'Equitable Compensation for Breach of Fiduciary Duty' (2013) 66(1) Current Legal Problems 307; JE Penner, "Is loyalty a virtue, and even if it is, does in really help explain fiduciary liability?' in A Gold and P Miller (eds), *Philosophical Foundations of Fiduciary Law* (OUP 2014).

[25] Peter Hicks, 'The remedial principle of Keech v Sandford revisited' (2010) 69(2) CLJ 287.

[26] Getzler (n 2).

the trustee was 'the only person of all mankind who might not have the lease' whatever the motives for his actions, or omissions.[27] The result is now commonly referred to as the 'rule in *Keech v Sandford'*.

In its simplest format the rule provides only that a trustee may not retain the benefit of a lease that is renewed in his favour if he previously held the lease as a trustee. If the lease is so renewed the law provides that the lease is held as a constructive trustee for the beneficiaries for whom he formerly held as express trustee. This is the case notwithstanding there is no evidence or suggestion of improper motive and even if the landlord makes clear he had no wish or intention to renew the lease in favour of the beneficiary (and no legal or moral obligation to do so). Such a renewal in favour of the trustee will have pretty well the opposite economic result to that the landlord sought, leaving behind the perverse consequences for the property rights of the landlord. Further problems begin to emerge when the rule is extended to apply to others in a fiduciary role,[28] as well as to require the disgorgement of profits derived, however indirectly, from the trustee or fiduciary role – including from information gleaned while acting as an agent, as illustrated in the landmark case of *Boardman v Phipps* that is discussed below.[29]

The profits to be disgorged may include, as in *Boardman*, profits that could not have accrued directly to the trust fund. An alternative response might be for the trust fund to be compensated for any loss but with the unauthorised profits that could not have accrued to the trust fund, even if no breach of trustee duty had occurred, being forfeit to the state, for example in the form of a fine for breach of regulations covering the same ground. This would preclude the trust fund benefitting simply because it was inappropriate for the fiduciary to profit from the breach of duty. While chapter 4 will suggest that the current regulation of financial services can be seen as, at least potentially, following this course, there was, in 1726, no obvious alternative recipient to receive an arguably unjustified 'windfall'.

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[27] *Keech* (n 23).

[28] *Re Biss* (1903) 2 Ch 40*; Chelsea Estates Investment Trusts Co Ltd v Marche* [1955] Ch 328.

[29] *Boardman* (n 18) 124.

The background to the *Keech* judgment has been extensively researched and analysed, with at least some studies calling into question its suitability as a foundation for fiduciary law. The 'no profits' rule cannot, however, be ignored, even if it, or liability for its breach, may be modified, or perhaps even excluded altogether. In the words of Chancellor King 'it is very obvious what would be the consequence of trustees having the lease'.[30] As a practical matter it may well be that the judgments of Lord Eldon are more important in the development of the principles of *Keech* into a more concise form.

Lord Eldon articulated the risks of inadvertent or opportunistic misconduct, as well as behaviour motivated by deliberate intent, in a series of cases at the beginning of the 19th century.[31] In 1802 he stated the fiduciary

> 'must be watched with infinite and the most guarded jealousy…. the Law supposes him to have acquired all the knowledge a [fiduciary] may acquire; which may be very useful to him; but the communication of which to the [beneficiary] the Court can never be sure he has made'.[32]

In 1803, in another case, Lord Eldon stated 'no Court is equal to the examination and ascertainment of the truth in the greater number of cases'.[33] The Court could never be certain that a trustee who purchased assets from the trust fund had not withheld information gleaned from his trusteeship which, if disclosed, would have resulted in the price rising. To these classic statements can be added, amongst many others, the words of Lord Herschell in *Bray v Ford*: 'human nature being what it is, there is danger of the person holding a fiduciary position being swayed by interest rather than by duty'.[34] The principle remains the same: the risk of trustee misconduct remaining undiscovered is, in certain circumstances, such that any transaction relating to the trust fund to which the trustee is a party is voidable at the instance of the beneficiary without further inquiry and whatever evidence there may be to the contrary. The same principle applies to the fiduciary agent, although the application is restricted to transactions linked to the agency

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[30] *Keech* (n 23).

[31] *Ex parte Lacey* (1802) 31 ER 1228; *Ex parte James* (1803) 32 ER 385; *ex parte Bennett* (1805) 32 ER 893.

[32] *Lacey* (n 31) 1228.

[33] *James* (n 31) 339.

[34] [1896] AC 44, 51.

role.[35] Whether and the extent to which the practical implications of the principle should or should apply to discretionary portfolio management is a topic for the next section.

In contrast there is less consensus as to the origins of the 'no conflict' rule, although Penner has suggested that *Keech v Sandford* is 'the extreme example' of this rule.[36] As Lionel Smith has pointed out, however, the only decision that Sandford made that could have been affected by a conflict of interests was the decision to accept the landlord's refusal to renew the lease in his capacity as trustee for the infant Keech and not (to continue) to seek to persuade the landlord to change her mind.[37] His subsequent decision to apply to acquire the lease in his own name was clearly not undertaken in his capacity as a trustee - at least as long as this decision followed a refusal to renew by the landlord, which there is some suggestion may not have been the case.... including that the landlord was never actually asked.[38]

This may explain the suggestion in Meagher, Gummow & Lehane that there was a conflict between the interests of the trustee in applying for a new lease after the renewal of the lease has been refused and the trustee's duty to seek renewal.[39] There is also a view that, based on the pleadings, Sandford had aimed to engineer a refusal of the lease to the beneficiary so he could take it for himself but the judge, following then current practice, was reluctant to ascribe bad faith and so avoided doing so in favour of ruling that motive was not an issue.[40]

The precise scope of the 'no conflict' and 'no profits' rules and the potential for exceptions, especially in the commercial world, remain a subject for debate, as do the

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[35] *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] UKPC 7, (1973) 1 WLR 1126 (PC).

[36] Penner JE, 'Is loyalty a virtue, and even if it is, does in really help explain fiduciary liability?' in A Gold and P Miller (eds), *Philosophical Foundations of Fiduciary Law* (OUP 2014) 12.3.

[37] Lionel Smith (n 1) 608.

[38] Andrew Hicks 'Proprietary relief in Boardman v Phipps' (2014) 65(1) NILQ 1quoting DR. Paling, 'The Pleadings in Keech v Sandford' (1972) 36 Conv 159, 173.

[39] JD Heydon, MJ Leeming, PG Turner (eds), *Meagher, Gummow & Lehane's Equity: Doctrines & Remedies* (5th ed LexisNexis 2015), 5-055.

[40] Hicks (n 38).

consequences if either rule is breached. A further issue, if the availability of equitable remedies for breach of fiduciary duty is left to the discretion of the Court and the exercise of discretion is not subject to clear rules, is uncertainty. This may, in turn, contribute to a reluctance to risk a dispute being decided by the courts, or even arbitration. The rule represents the law taking steps to reduce the risk of misconduct by assuming misconduct in certain factual circumstances without investigation whether the improper motive necessary for the fiduciary principle to have been breached was present. This and the potential for 'innocent breach' is one of the more controversial aspects of fiduciary duty under English law.

The assumption of impure motive if a breach of the no conflict or no secret profit rules is established owes much to the difficulties inherent in the Court deciding on motive considering the weakness of the evidential systems in the Courts of Equity prior to the Judicature Act 1873 and the merger of the courts of common law and those of equity. Some have argued that modern practice and modern courts are much more capable and experienced in judging motive based on evidence and thus that the rules that assume improper motive based on fact and thus can see the honest breach by a fiduciary who has, for example, acted in good faith should be revisited.[41] Others refute this,[42] with arguments that include that the purpose of fiduciary doctrine is to guard against self-interest and thus that this encompasses both intentional self-interest as well as circumstances where the decision maker considers the decision to have been based on a pure motive even though self-interest has been, unknowingly, a factor.

The special nature of the fiduciary relationship requires additional protection given the task of proving fraud or wilful misconduct is a high one. While the decision is to be made based on a balance of probabilities, where serious misconduct is alleged, especially if this requires proof of a dishonest state of mind, the courts understand that

[41] With John H Langbein the most prominent, see e.g. 'Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?' (2005) 114(5) Yale Law Journal 929.; see also Arden LJ in *Murad v Al-Saraj* [2005] EWCA Civ 959, [82].

[42] See e.g. R Flannigan, 'The Core Nature of Fiduciary Accountability' [2009] New Zealand Law Review 375–429 and 'The Court of Appeal recasts fiduciary accountability' (2019) 25(7) Trusts & trustees 737.

proof of a serious allegation is likely to require substantially more cogent evidence than would be required to prove a less serious case.[43]

Keech concerned a trustee and many of the early cases used 'trustee' and 'fiduciary' to some extent interchangeably. A later case which involved a trust but concerned the role and duties of an agent, albeit of a special kind, in a fiduciary capacity is *Boardman v Phipps*, a much analysed and debated 'landmark' case which, if nothing else, identifies many of the uncertainties of fiduciary law. In contrast to *Keech* there is no shortage of detailed, indeed lengthy, judgments in and academic coverage of this case, although few of the uncertainties of fiduciary principle as applied under English law are resolved. Not least there is divergence between the reasons given in the judgments of the House of Lords[44] upholding the Court of Appeal's refusal[45] of the appeal, the judgments in the Court of Appeal and the first instance judgment of Wilberforce J.[46] This divergence is also to an extent shared by academic analysis of the case, although it may be that the differences relate less to a disagreement in principle than as to how to apply the principles to the particular complicated set of facts.[47]

The case concerned Lester and Harris ('L&H'), a prominent midlands textile business owned by a private company in which a 27% stake was owned by a family trust established after the death of C.W. Phipps, an esteemed local manufacturer, in 1944. In 1956 the solicitor who advised the trustees, Tom Boardman,[48] consulted with Tom Phipps, a trustee who was also a potential beneficiary. Boardman had concluded that L&H was being poorly managed. He and Tom Phipps then attended the company's

[43] Lucy Walker and Ros Fentem, 'Civil Fraud Back to basics' (Guildhall Chambers, November 2012), para 69 et seq.

[44] *Boardman* (n 18).

[45] *Phipps v Boardman* [1965] Ch 992.

[46] [1964] 1 WLR 993 (Wilberforce J).

[47] *Murad* (n 41) 959; *Foster v Bryant* [2007] EWCA Civ 200, [2007[Bus L R 1565; Nicholas Collins, 'The no-conflict rule: the acceptance of traditional equitable values?' (2008) 14(4) Trust & Trustees 213; Hicks (n 38); Michael Bryan, '*Boardman v Phipps* (1967)' in C & P Mitchell (eds), *Landmark Cases In Equity* (Hart 2014).

[48] Although christened Thomas it was as Tom that he was more commonly referred to in his subsequent political career, which included a cabinet position from 1972 to 1974 and a subsequent (non-judicial) seat as a life peer in the House of Lords.

Annual General Meeting (the 'AGM') as representatives for the family trustee shareholders and sought to have Tom elected a director. The attempt failed.

The pair then had protracted negotiations with the Board of Directors concerning a possible reorganisation in which both represented to the Board that they were negotiating on behalf of the trustees, although the discussions included proposals for the purchase of shares that the trustees could not purchase. A considerable amount of information concerning the business was provided to them in the course of the negotiations. By now the widow of Charles Phipps had died and their children (including Tom) had become absolutely entitled to the shares.

The negotiations did not lead to an agreement for a reorganisation. Boardman and Tom Phipps then made an increased offer, based on the information they had been provided, to buy in their personal capacities the shares owned by the directors, which was accepted. The result was that Boardman, Tom Phipps and the trustees together had control of the company. An early form of asset stripping followed, orchestrated by Boardman, with the proceeds used to fund a substantial capital distribution to the shareholders, all of whom, including Boardman and Tom Phipps personally, enjoyed significant capital gains.

John Phipps, Tom's younger brother and so also beneficially entitled to shares held by the trust, then claimed that his brother and Boardman had been in breach of fiduciary duty and that as a result each held the proportion of the shares he had acquired equal to the proportion of the shares held by the trust for John on constructive trust for him and that each should account to him for the profits derived from the holding.

At first instance Wilberforce J held there had been a breach of fiduciary duty as buying the shares had placed Boardman and Tom Phipps in a position of potential conflict of interest to which fully informed consent had not been given. As a result, the shares were held on trust and the quantum of unauthorised profits to be disgorged should be the subject of a separate inquiry. The Court of Appeal affirmed the orders, but for different reasons. The House of Lords then dismissed the subsequent appeal, albeit on a three two split decision .

The issues raised in the case included what were the fiduciary relationships that led to the two defendants owing fiduciary duties, to whom were the duties owed, how exactly were the duties breached and what remedies became available to the beneficiaries as a result. There is no clear consensus in the judgments, except perhaps to the extent that the two dissenting judgments in the House of Lords agreed that no breach of fiduciary duty had occurred.

A number of comments in the High Court judgment suggests that the failure to obtain John's consent may have been the result of Boardman having even less regard for the capacity of John, a farmer, to understand corporate finance than his elder brother who, on his own admission, found financial matters difficult to follow. The result appears to have been that neither was fully aware of, nor understood, Boardman's plans. In any event it seems that Boardman's disregard for the intellectual powers of John Phipps contributed to the first instance decision being based on the information provided falling short of that the law required for 'fully informed consent', even if the breach for which consent was required was less clear.[49] The absence of fully informed consent was not challenged in the Court of Appeal and so was not an issue raised before the House of Lords.[50]

No party appointed either Tom as its agent, but the fiduciary relationship was ultimately based on agency. The analysis of Lord Denning in the Court of Appeal provided the justification: in representing, or perhaps allowing the Board of Directors to continue to assume, that they represented the family trustees in the course of the negotiations that followed the AGM, the pair had assumed the role of agents and thus owed their assumed principals the fiduciary duties of good faith, to avoid conflicts and to disgorge unauthorised profits. The potential problem that, as agents of the trustees, any fiduciary duties were owed to the trustees, not the beneficiaries, was dealt with as the statement of claim accordingly referred to the agency being referred to as agents for the trustees <u>and the beneficiaries.</u>[51] Wilberforce J gave judgment on the basis the evidence supported this.

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[49] [1964] 1 WLR 997, 1012-17.

[50] [1965] 1 Ch 992, 1023 (Pearson L J); [1967] 2 AC 46, 100 (Lord Cohen).

[51] [1964] 1 WLR 993, 1005.

The case did not concern agency in the sense of an agent appointed by a principal. Instead the issue was the obligations of those who assume the role of agents even though there has been no appointment, formal or informal, referred to 'self-appointed agents' in the judgment of Wilberforce J.[52] While Boardman and Phipps were appointed agents for the trustees for the purpose of attending certain meetings this did not extend to the negotiations during which they received confidential information from the L&H directors who remained under the impression that they were continuing to deal with them as representatives of the trustees. As a result, Lord Denning held that they became fiduciaries and therefore any breach of duty or unauthorised profits that resulted from the position, whatever the motive and notwithstanding that the trustees could not themselves have acquired the shares and realised the profits which accrued to Boardman and Tom Phipps as a result, could only be sanctioned by the fully informed consent of the beneficiaries.[53] As the trustees did not give consent this left the only option the consent of all the beneficiaries - and in the case of John Phipps that consent had not been given.

The variety of reasoning and conclusions within the judgments do little, if anything, to resolve the uncertainties as to the scope and role of the 'no conflict' and 'no profit' rules,[54] not least where the fiduciary is an agent. In the context of a fiduciary providing professional services the key lesson from the case is the need to have clear terms in the services contract that cover (i) the circumstances in which the fiduciary is permitted to act despite a conflict of interest and (ii) the ability of the fiduciary and its associates to earn fees and to generate profits which might be linked to the fiduciary appointment.

- proscriptive and/or prescriptive

The judgments also raise the further question whether Lord Millett's 'duty of good faith' is encompassed entirely within the no conflict and no profit rules that follow in his

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[52] [1964] 1 WLR 993, 1007.

[53] [1965] Ch 992 ,1017-18.

[54] There is a considerable volume of literature on this topic, for example RC Nolan, 'Controlling Fiduciary Power (2009) 68(2) CLJ 293; Matthew Conaglen,'The nature and function of fiduciary loyalty' (2005) 121 LQR 452; and the references therein.

judgment in *Mothew*[55] or whether a breach of fiduciary duty may also occur in circumstances where there is neither unauthorised conflict of interests nor unauthorised profit. This issue is often described as the 'proscriptive' and/or 'prescriptive' debate - and remains a topic of considerable and continuing controversy.[56] A variety of analyses and answers have been suggested, with, in one corner, fierce defence of the 'proscriptive only' analysis by some commentators, the most prominent Professors Conaglen[57] and Flannigan.[58] The strength of their argument and the level of support that they have gathered has led some to conclude that this is the orthodox and prevalent view in Anglo-Australian jurisprudence.[59]

In the opposite corner, J.D. Heydon and Professor Lee lead others who suggest that the 'proscriptive only' analysis sits uneasily with a number of other prescriptive duties that have been described as fiduciary in case law. [60] The former even goes so far as to contend that trends to 'proscriptive only' analysis and the consequent weakening of the defences against misconduct by fiduciaries 'conflict with established authority, are unsound in principle and have undesirable effects in practice'.[61]

The 'proscriptive only' view is propounded in perhaps the clearest manner in the judgments of the High Court of Australia in *Breen v Williams.*[62] These have been followed in a number of subsequent Australian cases and the 'proscriptive only' analysis seems close to settled law in that jurisdiction. This analysis has been criticised, not least by J H

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[55] *Mothew* (n 12).

[56] Kelvin Low, 'Fiduciary duties: the case for prescription' (2016) 30(1) Trust Law Journal 3, 3-25 identifies (and criticises) at least five inconsistent theses.

[57] Conaglen (n 1).

[58] Robert Flannigan, 'The Adulteration of Fiduciary Doctrine in Corporate Law' (2006) 122 LQR 449.

[59] Lusina Ho, 'Good faith and fiduciary duty in English law' (2010) 4 Journal of Equity 29, 38; Matthew Conaglen in John McGee, *Snell's Equity* (33rd ed, Sweet & Maxwell 2014), Ch 3 part 10.

[60] RWC Lee 'Rethinking the content of the fiduciary obligation' (2009) 73 Conv. 236-253; RWC Lee, 'In Search of the nature and function of fiduciary loyalty: some observations on Conaglen's analysis' (2007) 27(2) OJLS 327, 336-7.

[61] JD Heydon, 'Modern fiduciary liability: the sick man of equity?' (2014) 20(10) Trusts & Trustees 1006-1022.

[62] (1996) 186 Commonwealth Law Reports 71.

Heydon,[63] and the case law, even in Australia, is not entirely a one-way street,[64] even if the cases that take a different tack stand to some extent 'in lonely isolation'.[65]

The *Breen* case concerned the relationship between a doctor and one of his patients. The latter sought access to the records of her treatment that were in the doctor's possession. One of several arguments put forward on her behalf was that her right to access derived from the fiduciary nature of the relationship between doctor and patient. The judgments recognise the duty of the doctor to exercise a reasonable level of skill and care when reaching a decision as to what treatment was in the patient's best interests. This duty was considered not a fiduciary duty, rather a duty owed by reason of a professional relationship (which might or might not involve a fiduciary role) and thus breach of which provided the patient with remedies based on professional negligence: damages limited by causality and remoteness. This professional duty of care was considered to be separate from the doctor's fiduciary duty, which was analysed as a duty or duties neither to obtain any unauthorised personal benefit nor to be in a position of actual or potential conflict of interest or duty (in each case absent fully informed consent). A breach of this duty would be a breach of fiduciary duty for which equitable remedies were available to the patient principal.

The fiduciary duty was analysed as imposing a restraint on the doctor's power to decide on the patient's treatment where there was an undisclosed actual or potential conflict of interests or the doctor could make an unauthorised profit as a result of the decision. The risk of the fiduciary duty being breached - so that a treatment decision was taken not with regard only to the interest of the patient but instead influenced by improper motive(s) - led the Court to hold that breach would entitle the patient to equitable remedies, regardless of the real motive behind the action or omission. The existence of the undisclosed conflict or unauthorised profit meant that there was at least a risk that the motive behind the decision how to treat the patient was improper - and the law proceeded to conclude, without further inquiry, that this was the case.

[63] Heydon (n 61).

[64] E.g. *Westpac Banking Corp v The Bell Group Ltd (in liq) (No. 3)* [2012] WASCA 157, 270 FLR 1.

[65] Derham ASJ in *Hoh v Frosthollow Pty Ltd*[2014] Victoria Supreme Court 77 quoted in Low (n 69) 3-25.

In no English case has a judgment been quite as definitive in favour of the 'proscriptive only' view. In contrast there is a considerable number of cases that appear to indicate that fiduciary duties include prescriptive duties.[66] Examples of prescriptive fiduciary duties include Lightman J holding a trustee had failed in its 'fiduciary duty to ascertain the true wishes of the settlor'.[67] Lord Walker subsequently quoted this statement with approval in his judgment in the Supreme Court in *Pitt v Holt,*[68] in which he also drew attention to the 'general disinclination of equity to insist on rigid classifications expressed in abstract terms'. Lord Walker also expressly referred to the duty of a fiduciary with a fiduciary power to inform himself properly and to deliberate carefully whether to exercise the power as a fiduciary duty encompassed within the duty of good faith loyalty that is included within the core of fiduciary obligation[69].

Other examples quoted by J.D. Heydon[70] include the judgment of Sir Robert Megarry V-C in *Cowan v Scargill,* where he refers to the positive duty to invest prudently in the best interests of the beneficiaries as 'fiduciary'[71] and Lord Neuberger's judgment in *Sinclair Investments (UK) v Versailles Trade Finance Ltd*, where he stated: 'a person entrusted with another person's money for a specific purpose has fiduciary duties to the other in respect of the use to which those monies are put'.[72] Lord Neuberger's language is certainly more consistent with a positive (i.e. prescriptive) duty to put the money to a proper use than with a negative (i.e. proscriptive) duty to avoid the purposes for which the money should not be used. Equally it is not inconsistent with the concept that improper motive for breach is necessary for breach to be fiduciary breach, while leaving open, albeit suggesting, that a failure by the entrusted party to do anything with the

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[66] *F&C Alternative Investments Ltd v Barthelemy* [2011] EWHC 1731, (2012) Ch 613; *Top Brands Ltd v Sharma* [2014] EWHC 2753(ch), (2015_ 2 All ER 581; *AIB Group (UK) Plc v Mark Redler & Co Solicitors* [2014] UKSC 58, [2015] AC 1503; *Sharp v Blank* [2017] EWHC 3390(ch), [2017] BCC 187.

[67] *Abacus Trust Co (Isle of Man) Ltd v Barr* [2003] EWHC 114(ch), [2003] Ch. 409.

[68] *Pitt v Holt* [2013] UKSC 26, (2013) 2 AC 108, 143.

[69] Walker R, 'The Changing Face of Trust Law' (2016 lecture to the Association of Contentious Trust and Probate Specialists; a slightly modified text is at (2017) 31(1) Trust Law International 19)

[70] Heydon (n 61).

[71] *Cowan v Scargill* [1985] Ch. 270, 276 and 287-89.

[72] [2011] EWCA 347, [2012] Ch 453, 469.

money is, or at least may be, a breach of fiduciary duty.

J D Heydon continues by identifying other positive fiduciary duties in case law, including the duty of a trustee to identify and to obey the terms of the trust; the duties to invest in the best interest of the beneficiaries and the 'fiduciary duties of care' to which Lord Browne-Wilkinson referred in *Henderson v Merritt Syndicates Ltd,*[73] albeit in a judgment in which he advocated a thesis resembling that stated in *Mothew*, to the effect that there is only one type of negligence standard in the law, no matter in which type of legal setting or under which cause of action it emerges. This is essentially based on 'reasonableness', albeit as it applied to the particular circumstances of each case. The circumstances in question were the rather opaque practices of the Lloyds of London insurance market. The plaintiffs sought to claim under two heads, the first for negligence constituting breach of contract and the second for breach of fiduciary duty. The judgment made clear that the dual claims were misconceived, as they constituted one single claim as any fiduciary duty would arise under and reflect the contractual terms.

J D Heydon also suggests that the decision of the Supreme Court in *Pitt v Holt* involves a positive duty on trustees to consider all relevant matters when exercising a 'fiduciary power'.[74] There are other aspects of Lord Walker's *Pitt v Holt* judgment that indicate support for a prescriptive duty, not least where he described the case as being concerned with a technique for the law to control fiduciaries 'who make decisions without having given proper consideration to relevant matters which they ought to have taken into consideration'.[75] Lloyd J had closely examined the duties of trustees when exercising a fiduciary discretion in the Court of Appeal,[76] where he quoted Lord Wilberforce and Lord Truro[77] in support of the positive duty to be appropriately informed when exercising discretionary powers, breach of which would be breach of

[73] (1995) 2 AC 145 (HL).

[74] *Pitt* (n 68) 135 [60].

[75] *Pitt* (n 68) 120 [2], 131 [40]- [41].

[76] *Pitt v Holt and Futter v Futter* [2011] EWCA Civ 197, [2012] Ch. 132.

[77] *McPhail v Doulton* [1971] AC 424; *Re Beloved Wilkes' Charity* [1851[EWHC Ch J52, (1851) 3 Mac & G 440.

fiduciary duty.[78]

There is also the controversial Court of Appeal judgment in *Item Software Ltd v Fassihi,*[79] in which Arden LJ held that the fiduciary duty of a director included a positive duty to disclose to the company his own misconduct as, in failing to report his own misconduct, the director had failed in his fiduciary duty to promote the interests of the Company. The extension of the duty of loyalty to include a duty to confess has received a mixed reception in the English Courts, while the existence of any general fiduciary obligation of disclosure has been doubted in Scotland[80] and the Australian courts have expressly declined to follow the decision: fiduciary duties remain, in Australia, only and firmly proscriptive.[81]

Fassihi is also of interest as, while doubting Arden LJ's prescriptive analysis, Professors Armour and Conaglen have drawn attention to her use of the economic theory of agency costs to justify the director being found to have engaged in misconduct. This contrasts with the many earlier cases that rely on arguments concerning relationship integrity as the basis for the Court enforcing the fiduciary's undertaking to act in the sole interest of the beneficiary (or whichever diluted version applies).[82] Even accepting utilitarian or efficiency arguments, for example based on agency costs, are a type of moral argument, Arden L J's analysis represents divergence from the cases that preceded the emergence of information asymmetry or the 'agency problem' in the second half of the last century. These were determined on the basis that the fiduciary, having accepted a role that involved personal responsibility to favour others, should not be allowed to escape the consequences of that decision. [83]

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[78] Michael Ashdown, 'Pitt v Holt: What next for the Rule in Re Hastings-Bass?' [2011] Eld LJ 291.

[79] 2004 EWCA Civ 1244.

[80] *Commonwealth Oil & Gas Co Ltd v Baxter* [2009] CSIH 75.

[81] *P & V Industries Pty Ltd v Porto* [2006] VSC 131: Hollingworth J doubted, in his judgment, that the proscriptive only analysis represented the law in England.

[82] J Armour and M Conaglen, 'Case Comment: Directorial Disclosure' (2005) 64(1) CLJ 48-51.

[83] See e.g. Robert Cooter and Bradley J Freedman, 'The Fiduciary Relationship: its Economic Character and Legal Consequences' (1991) 66 NYUL Rev 1045.

- fiduciary and non-fiduciary duties

It is important to identify another potential source of confusion. The expression 'fiduciary duty' has been described as in 'a terminological mess'.[84] The expression refers, when used in this thesis, to the duty of loyalty that is the distinguishing feature of the fiduciary status. In the words of Millett L J: 'The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary'.[85]

The expression 'fiduciary duty' is also used to describe a duty of a fiduciary that is not a 'fiduciary duty' but a duty owed in the role that the fiduciary has undertaken to fulfill but which is not a duty restricted to fiduciaries. [86] It is important to remember this potential confusion of terminology as it is the explanation of a material body of case law in which a breach of the restraints imposed on the exercise of a power granted to a party that is a fiduciary has been described as a breach of fiduciary duty notwithstanding that the same duty is owed by non-fiduciaries and breach does not give access to the equitable remedies available for breach of 'fiduciary duty', albeit other equitable remedies may be available.[87]

This is another area of disagreement and uncertainty. The no conflict and no profit rules are in the former category, while the latter encompasses a number of duties that involve no decision making, for example recording obligations and administrative tasks. In between there is a range a number of duties which involve taking decisions that affect the interests of the principal but which are not only owed by fiduciaries but also by non-fiduciaries - and thus breach of which are not, in the words of Millet LJ, 'peculiar to fiduciaries'.[88]

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[84] Charles Mitchell, 'Good Faith, Self-denial and Mandatory Trustee Duties' (2018) 32(2) Trust Law International 92.

[85] *Mothew* (n 12).

[86] Conaglen (n 1) Ch 3.

[87] Robert Walker LJ in *Bairstow v Queens Moat Houses plc* [2001] EWCA Civ 712, [2001] 2 BCLC 531, [53] .

[88] *Mothew* (n 12).

The facts of the *Mothew* case provide a useful example of the difference between non-fiduciary and fiduciary duties. The case concerned a solicitor, who will usually owe the client a fiduciary duty by virtue of the obligation to act and to advise on the basis of what is in the client's best interest.[89] The claimant building society made a mortgage advance on the basis of a negligent report by the solicitor on the title of the property to be acquired by the mortgagors. The solicitor was not advising the mortgagors on the purchase of the property but prepared the title report on the joint instructions of the mortgagee company and the mortgagors. The mortgage had been approved on the express condition that the mortgagors were financing the balance of the purchase price from their own resources so that there was to be no second charge on the property when acquired. The property was acquired using the proceeds from the sale of the mortgagors' existing home but, as part of the arrangements, a small sum was left outstanding, repayment of which was secured by a second charge on the property.

The solicitor had overlooked this second charge in the title report, although it was accepted that this was the result of negligence rather than the result of any deliberate misconduct. The mortgage monies were duly advanced, conditions in the property market subsequently deteriorated significantly and the mortgagors defaulted. The mortgagee claimant foreclosed but the sale proceeds were insufficient to repay the mortgagor's outstanding debt in full. The Court of Appeal held that the solicitor's negligence was a breach of the duty of skill and care but not a breach of fiduciary duty. Damages should therefore be restricted to the loss suffered because the second charge was met out of the sale proceeds, with only the amount of the secured debt putatively recoverable from the solicitor's insurers and not the bank's overall losses, in particular those resulting from the economic downturn rather than the negligent report.[90] The bank had sought to recover all its losses on the basis that a fiduciary is liable for all losses that follow the breach of fiduciary duty with no reduction for foreseeability or causation.[91]

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[89] *Nocton v Ashburton* [1914] AC 932 (HL) cf. James Edelman, 'When Do Fiduciary Duties Arise?' (2010) 126 LQR 302.

[90] No award for damages was made with the assessment left for a further trial, which did not take place, with settlement likely to have intervened.

[91] *Brickenden v London Loan & Savings Co* [1934] UKPC 25, (1934) 3 DLR 465 and see further chapter 4.

The key determinant is that if the fiduciary has not been found to have been, as a matter of law, in breach of the no conflicts or no profit rules or otherwise in breach of fiduciary duty, the manager's 'conduct will be actionable, if at all, for other reasons and on other bases: negligence, breach of contract, breach of trust or whatever'.[92] At the same time a fiduciary can be in breach of fiduciary duty even though acting in good faith, for example when there is an unauthorised conflict of interest.[93] A further complication is that the law in other commonwealth jurisdictions is not always as clear, while American law and statute provide a wider scope for fiduciary duties.[94]

The *Mothew* example is straightforward and easy to comprehend. The situation becomes less clear where the actions or omissions of the fiduciary extend beyond mere negligence to encompass, for example if repeated on several occasions, gross negligence. Lord Walker has suggested a duty on the fiduciary to become informed as to the scope of, and to deliberate carefully whether to exercise, the fiduciary powers.[95] As Lord Walker has himself admitted, this prescriptive formula is hotly disputed, with others arguing strongly in favour of fiduciary duties being only proscriptive and confined to the no conflict and no profit rules.

The argument is to some extent a reflection of the separation of fiduciary law from trust law that is a feature of the last thirty years since *Mothew* and the practical consequences can be overstated given the availability of equitable remedies is increasingly not restricted to fiduciary relationships. The Court of Appeal recently went so far as to suggest that the duty that has been (allegedly) breached should be analysed to determine its exact scope and if breach had occurred- and if the answer is 'yes' 'Courts do not need to involve themselves in complex analyses of the nature of the fiduciary relationship'.[96] This does not mean that there is no recourse to equitable remedies,

[92] Paul Finn (n 11) 84.

[93] *Keech v Sandford* [1726] EWHC Ch J76, (1726) Sel Cas Ch 61; *Boardman* (n 18) 104; *Regal (Hastings)*(n 20) 381, 385, 391-2.

[94] Employee Retirement Investment and Savings Act of 1974 ('ERISA') and Criddle (n 6) subpart II(E); David Kershaw, *The Foundations of Anglo-American Corporate Fiduciary Law* (CUP 2018).

[95] Walker R (n 69).

[96] *Wood v Commercial First Business Ltd* [2021] EWCA Civ 471; [2021] 3 WLR 395; [2021] 3 WLUK 549 (CA (Civ Div)).

simply that the Court may exercise its discretion to award them without investigating whether the remedy is available automatically by virtue of a fiduciary relationship.

- *conflicts*

This brief summary of fiduciary duty has identified a number of the many associated uncertainties that remain unresolved. In English law, fiduciary duty involves compliance with the interpretation of the no conflict and no profit rules propounded by Millett L J, adapted to the particular circumstances of the fiduciary relationship, including any modification by virtue of a contract, such as, where the manager is a fiduciary, the IMA. It would seem, however, that the duty of loyalty may, as a matter of English law, also be breached in some situations where there is compliance with the no conflict and no profit rules.

The risk that potential conflict could become actual required for a potential conflict to be prohibited under the no conflict rule is also uncertain. Some guidance can be gleaned from the test suggested by Lord Upjohn that the potential conflict must be such that:

> 'the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict; not that you could imagine some situation arising which might, in some conceivable possibility in events not contemplated as real sensible possibilities by any reasonable person, result in a conflict'.[97]

This is not a test that, in practice, is always easy to apply. Problems also arise as to the scope of the no profit rule, in particular whether profits must be disgorged even where there is only a tenuous link between their source and any fiduciary role and the principals were not in a position to benefit in their own right.[98] Other unresolved questions include whether a complete failure to carry out any aspects of the duty of care that a fiduciary has undertaken to perform constitute not only contractual breach but

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[97] In his dissenting judgment in *Boardman v Phipps* (n 18) 125.

[98] S Worthington, 'Fiduciary Duties and Proprietary Remedies: Addressing the failure of Equitable Formulae' (2013) 72(3) CLJ 720.

also disloyalty on the basis of a failure to engage despite an undertaking to do so. In what circumstances is it necessary to investigate the reason for failure to ascertain the motive, if any, to distinguish fiduciary breach from negligence, perhaps through simple memory lapse? Would memory lapse repeated over an extended period constitute gross negligence and is this enough to be disloyal - or is a reckless or deliberate decision required?

A further issue is whether negligence in circumstances known to the fiduciary to be critical to the beneficiary's interests amount to disloyalty, which seems close to spiteful or malicious conduct that has been held to be disloyal?[99] Or does the fiduciary who 'had a conscious disregard for her duties on a material scale' fail the test of loyalty and thereby breach the fiduciary duty, as suggested in the judgment in *Top Brands Ltd v Sharma*?[100]

Finally acceptance that the terms of a contract between fiduciary and beneficiary may modify the no profit and no conflict rule as well as any other fiduciary duty raises the question whether fiduciary duty can be not just modified but excluded in favour of a simple contractual duty even where the fiduciary has, wilfully or fraudulently, breached the obligation in circumstances within the irreducible core of trustee duty identified in *Armitage v Nurse*[101] as wilful default or fraud. It has been suggested that, at least under Australian law, contract terms can exclude fiduciary duty in circumstances where the principal can reasonably be assumed to understand the implications of the exclusion and it was made clear to the principal that the appointment could only be undertaken if the agent was not a fiduciary and thus did not owe fiduciary duties.[102]

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[99] *Murad* (n 41).

[100] *Top Brands* (n 66).

[101] *Armitage v Nurse* [1997] EWCA Civ 1279, [1998] Ch 241.

[102] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Lt*d [2007] Federal Court of Australia 963; Joshua Getzler, 'Excluding fiduciary duties: the problems of investment banks' (2008) 124 LQR 15-21; R Stringer and J Harkness, 'SIC v Global markets Australia Pty Ltd' (2007) 122(10)Journal of International Business Law Review549-552; Y Bandi, 'Conflict of interest in financial advisory services in Australia after Asic v Citigroup: what next? (2008) 123(10) Journal of International Business Law Review 538.

The case concerned an investment advisory appointment in which the adviser specified that it would not be acting as a fiduciary although the role subsequently developed to include advice to which a fiduciary duty would normally attach and has been criticised, not least by Professor Finn. He concluded that the judgment was an error of 'characterisation'.[103] The contract described a course of conduct - providing information and advice - which would not have involved fiduciary obligations but which was not, in fact, the course the relationship eventually followed, in particular as the potential fiduciary took on, later in the relationship, an agency role which he considered should have involved fiduciary obligations as a result. He continued: 'The Courts should be slow indeed to give their blessing to a blanket denial of fiduciary responsibility in a relationship which manifestly would otherwise be fiduciary'.

The duty of a fiduciary, absent a modification in terms of the appointment or variation with the fully informed consent of the principals, involves compliance with the no conflict and no profit rules while carrying out the fiduciary role. However issues on which consensus is lacking include the scope of the prohibition on potential conflict of interests, the range of potentially forfeited profits which the principal could not itself earn and the possibility of a small set of circumstances that fall outside the no conflict and no profit rules but nevertheless represent a breach of the fiduciary duty of undivided loyalty.

- *interest/duty and interest/interest: the inhibition principle*

The conflicts themselves can generally be classified as falling into two categories,[104] though some will fall into both. The first is conflict between the interests of the fiduciary and the beneficiary; and the second conflict between the duty of the fiduciary to two different beneficiaries, both of whom have consented to the conflict, placing the fiduciary potentially at risk of favouring one beneficiary at the expense of the other. The first is commonly referred to as 'a conflict of duty and interest' or 'duty-interest': the second as 'a conflict of duty and duty' or 'duty-duty'.

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[103] Paul Finn, *Fiduciary Obligations 40th Anniversary Republication with Additional Essays* (The Federation Press 2017), para 818.

[104] I Walter, *Conflict of Interests and Market Discipline Among Financial Services Firms* (2004) 22(4) European Management Journal 361.

Historically the duty-duty conflict was often analysed as an example of the duty-interest conflict, with the interest of the fiduciary in conflict with the duty to the client seen, in the absence of any more suitable candidate, as the interest of the fiduciary in satisfying its obligations to the second client. Millett L J identified, once more in *Mothew*, what he referred to as the 'inhibition principle'. This applies in the circumstances where the clients whose interests conflict have all given fully informed consent to the fiduciary being retained by each of them notwithstanding the possibility, indeed even likelihood, that an actual conflict between duties will arise.[105]

Whether or not this is an aspect of fiduciary duty rather than a separate duty akin to the tort of inducing breach of contract is outside the scope of this thesis.[106] The duty will be treated as a close relation, not least given its particular relevance to discretionary portfolio management. These circumstances are commonly referred to as a fiduciary having 'double employment', that is more than one fiduciary relationship. In the words of Millett LJ: 'The principle which is in play is that the fiduciary must not be inhibited by the existence of his other employment from serving the interests of his principal as faithfully and effectively as if he were the only employer'. He then continued with an important rider to the basic proposition: 'the fiduciary must take care not to find himself in a position where there is an actual conflict of duty so that he cannot fulfil his obligations to one principal without failing in his obligations to the other'. I shall call this this 'the actual conflict rule'. [107]

Millett LJ continued the fiduciary: 'must not act with the intention of furthering the interests of one principal to the prejudice of those of the other…. He must not allow the performance of his obligations to one principal to be influenced by his relationship with the other. He must serve each as faithfully and loyally as if he were his only principal.' The cases indicate that for the inhibition principle to be breached there must be a mental element behind the action or omission that benefits one client over another.

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[105] *Mothew* (n 12).

[106] The issue is discussed but not resolved in Matthew Conaglen, 'Fiduciary Regulation of Conflicts between Duties' (2009) 125 LQR 111.

[107] *Mothew* (n 12) 19, see also *Hilton v Barker, Booth & Eastwood (a firm)* [2005] UKHL 8, (2005) 1 All ER 651; Joshua Getzler, 'Inconsistent fiduciary duties and implied consent' (2006) 122 LQR 1.

An unconscious omission that benefits one client at the expense of another, for example an agency cross[108] that is delayed through negligence may well be a breach of the duty of skill and care owed to the client who suffers from the price change in the interim (as well as to the client who benefits as a result) but the omission will not, of itself, constitute a breach of this variant of fiduciary duty.

Breach of the inhibition principle is an exception to the normal rule that no evidence of motive is required to establish breach of fiduciary duty. However the cases indicate an element of confusion as to the mental element required, possibly because the duty has been confused with the increasingly peripatetic duty of good faith. Lloyd J considered the conduct needed to constitute breach involved more than mere incompetence rising to 'the level of conscious bad faith'.[109] In contrast Blackburne J held that, for an action or omission that unfairly benefits one client over another to constitute a breach of duty, the action or omission must result 'from a conscious and deliberate decision' to prefer the interest of one client over another.[110] In contrast Millett LJ emphasised, in *Mothew*, that dishonesty need not be established. He considered that a conscious breach of duty need not be dishonest, for example where the breach by the fiduciary was considered by the fiduciary, even though erroneously, to be in the best interests of the client. In practice this is one of a number of areas of uncertainty in fiduciary law that is circumvented, in the context of portfolio management, by the terms of the IMA incorporating compliance with FCA regulation.

The next section identifies how the basic fiduciary duties and the surrounding uncertainties are modified when applied to the discretionary management of portfolios owned by third parties under English law.

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[108] A transaction in which the manager acts as agent for both parties, which is included in the permitted conflicts discussed in chapter 3.

[109] *Zwebner v Mortgage Corp* [1997] PNLR 504 (Ch), 514.

[110] *Nationwide v Goodwin Harte* [1999] Lloyd's Rep PN 338,414.

III -The fiduciary duty of the discretionary portfolio manager

The Client entrusts the manager with the Client's property – the portfolio - and relies on the manager to manage the portfolio for the Client's benefit in reliance on the manager's undertaking to seek the best performance available within the confines of the investment mandate. The relationship between Client and manager accordingly falls fairly within the description of a fiduciary relationship and the portfolio manager, as a fiduciary, owes the Client, while carrying out the portfolio management role, a duty of loyalty that involves fiduciary obligations.[111] This encompasses the no conflict and no profit rules with the further possibility that a serious failure to satisfy obligations when carrying out its discretionary portfolio management duties which do not involve breach of the no conflicts and no profits rule might, depending on the circumstances, constitute a breach of fiduciary duty. The manager's obligations are, however, governed and the 'no conflicts' and 'no profits' rules modified by the terms of the IMA.

An action or omission that would otherwise be a breach of fiduciary duty can be authorised , typically by the principal[112] but also by the Court [113] or by the creator of the power at the outset.[114] Once a fiduciary relationship arises a potential breach may also be authorised but the principal must give 'nothing short of fully informed consent' [115] . The additional requirement may also apply where a different fiduciary relationship exists between the parties to the relationship in respect of which modification is being sought.[116]

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[111] *Bowstead & Reynolds* (n 4) 6-033; *Lowther v Lowther* (1806) 13 Ves 95; *Hurstanger Ltd. V Wilson* [2008] Bus L R 216; *FHR European Ventures LLP v Cedar Capital Partners LLC* [2015] AC 250.

[112] See e.g. *Gibson v Jeeves* (1801) 6 Ves 266; *Quarter Master UK Ltd v* Pyke [2004] EWHC 1815 (ch); *Australian Securities & Investments Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963, (2007) 160 FCR 35.

[113] See e.g. *Re Drexel Burnham Lambert UK Pension Plan* [1995] 1WLR 32 (ChD).

[114] E.g. in a Trust Deed (in relation to the duties of the trustee(s)) or the Articles of Association (in relation to the duty of directors) - as well as in the contract that establishes the fiduciary relationship, with one example the IMA.

[115] *Re Halslam & Heir-Evans* [1902] 1 ch 765,770; *Boardman* (n 18).

[116] *Australian Securities & Investments Commission* (n 112).

The Client's consent (or consents where the Client is more than one investor) to the modification of the strict fiduciary prohibitions will normally be indicated by agreement to the terms of the IMA if the Client is a professional investor [117] and accordingly assumed to have the knowledge and skill to understand and to negotiate the terms. While the same common law principle applies to IMAs with retail investors, the manager is subject to a number of regulations that apply to the process that leads up to an IMA being agreed which include an obligation to ensure that the IMA is the 'suitable' for the Client. This encompasses, for the retail investor, that the investment objectives and risk tolerance of the Client are suitable; that the Client understands the nature of the service; and that the Client is financially able to bear the risks involved. While certain assumptions are made in respect of a professional investor these do not apply to a retail investor.[118]

As a result, as well as to reduce the risk of an accusation of misrepresentation, market practice is to take additional precautions to evidence that the Client had been fully informed of the consequence of agreeing to the IMA terms, including the modifications to the fiduciary duties the terms contain. Normal practice includes that each Client signs an IMA that includes a long and exhaustive list of circumstances in which potential conflict of interests may arise in the course of the manager providing services pursuant to the IMA, to which conflicts the Client, by becoming party to the IMA, consents.[119] The list will typically begin with words to the effect that 'the Investment Manager or an Associate undertakes investment business for other Clients'. The effect is that each Client has consented to the manager and any associate owing duties to third parties that may conflict with the duty of the manager to the client. [120]

In addition a written statement including a summary of the practical consequences of the Client agreeing to the proposed modification would be given to the

[117] An expression defined in COBS ch 3, the Handbook, see Chapter 1 page 9.

[118] COBS chs 9& 10.

[119] The additional steps taken, in some circumstances, to seek to ensure consent is fully informed are discussed in Chapter 1, section IV.

[120] Typically defined as any entity in the same group or under the same control or majority ownership, directly or indirectly, as the manager.

investor after a verbal explanation. The Client (or its representative(s)) would then be given an opportunity to ask questions which would be answered after which the Client would then be asked to sign the written statement and thereby acknowledge that the consequences of agreement had been explained, there had been an opportunity to ask questions and the Client did not object to the consequences of agreement.

The scope and complexity of the written memorandum or, in some cases, memoranda will depend on the range of services that other members of the group of which the manager was a member provide services. It is, however, not unusual for memoranda to include services which no associate is providing at the time but may in the future (or has in the past) as this reduces the need for updating. It is not necessary for the Client to be aware that agreement to the terms proposed in the IMA involves a modification of fiduciary duties, only that the investor had been fully informed of the consequences of agreement to the term and had approved this the proposed.[121]

The manager undertakes in the IMA, amongst other matters, to carry out its investment management responsibilities with the application of a level of knowledge and skill that it is reasonable to expect a portfolio investment manager to apply when carrying out these duties or as otherwise specified in the IMA.[122] On the basis of the *Mothew* judgment this undertaking is not, of itself, a fiduciary duty and a breach of the undertaking, for example through negligence, is unaffected by the status of the manager as a fiduciary. The fiduciary status may, however, be reflected in the level of skill and knowledge it is reasonable for the portfolio owner to expect will be applied to satisfying the obligation.[123]

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[121] *Re Pauling's Settlement Trusts* (1962) 1 WLR 86*; Sofer v Swiss Independent Trustees SA* [2020] EWCA Civ 699.

[122] Sale of Goods Act 1982, s.13.

[123] Charles Mitchell (n 84) refers to sources indicating support for this concept from His Honour J D Heydon, Joshua Getzler, Lionel Smith, Richard Nolan and Matthew Conaglen.

- *conflict of interest*

As the CFA Society of the United Kingdom[124] has explained,[125] in the ordinary course a manager is paid by its Clients and so profits from the appointment while typically acting for more than one Client. A manager also encounters actual and potential conflicts of interests on an almost daily basis, with this an integral part of the investment management process. Where the manager is a subsidiary of a group the potential conflicts expand to include the provision of services to the portfolio by any other member of the group. The strict fiduciary duty and application of the no conflict rule must accordingly be modified. To do otherwise would be an impractical restriction on a global business, with the vast majority of managers having control over the content of multiple portfolios managed for many different clients, even after taking into account that, while a collective investment vehicle may have many investors with interests in its portfolio, the vehicle is, for portfolio management purposes, only a single Client.[126] In the case of the manager the prohibition on conflicts, if not modified, would leave the manager unable to carry out the portfolio management role.[127]

If the manager is to be entitled to manage the portfolio notwithstanding conflicts of interests, three questions arise: first, what constitutes a conflict of interests: second, in what circumstances are conflicts permitted; and third whether and how are those circumstances to be managed and policed. A conflict of interests in the context of financial services has been described economic terms as 'a situation in which a party to a transaction can potentially gain by taking actions that adversely affect its

[124] The branch of the CFA Institute in the UK.

[125] CFA, 'Fiduciary Duty'(CFA Position Paper April 2014) issued in response to John Kay, 'The Kay Review of Equity Markets and Long-term Decision-making, Final Report' (HM Gov, July 2012); Law Commission 'Fiduciary Duties of Investment Intermediaries' (Law Com CP 350, 2014).

[126] The rights of the individual investor will be set out in the constitution or other governance document, to which the manager need, indeed often will, not be a party.

[127] The United States of America Securities and Exchange Commission made a similar point in its 1963 'Special Study of Securities Markets', while Professor Gower talked of 'commerce grounding to a halt' if conflicts of interests were not permitted in his 1984 'Report on Investor Protection' (now in the national archives).

counterparty',[128] which highlights the difficulty of a precise legal definition given the uncertain scope of 'potentially'.

In the context of portfolio management conflicts can generally be classified as falling into two categories,[129] though some will fall into both. The first is conflict between the economic interest of the manager and the economic interest of its Clients - 'a conflict of duty and interest'; and the second conflict between the economic interests of different clients, placing the firm potentially at risk of favouring one client at the expense of the other - 'a conflict of duty and duty', a situation where the duty of the manager to one client conflicts with the duty of the manager to another and the inhibition principle identified by Millett LJ, applies. This is among a number of the uncertainties of fiduciary law that is circumvented, or at least ameliorated, by the modifications to the rules included in the IMA.

The IMA will typically refer to the manager having in place arrangements for the management of conflict of interests in accordance with FCA rules. The relaxation to the fiduciary prohibition on unauthorised conflicts permitted by regulation can be summarised as permitting conflict of interests provided that the manager identifies the conflict and records the specified details; takes reasonable steps to avoid the conflict: notifies the client when a conflict cannot be avoided by taking reasonable steps; and takes reasonable steps to ensure that all clients affected by the conflict receive fair treatment. Fair treatment includes giving the clients priority over the interests of the manager unless the custom of the market or any applicable regulation permits otherwise - and in any event not favouring any one client over any other (at least unless both parties give consent or regulation requires this).[130]

The obligation of the manager under the IMA will not be to comply with the relevant FCA regulations. The IMA will contain a modification that permits conflict of interests provided the manager 'takes reasonable steps to ensure fair treatment for the

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[128] H Mehran and RM Stulz, 'The Economics of Conflicts of Interests in Financial Institutions' (2007) 85(2) Journal of Financial Economics 267.

[129] I Walter (n 104) .

[130] The rules and guidance are contained in the FCA Handbook: SYSC chapter 10.

Client' (or some variant with a broadly similar meaning). This prevents a minor breach of the FCA rules constituting a breach of the IMA and, as the modification to the fiduciary principle would no longer apply, a breach of fiduciary duty entitling the Client to equitable remedies. A breach of the exemption from the no conflicts rule instead requires a failure to take reasonable steps to ensure fair treatment for the Client. 'Fair treatment' is not guaranteed, however, only that the manager will take reasonable steps with a view to achieving this. This reflects that judging 'fairness' is an issue on which opinions often differ and the result is uncertain unless detailed rules for determining fairness have been agreed, the same principle that applies to the intervention of equity under the common law.[131]

A complication is that conflicts of interest have a different meaning for regulatory and IMA purposes. The IMA is concerned with the relationship between Client and manager and the terms will expressly exclude any interests arising under the IMA for third parties. The FCA expands conflicts to include conflicts with an expanded definition of client[132] that includes, amongst others, potential clients, a Collective Investment Scheme ('CIS') that is a Client and the investors in the CIS ,as well as the members of a personal pension scheme where the scheme itself is or its trustees are the Client. At the same time there is a reduction to the common law scope of conflict of interests in the description – there is no definition - of 'conflict of interests ' that appears in the FCA rules.[133] These provide as guidance that for an actual or possible situation to represent a conflict between the manager's duty to the client and its interests it is not enough that there is a risk that the manager may benefit from the situation, there must also be a potential disadvantage to the client. The guidance continues by providing that it is not enough that a client of the manager may benefit from the appointment for an actual or potential conflict between the duties owed by the manager to one or more clients there must be both a benefit to one client and a potential loss to another client as a result.[134]

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[131] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (CUP 2010) Ch IV 1 and 2.

[132] FCA Handbook: Glossary.

[133] FCA Handbook: Senior Management Arrangements, Systems and Controls ('SYSC') chapter 10 contains the applicable rules and guidance.

[134] FCA SYSC 10.1.5G.

While an actual conflict may be relatively straightforward to detect, the wide scope of potential conflict makes identification potentially more difficult. There is a role for common sense, as suggested by Lord Upjohn's test in *Boardman v Phipps*, with the decision to be based on the reasonable person's view of the likelihood of actual conflict, as well as similar observations in other judgments that decisions, for example that the test as to what constitutes conflict 'must be applied realistically to a state of affairs which discloses a real conflict of duty and interest and not to some theoretical or rhetorical conflict'.[135] While the common law may not be bound by regulation it seems realistic to assume that, in the context of portfolio management, the Court would be guided by the regulator's view of when a conflict of interest between manager and Client arose. At the same time a conflict involving a third party other than the Client would fall to be governed by the FCA rules, with any breach a matter for regulatory enforcement rather than a breach of contract. In the absence of any assumption of liability by the manager to the third party it would seem unlikely that any tortious duty would arise.[136]

Even so the judgment for the manager is not an easy one: too cautious an approach means additional time and cost to deal with the consequences, too restrictive saves time in the short term but raises the risk of regulatory criticism, censure or worse if the decision is questioned on review. Most managers accordingly prefer caution, notwithstanding the additional time and costs, much if not all of which will be passed on, directly or indirectly, to the Client and thus to any indirect investors.

Conflicts of interests are a topic that attracts much attention from regulators, not only in the UK but in the many other jurisdictions around the world. In its 2012 report[137] the Financial Services Authority (the 'FSA') - the predecessor to the FCA - reviewed conflict of interests likely to be encountered by managers and others in the ordinary course of investment business. The report was generally critical of the steps industry participants were taking to identify conflicts, which the report reviewed under five main

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[135] *Boardman* (n 18); *Boulting v Association of Cinematograph, Television and Allied Technicians* (1963) 2 QB 606 (CA) *; Burns v Financial Conduct Authority* [2017] EWCA Civ 2140, [2018] WLR 4161.

[136] *South Australia Asset Management Corporation v York Montague Ltd* [1996] UKHL 10, (1997) AC 191.

[137] Financial Services Authority, 'Conflict of interests between asset managers and their customers: identifying and mitigating the risks' (FSA, November 2012).

headings: research and trade execution (more generally known as 'soft commission'); gifts and entertainment; access to investment opportunities; personal dealings by employees; and errors.

The FSA report did not mention conflicts arising in the course of portfolio review and decisions to change portfolio content as a matter of concern. This is an area that has proved difficult, if not impossible, to police: an investment choice involving an associate can almost always be justified as reasonable, while such tests as a connected appointment or investment must be shown to be 'better than the best' otherwise available from an independent source have proved impractical. The FSA's 'Treat Customers Fairly' ('TCF') 2007 initiative proposed such a test for investment in a connected company but this was withdrawn after the industry pointed out that this could work to the detriment of investors by preventing investment in CIS managed by a successful associate. The conclusion to be drawn is that the regulator has accepted that improper motive is all but impossible to police, with a requirement only that the investment or decision not to change portfolio content represents a reasonable decision which is recorded contemporaneously.

The report highlighted a lack of awareness amongst managers of situations where the short-term business goals of the firm conflicted with the long-term interests of the client. Although the paper included no examples, one is the practice of the individual manager(s) of a portfolio being urged by the firm's management to reduce the risk element in the portfolio in order to 'lock in' a successful, relative to the benchmark against which performance is measured, 'run' in the early section of a period by which performance is measured. One, indeed potentially the principle, reason for this may well be a desire to enhance the reputation of the firm through a strong overall performance of all, or simply similar, portfolios under its management.

The many publicly available performance tables split participating portfolios into categories based on the reference index either specified or which most nearly matches the investment objective.[138] The perception within the industry is that the higher the

[138] Broadly all portfolios available for direct investment by a retail investor or whose managers volunteer performance statistics to the compiler of the table.

percentage of assets under management in portfolios whose performance is, or equates to, the first quartile of the relevant category, the higher the reputation of the firm. At the same time, attracting new money for (i.e. investment in) a fund from an institutional investor or independent financial adviser ('IFA') is considered a worthwhile use of marketing resources only if the fund's portfolio has appeared in the top quartile of the relevant performance table on a consistent basis over a period that depends on the targeted IFA or institution, but typically exceeds one year and may be as much as three.

Such a move to 'beta tracking', the intent and effect of which is that the fund's performance matches the performance of the relevant index for as long as the strategy remains unchanged, means that the risk profile of the portfolio may be materially less than the interests of the Client alone would justify. This will be justified, if challenged, as an appropriate response that is in the best interests of the Client in light of the risk that short term performance may involve an element of good fortune. The reasons for good fortune could just as speedily reverse - so that the risk reduction is in the interests of the investor, with benefit to the firm only (allegedly) a corollary rather than the motive behind the decision.

The feature that an act or omission in an area of conflict can be justified as in the interests of both the Client and the manager is shared in many of the conflicts that arise as a matter of routine portfolio management. While the fiduciary principle is breached if the motive behind the act or omission is the interest of the manager, the availability of argument that the act or omission is appropriate in the interests of the Client makes detection, in practice, difficult if not impossible: suspicion alone is not enough as evidence would need to be uncovered that established, even if only on a balance of probabilities, the real motive.

As Finn has pointed out, a major difficulty facing an aggrieved principal in the normal course is that the fiduciary may not be required to give reasons for its decisions.[139] This defect is combatted by regulation that requires contemporaneous recording of the reasons behind every decision to change portfolio content. There are, however, many valid reasons for an investment decision and if a plausible reason is

[139] Finn (n 103) para 89.

recorded the real reason may never be revealed (perhaps even to the decision maker, for example if the underlying reasons for the decision are not fully appreciated or involve unconscious bias).

The result is that, as a matter of practice, the fiduciary duty has been modified to become a requirement to record a reason for the investment decision that is plausible, with breach likely to be established only where no recording is made or the reason recorded or process followed is one that no reasonable manager acting reasonably could have used to justify the investment decision.[140] Similar features are present in the case of the conflicts that arise in 'fund seeding', manager acquisitions and sales to managed portfolios, agency crosses and cross holdings – a portfolio having a holding in another portfolio managed by the same manager. These are among the industry practices that run counter to the fiduciary principle that are reviewed in the next Chapter.

The payment to brokers for research as part of the fee for implementing a manager's decision to change the portfolio – 'soft commission' - is a further example of permitted conflict between manager and client that may operate against the client's best interests. The practice and its history are analysed in section II of the next chapter, including its severe curtailment by the introduction of MiFID II in January 2018. This curtailment by regulation automatically applied to IMAs and affects dealing, including implementing decisions to change portfolio content, by portfolio managers based in the EU when operating outside the European Economic Area (the 'EEA') and therefore throughout the world: the consequences are also discussed in the next chapter.

As discussed in the chapter 1, 'best execution' refers to the execution of decisions by a manager to change the content of the portfolio. The reforms introduced by MiFID II include a requirement for a substantial increase in the monitoring and reporting by managers of the costs incurred when dealing as agents for their clients on alternative exchanges and other trading venues. The expectation is that the increase in information will lead to greater efficiency in broker selection and an overall reduction in dealing costs. The risk is that the increase in costs, in particular incurred to satisfy the expanded

[140] This was the position in the Martin Currie disciplinary proceedings case, with this and the aftermath reviewed in chapter 4.

reporting obligations, will be greater than any resulting benefit to clients. Not least the changes will favour the larger managers, as economies of scale permit the increased costs to be spread across many portfolios, so once more potentially hindering competition.

The FSA also criticised the acceptance of gifts or entertainment by a manager or its staff from a broker or associate. This is a long-standing practice. The concern is that the, or a motive behind the gift or entertainment is to influence decisions by the manager (or its staff) as to which firm to instruct to implement a decision to change portfolio content in favour of the donor or host. The risk is that the concern is valid, the choice is not made based on the best interests of the client and the client does not receive best execution as a result. The compromise is regulation that permits gifts and entertainment provided that records of all gifts and entertainment outside *de minimis* limits are made and these confirm that the value and frequency involved is not 'unreasonable'. That said if senior employees or officers enjoy a good personal relationship with a broker it may be hard to persuade them that the broker is not offering best execution notwithstanding that the considerably increased monitoring of execution required of managers by regulation provides strong evidence that suggests to the contrary

It is not unusual for decisions involving the portfolios under the management of the same discretionary portfolio manager to involve the same security, in some cases with one portfolio to acquire and another to sell. Where the decisions are the same and both portfolios seek to sell or to buy there may be advantages if the order is aggregated, for example as the larger transaction achieves a better price for each portfolio. The transaction costs may similarly be reduced if a portfolio contracts with another portfolio – an agency cross[141] - under the same management as there is no need to identify another party through an exchange or other trading venue. Under the rules of many exchanges such a transaction is permitted as long as recorded by the single broker involved and at the prevailing market price. The practice may operate against the interests of an individual portfolio in some transactions as the pricing for the aggregated order is not as good as would have been available for the smaller single order. There is also a risk that decisions to trade between portfolios may not always be in the interests of both parties,

[141] Problems emerge if there is little or no market in the investment and there is thus no market price, as happened in the split capital trust crisis, which is discussed in chapter 4.

with one portfolio being used to assist another which needs to sell to meet a demand for cash and is finding the necessary investment sales difficult to achieve.[142]

Personal dealing is the practice of employees dealing for their own accounts. The manager receives no direct benefit but is required to take steps to ensure that an employee does not damage the interests of any client by using confidential information, for example as to pending transactions for other portfolios under the manager's management, to obtain an advantage,[143] which might be by 'front running', dealing in advance of the portfolio to take advantage of the likely effect on price of the portfolio trades. An issue then becomes whether the manager has taken reasonable steps to ensure fair treatment for the Client, as a failure to do so would mean the modification to the fiduciary principle would not apply and a potential breach of fiduciary might arise. As long as there had been no negligence in the manager's compliance operations no issue of fiduciary breach would arise, with vicarious liability for losses caused by the front-running a separate issue dependent on the facts.

The final category highlighted by the FSA was errors, in particular the practice of the losses incurred through error being met by the Client, if a professional investor, in reliance on a clause excluding the liability for negligence in the IMA. The FSA pointed out that repeated mistakes might, in appropriate circumstances, escalate negligence to gross negligence or even recklessness, so falling outside the limitation clause. The extent of the possibility for and actual errors, both inadvertent and as the result of mistake, as well as validity and enforceability of such clauses was discussed in Chapter 1. In summary the clause will not be enforceable against a retail client but may be where the Client is an institutional client with access to independent professional advice and the term has been negotiated.

- no secret profits

Boardman v Phipps upheld the principle that an agent must account to his principal for all profits derived from his fiduciary position unless the principal's fully

[142] As in the Martin Currie case, also discussed in chapter 4.

[143] FCA Handbook: SYSC ch 11.

informed consent has been obtained.[144] The fact that the beneficiaries could not have secured the profits for themselves was irrelevant. This aspect has caused particular difficulties when applied to commercial arrangements, including agents with discretion (which includes portfolio managers, company directors, partnerships and joint ventures) with perhaps the best summary of the law provided by Bowstead and Reynolds: the application of the rules in these circumstances is 'as yet to be fully worked out'.[145]

The basis of the rule is that the manager may only profit from the appointment if the Client has given consent. In practice the rule is modified by the terms of the IMA reflecting the relaxation allowed by the COBS to allow the manager to retain, to quote from a standard formula included in the IMA: 'any profit, commission, remuneration made or received from or in connection with' any transaction or provision of services in relation to which the manager has an actual or potential conflict of interest [that is permitted]' provided the manager has taken steps to ensure that no risk of loss to the portfolio owner remains as a result of the transaction.[146]

The IMA provides for the payment of management fee and allows associates to profit from contracts with the Client (acting through the agent manager) providing certain conditions are met, broadly that the services provided are not available from an independent party on a materially better basis taking into account both price and quality. It is accordingly difficult to envisage what other profits might be gleaned from the appointment absent a conflict of interest . If, for example, the manager accepted a bribe to procure the manager to contract with a third party as agent for the Client this would not only represent inappropriate treatment of a conflict of interest but also an unauthorised profit.[147]

[144] *Boardman* (n 18).

[145] *Bowstead & Reynolds* (n 4) 6-049.

[146] FCA Handbook: Senior Management Arrangements, Systems and Controls ('SYSC') 10.1.6.

[147] *AIB Group (UK) Plc v Mark Redler & Co Solicitors* [2014] UKSC 58, [2015] AC 1503.

While the firm might be vicariously liable for the actions of a rogue employee, for example who revealed confidential data to a third party in exchange for money, this would not place the firm at risk of fiduciary breach. The money would not be a profit for the firm so no unauthorised profit would have been earnt. There might be a question as to the efficiency and adequacy of the internal compliance and other procedures designed to prevent such action, but the liability of the firm for the breach would be vicarious not for breach of fiduciary duty and there would be no secret profit, rather loss as a result.

The practice of securities lending has raised issues concerning 'secret profits', but these do not, in practice, affect managers. Securities or stock lending is, in fact, a misnomer. The transaction is not a loan but instead the security being 'lent' is transferred to a third party in exchange for an undertaking to return a similar security at a future time and thereafter on demand. The undertaking is not itself a security and therefore express reference is required in the investment mandate in the IMA as otherwise the use of the portfolio for lending would not be permitted. An IMA will therefore contain a consent to securities lending if the manager intends to use the portfolio for this, with the consent setting out the extent to which, if any, the fees for lending will be retained by the manager. In the case of substantial portfolios holding stocks for which there is a demand for lending the fee retention may well lead to the management fee being reduced or even eliminated. If a manager did engage in stock lending without the Client's consent any fees retained by the manager would be unauthorised profits and thus due to the Client for fiduciary breach, as discussed in chapter 4.

The practice is generally considered to have started as an informal practice amongst London stockbrokers in the early 1960s whereby share certificates were lent in order that the borrower could complete a share sale where the vendor client had lost or otherwise failed to produce a certificate in a timely manner, with completion accordingly delayed until either the certificate was found or a replacement obtained from the registrar, which involved completion and delivery of a Deed of Indemnity in the registrar's favour. Securities lending has subsequently grown into an integral part of the securities business as the practice of short selling – selling stocks that the vendor does not own – has swelled demand to 'borrow' stocks to complete the sale transaction rather than buy and then sell them, with the fees earnt from stock lending by a portfolio consisting of securities for which there is a demand because of heavy trading potentially very high, in some even cases exceeding the fees for portfolio management.

Current practice involves the manager or an associate indemnifying the portfolio against any losses resulting from a securities lending transaction with a fee being charged based on the current market price. The risk of loss is small, requiring the counterparty to default and the security given by the counterparty (typically with a market value in excess of the liability at close of business the preceding business day) proving insufficient when realised following the default. Associates who provide other services in connection with the process, for example acting as broker or otherwise arranging transactions (including providing security for lender obligations), will similarly receive fees at market rates.[148]

IV. Summary

This Chapter has established that the portfolio manager, by virtue of the discretion to change the content of a portfolio under management, is an agent with discretion and thus has a duty of loyalty that involves fiduciary obligations. The scope of the duty of loyalty is then limited by the terms of the IMA that incorporate FCA regulations on the basis that compliance with the regulations is taking 'reasonable steps'.

The concept is that conflicts of interests are permitted provided the manager takes reasonable steps to treat clients fairly, so that, for example, the uncertainty as to proof of motive required to breach the inhibition principle is replaced by an objective test based on what steps were in fact taken to ensure 'fairness'. At the same time FCA regulations and guidance represent what is reasonable for an investor to expect but not a comprehensive nor compulsory set of rules breach of which gives any right of action other than to a retail investor pursuant to the Financial Services and Markets Act 2000 (as amended) ('FSMA') s.138D. The absence of a requirement for a mental element where the conflict is between the duties owed to different Clients appears, however, to lead to a potential breach of fiduciary duty under the modified duty which would not be a breach of the common law inhibition principle. This would only be of consequence if, in practice,

[148] Based on the author's personal knowledge and experience (as a non-executive director).

this led either to a Client having additional remedies to those available for breach of the IMA or to the manager not being allowed to claim that the Client had failed to mitigate the damage suffered by contributory negligence, both of which issues are considered further in chapter 4.

The examples of business practice that modify the strict fiduciary doctrine illustrate a policy decision that, notwithstanding the purpose of the fiduciary doctrine is to guard against the opportunism for improper motive that the fiduciary role offers,[149] it is appropriate to reduce the stringency of the traditional doctrine in the context of portfolio management to reflect that modern practice provides additional safeguards. These developments include changes in technology, the growth of public sector regulation and the changes in market practice that have resulted. Technological change includes electronic communication and computer capacity and capability, so permitting those investors that have the resources and skills (or access to them) to monitor the performance of their manager on an increasingly close basis – so arguably reducing their need for the safeguards the fiduciary doctrine provides.

Regulatory change includes an array of procedural requirements that require all but contemporaneous recording, in greater and greater detail, of decisions, the reasons for them and, where relevant, the method in which they were implemented. Market practice includes not only changes necessary to maintain regulatory compliance but also changes to investment techniques, both the adoption of modern portfolio theory – now over 50 years old[150] - and newer techniques such as asset rotation,[151] and the increasing use of asset rotation, index tracking and Exchange Traded Products ('ETPs').

While index tracking in the form of ETPs does not involve discretionary portfolio management other forms of index-tracking do. This is because, in summary, where there is a manager, the manager will have a discretion, which may be prescribed but will never

[149] HE Smith, 'Why Fiduciary Law Is Equitable' in Gold and Miller (eds) *Philosophical Foundations of Fiduciary Law* (OUP 2004), 282.

[150] Harry Markowitz, 'Portfolio Selection' (1952) 7(1) Journal of Finance 77.

[151] MP Erickson, *Asset Rotation: The Demise of Modern Portfolio Theory and the Birth of an Investment Renaissance* (Wiley 2014).

be completely extinguished, as to the precise manner in which the target index is to be 'tracked' and as to the choice of investments to achieve this. Exact replication of movement is all but impossible as the tracker cannot move in exactly parallel lines but must seek both to anticipate and to reflect index movement. An index also incurs no transaction costs. While the differences in performance may be small the competition between tracker funds to provide performance ever close to the index - and thus with a minimum of 'tracker-error' - is intense.

J H Langbein is a, perhaps the leading proponent of the case for relaxation of the fiduciary doctrine. He argues that the no conflicts and no profits rules can operate against the interest of the beneficiaries, suggesting the message from the *Boardman* case is that a fiduciary must avoid all possibility of (unauthorised) conflict 'where there may be actual or potential benefit to thyself. In such cases, the deterrent effect of the sole interest rule and the no conflict and no profit rule that it has spawned contravenes the purpose of the rule, which is to benefit the beneficiary'.[152] The merits behind the argument have been questioned,[153] but this is the regulatory approach in the United Kingdom with an overriding duty to 'act honestly, fairly and professionally in accordance with the best interests of its' client.[154] The fiduciary principle is modified to permit fiduciary involvement despite conflicts of interest but the investor is protected against manager misconduct by detailed regulation and the overarching regulatory duty . These provisions are reflected in many practices which would, but for the modifications in the IMA and the FCA regulations, breach the common law fiduciary prohibitions. The next chapter investigates a number of the more important and the manner in which the conflict between competing interests has been settled, including how in some cases the settlement changes over time to reflect changes in market practice and regulator perception as to what is and what is no longer 'fair'.

[152] JH Langbein, 'Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest? (2005) 114(5) Yale Law Journal 929, 955; Shue Sing Churk, 'Just Abolish the No Profit Rule' (2015) 26(7) International Company and Commercial Law Review 244.

[153] Getzler (n 107).

[154] FCA COBS 2.1.

The effect is to modify the fiduciary prohibitions to an obligation to act reasonably when making and, where appropriate, implementing investment decisions. This is in addition to the duty of skill and care when managing the portfolio as a whole. Motive is of itself irrelevant, with honest incompetence breach of either or both duties, although if the breach can be shown to be the result of wilful breach or fraud this may affect the level of damages awarded by a Court, as discussed in chapter Four. If it is accepted that there are prescriptive fiduciary duties then these would apply subject only to the express wording of the IMA. Together this raises the question whether such a modification of fiduciary duty (whatever its precise scope) is, in practice, an exclusion: this is addressed in the final chapter.

Chapter Three -The discretionary portfolio manager in practice

I – Introduction

The first two chapters identified that the key to the role of the discretionary portfolio manager (the 'manager') is the capacity and duty to act as the agent of the portfolio owner (the 'Client') while managing the portfolio by exercising the discretion provided by the investment mandate that forms part of the investment management agreement (the 'IMA') with the Client. This task involves not only agency in the legal sense of the capacity to enter into transactions on behalf of another, the principal, who becomes bound by obligations and entitled to the benefits arising from the contract, but also the economic or colloquial sense of taking decisions on behalf of the principal that, while not binding the principal to any legal contract, nevertheless represent decisions taken on the principal's behalf which the agent is obliged to decide in the principal's interest: for example a decision not to change the content of a managed portfolio.

The risks inherent in the principal agent relationship, both legal and economic, have been recognised for even longer than the risks of misconduct by a trustee. Economic solutions have tended to involve attempts to structure the relationship so the interests of principal and agent run, if not in parallel, on similar lines; for example through management fees based on investment performance ('performance fees') or managers being required to co-invest with the Client, with the emphasis on prescriptive solutions. In contrast the prohibition on conflict of interests and profits absent fully informed consent lies at the heart of the traditional proscriptive protection provided by the common law.

Discretionary portfolio management is an industry where regulations permit controls over the opportunities for manager misconduct involving conflicts and unauthorised profits rather than prohibition. The basis is that the benefit from allowing these practices, albeit subject to significant conditions, is perceived to outweigh the increased risk of manager misconduct. Without such arrangements the capacity of the industry to serve the interests of investors, as well as to compete internationally, would be severely curtailed. Results include industry practices that evolve to reflect regulation and regulatory changes that reflect changing market practices and seek to combine the common law with an economic approach. The regime concentrates on prescriptive rules rather than proscriptive rules and prohibition.

This chapter examines the dilution of the fiduciary doctrine in the context of market practice. Several of the more important practices are reviewed, together with a brief history and some observations on the effectiveness of the controls that have emerged. The primary source of controls is the FCA regulations and guidance,[1] with these being incorporated into IMA terms and reflecting how market practice and regulation have evolved, both to cater for new market conditions and products and to introduce further, or at least more detailed and prescriptive, regulation.

II- Conflict of interests

A regulatory requirement on a manager is to identify when a conflict of interest arises while carrying on investment business. Neither the FCA regulations nor the European regulations (which the FCA regulations have implemented) include a definition, so leaving the term to be interpreted based on the language used. This raises the potential for discrepancy with the common law, although in practice the Courts can be expected to take the regulatory limits on potential conflict of interests into account when deciding on the appropriate 'common sense' approach, as well as the approach that industry practitioners adopt in practice and consistent with the regulatory view that conflict rules need to be applied proportionately.[2]

The FCA rules specify that managers must take 'all appropriate steps' to identify conflicts of interests between the firm and a client'.[3] 'Firm' includes the firm's managers, employees and any person directly or indirectly linked to the firm by control (e.g. through membership of a group). 'Client' includes a Client, a potential client, an investment fund (even if it has no separate legal personality), an investor in an investment fund and a person acting through an agent if this has been agreed by the

[1] FCA Handbook: Senior Management Arrangements, Systems and Controls ('SYSC') Ch 10.

[2] FCA Handbook: SYSC 10.1.7R; *Seymour v Ockwell* [2015] EWHC 1137.

[3] FCA SYSC Rule 10.1.3R.

manager or the use of the agent is intended to reduce the protection afforded to the principal. Conflicts are then divided, consistent with the common law, between 'firm-client' conflict and 'client-client' conflict.

The extended definition is designed in part to avoid technical arguments concerning which legal entity(ies) owe duties to which other entities. Similarly, a reference to a duty to identify where a conflict 'may arise' is, in practice, treated as restricted to the reasonable limits suggested by the common law, with the risk of damage to the client required for a conflict of interest required to be 'material', which is arguably more restrictive than the 'not theoretical or rhetoric' of the common law. [4] It seems likely that the Courts would place considerable weight on the regulator's views as expressed in the FCA rules when interpreting how the common law should be applied to portfolio management.

The FCA rules contain a series of matters that a decision on conflicts must consider. The non-exclusive list provides that the decision should be based on whether any person associated with the manager: (i) is likely to gain or avoid a loss at the expense of a client, for example the manager acquires securities issued by a company which is indebted to an associate and in danger of defaulting on that loan without the further funding that the security issue will provide; (ii) has a different interest in a service to or transaction for a client to that of the client, for example appointing an associate to provide services to the portfolio or transacting with an associate for the account of the portfolio, which may lead to the fees or price not being negotiated for the portfolio as keenly as if the other party was independent and thus disadvantage the portfolio; (iii) has a financial incentive to favour one client over another, for example if a portfolio with an overlapping investment mandate pays a higher fee than another portfolio the first portfolio may be given priority so the manager earns a higher fee, so disadvantaging the other portfolio; (iv) carries on the same business as the client, for example the client is a competitor of an associate and receives less favourable terms or treatment than would be available to an independent client as a result; or (v) receives an impermissible inducement from a person other than the client, for example an associate of the manager receives a 'success fee' for advising the client to appoint the manager, with the advice

[4] Lord Upjohn in *Boardman v Phipps* [1967] 2 AC 46 (HL), 125.

accordingly not given in the best interests of the client.[5] It is , however, important to bear in mind that all these circumstances, although involving conflict of interests, are not prohibited but permitted provided they are managed in accordance with the FCA Handbook. Thus, for example, the restriction on a manager taking on a client in circumstances that will likely lead to a conflict between its duty to each client is removed provided the terms of the IMA so provide (and there is no other prohibition).[6]

There is specific guidance[7] that a conflict does not arise if no actual or potential risk of loss to (including reduction in gain for) a client is involved. This restricts the no profit principle, as outlined in the previous chapter, to an unauthorised profit that could have been credited to the portfolio, while also permitting the manager to gain from the appointment provided there is no risk of loss to the client/portfolio.[8] There is, however, no prohibition on the IMA including an express term that prohibits a practice that would lead to the manager retaining such a gain, albeit the manager may be unwilling to agree to this.

The FCA rules apply to managers whether the portfolio under management is owned by a single investor (or joint investors) or is an investment fund with multiple investors, each of whom has a direct or indirect interest in the portfolio. The rules currently incorporate the European legislation that regulates the management of collective investment schemes ('CIS') under two different, if broadly parallel, regimes. The Undertakings for Collective Investment in Transferable Securities ('UCITS') directives regulate open-ended CIS which are eligible for direct investment by retail investors; and the Alternative Investment Fund Marketing Directive or ('AIFMD') regulates the marketing of CIS that are not UCITS funds within the EU, with these regulations specifying a number of conditions that such a CIS (an 'AIF') must satisfy if it is to be eligible for marketing within the EU. There have been a few minor divergences from European regulation since the UK left the EU, but material differences seem less

[5] FCA Handbook: SYSC 10.1.4.

[6] *Hilton v Barker Booth & Eastwood (a firm)* [2005] UKHL 8, (2005) 1 All ER 651.

[7] FCA Handbook: SYSC 10.1.5G.

[8] Ibid.

likely, at least in the short term.[9]

Both directives contain the same general provisions for the identification and management of conflicts of interests as are provided for portfolio management for a single Client. The European Securities and Markets Authority ('ESMA'), the European regulator, included a long and extremely wide-ranging list of conflicts of interests (the 'ESMA list') that potentially arise in CIS management in its 2011 Consultation Paper on the implementation of AIFMD. Many of the conflicts in the ESMA list also occur in the context of the management of portfolios for single or joint investors. The Directives apply directly to the entity that is responsible for managing the CIS and its governance, the 'Authorised Corporate Director' (or 'ACD") under UCITS in the UK[10] and the 'Alternative Investment Fund Manager' (or 'AIFM') under AIFMD. As the manager of the portfolio(s) owned by the CIS and the ACD or AIFM are typically, but not always, members of the same corporate group the conflicts are also potentially relevant to the manager .

The duty of loyalty owed to a CIS depends on whether the CIS has separate legal personality. Where this is the case, the duty is owed to the legal entity, for example an investment company, with investors then having rights against the company based on the security acquired (i.e. as shareholder or creditor) but no direct relationship with the manager. Where the CIS has no separate legal personality, the duty is owed to the investors on a collective basis and can be enforced only by a representative of the investors in the manner that will be set out in the governance provisions of the CIS, to which all investors agree as part of acquiring an interest in the portfolio. The existence of potential fiduciary obligations to investors with no direct contractual link to the portfolio manager is an area of law that remains unclear. While it would be a considerable development to provide an investor with a personal claim against a manager who contracted with a company in which the investor was a shareholder or creditor, there is a least the suggestion that where the contract is with a trustee and the investor a beneficiary of the trust the position may, depending on the circumstances, be

[9] The main changes reflected long held industry concerns that the regulations regarding performance recording were leading to the compulsory publication of misleading information.

[10] The entity is known as the Investment Fund Manager (or 'IFM') elsewhere in the EU, in contrast to the portfolio or 'fund' (or 'sub-fund') manager in the UK.

different.[11]

Strictly speaking the manager is not party to a conflict of interests between investors in a CIS as the investors are part of the single client to whom the manager's duty of loyalty is owed collectively. The expansion of the meaning of client in the FCA rules means, however, that these are conflicts for the purposes of the FCA rules and thus are subject to the same regulation. In practice the governance provisions will set out how conflicts of interests between the investors wishing to realise some or all their holding, investors wishing to retain their holding and investors wishing to acquire or increase a holding (all 'clients' within the FCA rules). These provisions will then be incorporated into the IMA so that the manager is aware how portfolio management will need to be adjusted to cater for these provisions.

The ESMA list includes the following CIS specific examples: (i) where an increase in the size of the CIS increases the fees this may not be in the interest of existing investors, for example because of the limited availability and/or size of investment opportunities within the investment mandate - this conflict is normally restricted to CIS investing in private equity; (ii) an extension to the life of the CIS will also increase the manager's fees but may not be in the interests of the investors in light of market conditions and/or their reasonable expectations for portfolio realisation and distribution of the proceeds; (iii) an associate may be appointed to provide a service required by the CIS, for example property valuation or property management, which will not be in the interests of the investors if a better service could be provided from an independent (or any other associated) firm; (iv) two AIFs have an overlapping mandate with and both having capacity for a new investment opportunity and the AIF manager allocates the opportunity to one fund, so disadvantaging the other; (v) an AIF is invested in a company that pays fees to the AIFM or an associate for services provided; and (vi) an investor in an AIF is granted preferential redemption rights to the other investors or a right to co-invest with the AIF, including potentially on more favourable terms that those available to the AIF.

[11] *Barclays Wealth Trustees (Jersey) Limited & Another v Equity Trust (Jersey) Limited & Another* [2014] Jersey Royal Courts 102D.

The balance of this chapter reviews common practices in discretionary portfolio management, the dilution of fiduciary principle required to permit them and the justifications, together with a history of how the dilution may lead or has led to misconduct as well as, in some cases, altered over time to reflect changes in market practice and advances in technology and communication. An example of the steps necessary to introduce a new product is also included as an illustration of the potential of regulation to impede innovation by managers that do not have the financial resources to identify and then clear the regulatory hoops.

III - Soft commission

'Soft commission' is the topic related to conflicts of interests that has attracted the greatest academic, regulatory and market interest - and variation in regulatory treatment. The history of the practice is also a useful example of the different forces at work and how the compromise that the regulations represent changes over time. The expression refers to the practice whereby a manager pays a broker a fee or commission for arranging a transaction ('executing an order'), typically a purchase or sale of an equity or equity-linked security listed on a stock exchange, for a portfolio under management. Under the terms of the IMA the commission for the broker executing the order is charged to the portfolio(s) for which the transaction is undertaken. The broker, however, not only arranges the transaction the subject of the order but also supplies the manager, directly or indirectly, with other benefits, for which there is no additional charge: there is instead 'soft commission'. The manager pays for the benefits with 'soft dollars', the expression used for soft commission in the USA[12].

The treatment of fees charged by brokers for services that go beyond executing an order fall into three categories: the first is as described in the previous paragraph with no involvement or knowledge of the client. The commission the broker receives is for the combination of executing the trade and 'bundled arrangements' under which

[12] This section is based, in addition to the sources mentioned, on the author's experience as a legal adviser in the City of London and New York together with various professional guides, for example Soft Dollar Standards for client brokerage (CFA Institute 2020); Ashursts, 'Dealing Commission: A History', July 2014; and James A Fanto and Jill I. Gross, *Broker-Dealer Law and Regulation*, Fifth Edition (Wolters Kluwer Legal & Regulatory U S 2019).

additional benefits are provided by the broker itself. There may also be Commission Sharing Agreements (or 'CSAs')[13] under which additional benefits are provided by a third party paid by the broker, with the third party typically an independent company that produces investment research (and which has no direct contractual link with the manager). This allows the smaller broker to provide research without incurring the costs of maintaining its own research capability, thereby enhancing, it was (and in some cases still is) argued, the ability of the smaller broker to compete with brokers whose size makes the expense of maintaining an 'in-house' research capability more easily affordable, with the increased competition in the interests of investors.

The second category is known as 'directed commission': the Client directs the manager to instruct a specific broker on a fixed proportion of the orders the manager places (as the Client's agent) and the broker then uses the commission to pay for goods or services provided to the Client. This structure does not directly involve the manager beyond carrying out, as agent but without discretion, the instructions of the portfolio owner principal. If, however, the principal is itself a fiduciary, for example the trustees of a pension fund, similar issues arise in relation to the underlying beneficiaries and the possible implication of the manager in a breach of fiduciary duty by others. While the broker must always undertake to deliver 'best execution', there is less incentive for the broker to monitor this given the difficulty involved and the knowledge that, absent exceptionally bad performance, a fixed proportion of the portfolio orders will be channeled to the broker. A further concern is that the broker's fees may be increased or otherwise adjusted, consciously or otherwise, so that goodwill is generated and the possibility of orders for the manager's other accounts is potentially increased.

The third category is 'directed recapture', whereby the Client instructs a third party to negotiate commission rebates with one or more brokers on behalf of the Client and several other portfolio owners. The third party uses the aggregate assets under management of the participating portfolios to secure larger discounts than would be available on an individual basis. The manager is then instructed to instruct the brokers which offer appropriate discounts on a specified proportion of orders in each market segment and the broker pays the discount to the third party which then distributes the

[13] Referred to as Client Commission Agreements or 'CCAs' in the USA.

rebates amongst its clientele. The major risk is that the brokers who offer the best discounts are not those who provide the best performance, so harming portfolio performance, which may also suffer as the manager's receipt of 'free' investment research is reduced. The manager may also seek to blame poor portfolio performance, at least in part, on the poor selection of brokers available for the manager to instruct leading to unnecessary (explicit and implicit) transaction costs: such an assertion is all but impossible to verify or to disprove.

The third party can reduce risk by reaching agreement with several brokers, but this in turn reduces the expected number of instructions for each and thus the willingness to offer significant discounts. Unsurprisingly managers in the main dislike commission recapture and there is a strong argument that it serves no purpose once fees for execution only services have fallen to reflect increasing competition and fee transparency if separate charges for execution and other benefits ('unbundling') becomes widespread.

The history of these practices is a saga of the dilution of the manager's duty of loyalty. The early stages saw managers entering a marketplace for the execution of orders operating for the first time as agents with discretion as part of an independent business. This was a change to earlier practice whereby investment management was carried out internally by institutional investors managing their own assets, most prominently life companies but including trustees of charities and other trust funds, including employee pension funds. Although many took investment decisions with the benefit of investment advice,[14] this was often in addition to 'in-house' recommendations with the investment decisions, as a matter of law and practice, not delegated.

While the investment performance of a life company will indirectly affect the economic interest of the policy holders, the life company at all times remains the owner of the investments and the issue of the life company as a fiduciary in this context does not arise, although the life company is subject to regulation that is designed to protect

[14] The investment advisers may owe fiduciary duties to the clients, but not as agents with discretion.

the interests of policy holders.[15] In contrast the manager as agent with discretion makes fiduciary status relevant as a matter of law even though in concept the individual manager is carrying out the same role whether as employee of a life company or as employee of a manager - and so might expect to be able to compete on a regulatory 'level playing field'. While this is now true in the context of marketing to retail investors, the regulatory systems remain different, even if at least one objective, protection of the investor, is shared.

The manager acting as agent had existed, in practice if not in law, for some time. This reflected that some investors rarely if ever acted other than as recommended by their investment advisers, who often combined the roles of personal adviser and stockbroker. Formal recognition of managers as agents only followed the establishment of open-ended CIS aimed at retail investors: unit trusts in the UK, mutual funds in the USA. Each type of CIS operated under its own legal regime, which included regulations governing the duties of the manager and the managers tended to be, or connected to, existing institutional investors, in the main insurance companies. It was only in the 1960s that independent discretionary management began to be a significant participator in the market, acting for individual clients and for investors on a collective basis in both the retail (and regulated) and the professional (and largely unregulated) sectors, with the latter including the employee pension funds whose assets under management rose steadily as the economy and employment grew.

In these early stages the practices were not subject to regulatory scrutiny as the Stock Exchanges in London and in New York benefitted from, respectively, an exemption from legislation placing restraints on unfair restrictive practices and an exemption from anti-trust legislation.[16] The later stages followed the exemptions being removed and the practices becoming subject to regulatory scrutiny. This resulted initially in regulation aimed at the management of conflicts of interests rather than their prohibition, though in practice the regulators appear to have expected that, over time, market developments would lead to the practices becoming increasingly less common. Recent regulation in

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[15] By the Prudential Regulatory authority ('PRA') and Financial Conduct Authority ('FCA') pursuant to Financial Services and Markets Act 2000.

[16] Exchanges elsewhere in the USA and UK and many other jurisdictions also enjoyed similar exemptions benefits (in some cases as there was no anti-trust legislation).

Europe, in particular MiFID II, has become more prescriptive with compliance sufficiently costly, particularly for what is now a global industry dealing in multiple jurisdictions with a variety of similar but different regulatory regimes, that soft commission may well survive, if at all, only in a very significantly reduced state.[17]

To return to the beginning, soft commission predates the development of the discretionary portfolio management industry and was accordingly introduced at a time when fiduciary duty was not an issue. It represented a market solution to a problem that resulted from the combination of (i) 'fixed commission', based on a fixed percentage of the value of an order and considerably exceeding the costs incurred by the broker in its execution; and (ii) a growing disparity between the values of transactions for institutional investors and individual investors, with the former representing an increasing proportion of aggregate transaction value. The fall in commission rates that followed the banning of fixed commission in the USA on May 1, 1975, suggested the level had been fixed at five or six times the cost, with the figure higher for larger transactions.[18]

The origins of fixed commission can be traced back to the 1792 Buttonwood Agreement that led to the development of the New York Stock Exchange ('NYSE'). Minimum or fixed commission was part of the Agreement and in due course adopted by many other exchanges, including the London Stock Exchange the ('LSE'). The LSE adopted the practice in 1912, in a move described as 'more or less ring-fencing the Stock Exchange' members from competition through 'a thoroughly comfortable, club-like dispensation'.[19] One consequence was that the larger the value of a transaction the greater the commission the broker received. If transactions were predominantly brokered between individual investors and transaction volumes generally similar and, in absolute terms, small this feature attracted little criticism, particularly as bonds and unlisted securities traded on a principal-to-principal basis with the broker engaged as

[17] An estimate that some 80% of EU asset managers had decided to meet research costs form their own resources was reported to the January 2019 European Capital Markets Institute Seminar (ECMI Seminar Report 2019).

[18] Aharon R Ofer and Arie Melnick, 'Price Deregulation in the Brokerage Industry: An Empirical Analysis' (1978) 9(2) The Bell Journal of Economics 633.

[19] David Kynaston, *The City of London, Volume II: Golden Years* (Chatto & Windus 1995) p 547.

principal and the 'fee' derived from the difference between sale and purchase price (the 'bid and offer spread') rather than commission.

Over time transactions were increasingly for institutional rather than individual investors. The institutions also dealt in considerably larger transactions then individual investors. This was coupled with an increasing interest in equities rather than debt as the life companies had successfully illustrated investment in equities (rather than debt) to be the means to higher returns over the longer term.[20] The result was increasing pressure for relief from what was perceived, justifiably, to be excessive and unfair dealing costs. One solution was for brokers to provide what were, in effect, discounts in the form of non-cash benefits for which no additional charge was made, but which enabled compliance with the fixed commission rules.

The switch to investment in equities also led to a demand for investment research concerned with more than just the capacity of a corporation to meet its debts. For most of the third quarter of the twentieth century the provision of investment research to third parties was limited, in New York, to a few larger 'full service' NYSE brokers. It was also available in London, notably from Phillips and Drew, but its value was very much questioned,[21] perhaps reflecting that insider dealing was not a crime and, even if not technically permitted under the LSE rules, investigated only rarely.[22] Over time attitudes changed and what may have been, if only in retrospect, a pivotal moment occurred in December 1959 when a new firm, Donaldson, Lufkin & Jenrette, purchased a seat on the NYSE and offered to provide investment research on individual corporations, at that time itself an innovative approach, on the basis that the research could be paid for using brokerage commission, i.e. as long as the firm was instructed the research would be provided 'free'.

Over the next fifteen years investment research became an increasingly acceptable way for brokers to provide benefits to institutional clients. A further

[20] Described in chapter 1 section III.

[21] David Kynaston, *The City of London, Vol IV: A Club No More* (Chatto & Windus 2001), 171.

[22] Insider dealing – dealing when in possession of undisclosed confidential price sensitive information - became a criminal offence in the UK only in 1980 with the enactment of Part V of the Companies Act 1980.

development saw independent research companies emerge. These provided research that smaller brokers could pay for without incurring the costs of an internal research operation and then direct to investors in the form of soft commission. A similar process developed in London, but rather more slowly: as late as 1966 the Financial Times could talk of the longstanding tradition of the British company 'to tell the investment community as little as possible as seldom as possible'.[23]

These practices evolved at a time when discretionary investment management was still in its infancy and as the practices originated on the LSE and involved actions by brokers (with inaction by investment managers, save for omitting to refuse the researched provided) they were considered LSE 'custom and practice'. This seems to have been enough for managers to conclude, if the issue of fiduciary duties ever arose, that soft commission, whatever the conflicts involved, was simply a matter of market practice that the manager was in no position to refuse, not least as refusal would not change the commission deducted from the portfolio, simply reduce the research (or other benefits) the manager would receive.

The removal of the exemptions from anti-trust law, in New York in 1975 and in London in 1986[24], put an end to fixed commission. Commission became negotiable and fell dramatically, while the volume of transactions grew. While some 'discount' brokers offered execution only services, others continued to offer soft commission and many managers found this a convenient way to continue to receive investment research and other benefits notwithstanding the higher commission charged to the portfolios under their management. This led some USA managers to be concerned that opting to instruct a broker who charged commission at a higher level than that available elsewhere might be a breach of their fiduciary duty (under United States federal and/or state law) and the Securities and Exchange Commission (the 'SEC'), the USA regulator, became involved, with the conflicts of interests involved now subject to regulatory scrutiny.

[23] Harold Wincott, 'How good is the Stock Exchange?' Financial Times, September 13, 1966 and 'Capitalism – or a giant Co-op?' Financial Times, September 20, 1966.

[24] Following the removal of the LSE exemption from restrictive trade practices legislation.

Where the investor both pays the commission and receives the benefits that represent the discount no issue of fiduciary duty arises.[25] The situation is different if the Client pays the commission, but the manager enjoys the benefits. This gives rise to several potential conflicts, including between the interests of the manager (in receiving benefits) and the Client (that is paying for them). The conflicts increase the risk that the manager enters into transactions less in the interests of the Client portfolio than its own, in expectation of 'soft dollar benefits'. The manager's choice of broker to execute an order may thus be determined less based on the quality of the broker's execution services than the benefits available to the manager as a result. This in turn may lead the manager not only to be satisfied with order execution of a lower quality than would be available from a rival broker but also to pay less attention to monitoring the broker's performance than would otherwise be the case: referred to as 'shrinkage' in the USA.

Even where the benefits provided do improve the quality of the portfolio management, for example by providing investment research that potentially improves decision making by the manager, the benefits to the investor(s) whose portfolio has paid the commission that is the source of the 'soft commission' benefits may be non-existent (for example if the research concerns a sector outside the portfolio's investment mandate) or shared with other investors whose investment mandate overlaps but which were not party to the order for execution of which the commission was paid.

The SEC considered and then accepted that the continuation of soft commission rather than its abolition was in the best interests of investors and that this was a case where conflicts of interests should be managed not prohibited. The reasons can be summarised as (i) the availability of investment research would assist investment decision making and thus investment performance; (ii) if the manager benefitted only marginally from better performance the manager would be reluctant to bear the full cost of investment research and soft commission enabled the interests of the manager and the Client to be more closely aligned; and (iii) competition between brokers would be improved if smaller brokers could provide managers with research from independent research providers.

[25] There may be issues internally as to how the benefits are distributed, but the fiduciary duties of company officers and employees are outside the scope of this thesis.

The SEC accordingly recommended, and Congress enacted, a 'safe harbor' that provided there would be no breach of fiduciary duty (under US law) provided that the manager believed, in good faith, that any premium in the commission was reasonable in relation to the research or brokerage services provided in terms of either the particular transaction or the manager's overall responsibilities with respect to the accounts over which it exercises investment discretion.[26] Thus the fiduciary duty of the manager in the USA permitted, in the case of soft commission, the subjugation of the interests of the owner(s) of the paying portfolio in favour of the collective interest of the owners of all the portfolios under the recipient's management.

Although the safe harbor and the relevant SEC regulations have no direct relevance to the United Kingdom or any other overseas jurisdiction, this development was important as it represents the first introduction of a regulatory standard. It thus enabled practitioners to argue, whenever a regulator proposed a regime that was stricter than that prevailing in the USA or elsewhere, that the effect of its introduction would be to impair the ability of the local investment management and brokerage businesses to compete in an increasingly global industry.

Although not directly relevant, the abolition of exchange control in the UK in 1979 removed a significant restraint on the UK financial services industry and augmented the development of the City of London as the prominent international centre for financial services. Before 1979 this had been based heavily on its role in the burgeoning – and all but unregulated – euro dollar and Eurobond markets[27], essentially investments acquired by US dollars earnt and retained outside the USA. It was then only a matter of time before the LSE exemption from competition legislation was removed - and fixed commission was among the restrictive practices that ended as a result. At this point soft commission and the no conflicts and no profits absent informed consent rules of the common law came within the ambit of the new regulator, introduced pursuant to the FSA 1986, the Securities and Investment Board (the 'SIB').

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[26] Securities and Exchange Act 1934 (USA), s.28E.

[27] Principally investments acquired with US dollars earnt and retained outside the USA.

The SIB was charged with reviewing the proposals put forward by the Investment Management Regulatory Organisation ('IMRO'), the Self-Regulating Organisation ('SRO') for investment managers also introduced pursuant to the Financial Services Act 1986. The SIB concluded was that there was 'no mischief' in soft commission if the services improved the quality of the management services provided by the recipient. Difficulties arose, however. in 'drawing a line' between what is of benefit to the Client(s) and of benefit only to the manager. Research was placed in the first permissible category, while such matters as paying for a holiday for a portfolio manager who might benefit from the rest in the second, which was not.[28] It is fair to say that the issue of which side of the line the various and varied categories of benefits available from brokers remained the key issue over the more than three decades that followed, with the wrong side of the line becoming more populated over time. Whether this reflected increasing regulator knowledge, experience and confidence or technological and other market advances, or (more probably) a combination of all, remains a subject for debate.

The SIB proposed that soft commission could be permitted provided the IMA included a statement that all transactions for the portfolio would be 'effected so as to secure best execution'(by the selected broker) with an alternative for the manager to provide detailed disclosure of every soft commission agreement and annual disclosure of particulars (with a monetary value on request).[29] Somewhat in contrast to the tolerance the new rule indicated, the SIB also included, in a July 1990 policy statement, its view that the complete unbundling of broker services was a desirable long-term aim.

In practice soft commission increased remorselessly. This led to the first detailed attempt to limit what was permissible. The SIB was replaced by the Financial Services Authority (the 'FSA') in late 2001 and the FSA soon 'clarified' that research, market data service, dealing systems and dedicated telephone lines were permissible but travel expenses, seminar and publication costs not directly connected to portfolio management, office administration and fixtures and any direct payments were not. Furthermore, arrangements that tied benefits to volume were prohibited, although this

[28] Such a payment has formed the basis for at least one regulatory action against a manager in the USA , SEC Compliance Alert: Soft Dollar Practices July 2008.

[29] SIB Conduct Rules, October 1987 (5.09).

was easily circumvented by the manager receiving the research or benefit first and having the right to cease to instruct the broker if at any time, including before the specified volume of business had been reached, the manager considered that best execution had not been provided.[30]

The FSA continued to keep soft commission under review and commissioned a review by Paul Myners,[31] a prominent and highly successful investment manager. His review concluded, in 2001, that soft commission and 'bundled charges', a single charge levied for brokerage and benefits, typically where the IMA option had been adopted and so no breakdown was required, or given voluntarily, represented a 'market distortion'.[32] The FSA then issued a consultation paper that referred to both this conclusion and the SIB's long term aim before proposing not only the addition of more benefits to the 'not permitted' side of the line and the same treatment for soft commission and bundled charges but also, to the surprise and consternation of the industry, that research costs must be related to the portfolio from which the relevant soft commission is debited.[33]

The proposals met with stiff opposition from the industry, with arguments based on a London Business School study,[34] prepared for the Investment Management Association,[35] that concluded implementation would significantly reduce trading volumes and cause damage to international competitiveness. After over two years of discussion, two policy statements and another consultation paper, the FSA backed down with a compromise that involved increased disclosure requirements and a further shift of benefits to the 'not permitted' side of the line: portfolio valuation services, dedicated telephone lines, all seminar fees and computer hardware and software (subject to some

[30] Oxford Economic Research Associates (OXERA), 'An Assessment of Soft Commission Arrangement and Bundled Brokerage Services in the UK' (study commissioned by the FSA, April 2003).

[31] Subsequently Lord Myners and financial services secretary in HM Treasury, a post often referred to as the 'City Minister', in the period 2008 to 2010.

[32] HM Treasury, 'Institutional Investment in the UK: a review' (HM Treasury 2001).

[33] FSA, 'Bundled Brokerage and Soft Commission Arrangements' (Consultation paper 176, FSA, April 2003).

[34] Tim Wilsdon and Tim Giles, 'An assessment of the proposed changes to regulation of bundled brokerage and soft commission arrangements' (final report, Charles River Associates Limited, October 2003).

[35] Now the Investment Association.

exceptions) ceased to be permissible. At the same time, the same treatment for soft commission and bundled charges was confirmed.[36]

The FSA also introduced two new tests before a benefit could qualify to be permitted as related to 'execution services': linkage to a specific transaction or series of related transactions; and provided in the time between the manager's investment decision and the conclusion of the implementation of the transaction or the last of the transactions. At the same time research had to pass four tests: (i) add value to an investment decision; (ii) represent original thought; (iii) have intellectual rigour; and (iv) reach a conclusion based on analysis or manipulation of data.[37]

These changes took place as part of the reforms heralded by the EU in the Markets in Financial Instruments Directive, or 'MiFID', agreed on April 21, 2004 but effective within the EU from November 1, 2007.[38] The compromise nevertheless still represented the FSA to an extent 'gold-plating' the requirements of MiFID.[39] The Global Financial Crisis (the 'GFC') followed, with regulatory failure perceived as, if not the cause, a significant contributory factor. Although investment management and managers had, at best, a small role in the GFC, the losses incurred by EU investors, in particular because of the Petters and Madoff scandals in the USA,[40] contributed to a general perception that increased regulation was required not only of the banking sector but also of the other financial services, including asset management. At the same time there was a desire to

[36] FSA, 'Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/5 and final rules' (Policy Statement PS05/09, FSA, July 2005).

[37] FSA COBS 11.6 2006, which was more restrictive than the then current SEC requirements.

[38] MiFID is sometimes now referred to as 'MiFID I' with the second MiFID directive, amended and enhances regulations introduced in the wake of the GFC, known as MiFID II.

[39] Implementing MiFID in a more restrictive manner than the language of the Directive required, an option the Directive granted to EU member regulatory authorities (that was not repeated in MiFID II).

[40] These were two USA based 'Ponzi' investment schemes – investor withdrawals met out of subscription proceeds with no, or insufficient, investments retained to meet obligations to investors - that failed as a result of the GFC. Petters Group Worldwide LLC was, when revealed, the largest ever such scheme with $6 billion of investor losses, only to be dwarfed by the collapse of Bernard L. Madoff Investment Securities LLC a few months later, in which investors lost some $60 billion based on the client statements (though further investigation revealed that 'only' less than $20 billion had been misappropriated). Although not directly linked to the GFC, the different treatment of investors in CIS regulated in France and Luxembourg as a result of different interpretations of the regulations governing the responsibilities of depositaries by the regulators was a further spur for regulatory reform in the investment management sector.

use the opportunity to increase harmonisation within the EU and this, in turn, led to a review and strengthening of the reforms introduced by MiFID. The process of revision was achieved by MiFID II, which took over six years from initial approval to implementation.[41]

The FSA accordingly directed increased attention to the asset management industry, not least in recognition of the industry's growing size and importance to the UK economy. Between June 2011 and February 2012, the FSA conducted thematic reviews of asset management firms to assess their arrangements for managing conflict of interests. The report, published in November 2012 (the '2012 Report'), was critical and concluded that too few firms had adequate controls over spending on research and execution services adequately. Weaknesses highlighted included failures by managers to review whether services received were eligible to be paid for using commission; poor monitoring of the broker's performance in achieving best execution; and failures to disclose details of commission payments to portfolio owners.

The Financial Conduct Authority (the 'FCA') succeeded the FSA in 2013 and announced a further review of soft commission in October 2013, which was followed by publication of a discussion paper in July 2014.[42] The conclusions included that insufficient rigour was (still) being applied to the assessment of the value of research, that the research market lacked price transparency and that unbundling research from dealing commission would be the most effective way of remedying these problems and managing, in part by reducing, the conflicts involved.

The criteria for investment research were further strengthened by requiring research eligible to be paid for by soft commission to include original thought or intellectual value. 'Corporate access', broker organised meetings or conference calls with senior executives of companies to discuss the company operations and prospects, were also added to the 'not permissible' list (introduced by the SIB nearly 30 years earlier).

[41] In October 2011 the European Commission approved the concept of MiFID II, to consist of a revised directive (MiFID) and a new regulation (MiFIR); on January 2018 MiFID II applied to all EU member states. The FCA conducted three consultations on implementation during this period.

[42] FCA, 'Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research' (Discussion paper DP14/3, FCA, July 2014).

This was followed by a FCA report, published in March 2017, which concluded, once more, that most of the firms that the FCA had visited were continuing to fail to meet expectations concerning commission. In contrast those firms that were taking steps to achieve compliance had seen a drop in dealing commission used to acquire research, which reduced portfolio disbursements and, according to the report, improved investment performance. This challenged the contention that a reduction in research, if soft commission was abolished, would weaken the quality of investment decision making.

In the interim the FCA had been playing a major role, as regulator of a significant majority of discretionary asset management carried on within the EU,[43] in the processes that led to the drafting of MiFID II, with by far the most controversial area of the reforms MiFID II introduced relating to soft commission. The reforms included, for the first time, the provision of research within the goods and services that could constitute 'inducements' for the purposes of the FCA regulations unless either paid for by the manager out of its own resources or funded from a separate research payment account ('RPA') maintained in accordance with the new regulations.

The effect of the new and more detailed regulations include that the RPA must be funded by a separate charge met by the Client, which is not linked to transaction volume and within a research budget agreed by manager and the Client.[44] Furthermore, detailed information concerning, amongst other matters, the research costs incurred, the providers and the amounts paid to each must be recorded and made available to the Client and the FCA on request. Similar provisions also apply where research is subject to a Commission Sharing Agreement with any surplus in the RPA repayable on demand. Bundled charges are thus only permitted if the recipient manager undertakes, in effect, the unbundling.

The relevant provisions came into effect in the UK on January 3rd, 2018. Not only did the new framework significantly restrict the benefits available through 'soft commission' to investment research directly relevant to the portfolio owner(s) meeting

[43] Chapter 1, section II.

[44] FCA Handbook : SYSC ch 10.

the commission charge but it also required that the manager must maintain detailed accounts. The provisions also significantly increased the administration and costs involved in compliance. The results have raised doubts whether the practice of soft commission will survive to any material extent, not only in Europe, where the additional time and cost required for compliance led many portfolio managers to decide to end the practice,[45] with others then following suit because of competitive pressure not only in the EU but also elsewhere. A contributory factor was that managers operating both within the EU and in jurisdictions that continue to permit soft commission, with the USA the most prominent, must incur the costs of maintaining two separate administrative systems.[46]

The results include a significant reduction in fees paid for investment research to third parties, both within and outside Europe. While this has led to claims that the significant reduction in costs evidences the success of the new regulations,[47] it remains an open question whether there has been or will be a material reduction in the quality of investment decision making – and thus whether the new regime will operate, over time, in the best interests of investors. Soft commission remains permissible in the USA under less restrictive regulations with compliance less expensive than under MiFID II, while there are a variety of regimes with minor differences in other jurisdictions. As a result, there are complications and additional costs involved in running different systems, although the main new factor is competitive pressures as an increasing number of managers choose not to charge for research within the EU to reduce disbursements met from the portfolio (that reduce portfolio performance).[48]

Other consequences were expected to include a significant reduction in the volume of research with smaller companies potentially losing market demand and value

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[45] ECMI (n 17).

[46] PG Mahoney, 'Soft Dollars, Hard Choices: Reconciling US and EU Policies on Sell-Side Research' (Virginia Law and Economics Research Paper No. 2019-21).

[47] Andrew Bailey, text of keynote speech to European Independent Research Providers Association, 25 February 2019 (FCA 2019).

[48] James Allen, Tyler Gellasch, Kurt Schaft, 'The future of Research in the US after MiFID II; Resolving EU/US disparities' (CFA Position paper, 29 August 2019).

as they ceased to be the subject of research.[49] The FCA's preliminary review was that the results were broadly favourable to investors, albeit the conclusion was that the market reaction to the new regulations is still evolving and the results should become clearer when the FCA next reviews the research market, scheduled for 2021/2.[50] The limited academic research to date also supports the conclusion that the changes are working in the interests of investors overall.[51]

An important feature, from the perspective of English law, is that, while conflicts of interests and their management are at the heart of the regulatory debate, the concepts vary between jurisdictions. Fiduciary law in the USA is very much delineated by state and federal law which is then augmented by SEC regulation: in contrast English law, in the context of financial services and portfolio management, remains a creature of common law relatively untouched by statute until subject to regulation, initially under the SIB and now by the FCA, which was under the ultimate direction of the European Union and the detailed regulations and guidance approved by ESMA until the UK left the EU at the beginning of 2021.

This raises two issues: first whether and to what extent English law would have treated the dilution of fiduciary duty inherent in market practice, both before and when supplemented by regulation, as valid given trade custom is permissible only if it is reasonable and there is no disadvantage to the client;[52] and second whether the new prescriptive rules have gone too far, in the sense of prohibiting soft commission if an institutional investor that has, or has access, to the knowledge required to be fully informed is prepared to agree to a less exacting version than the detailed prescriptive rules, perhaps with its agreement reflected in a reduction of fees because the regulatory cost of maintaining the account is reduced. The question is whether the dilution of the fiduciary principle operates, in practice, in the interests of investors: ultimately the same

[49] A Pal, 'UK stocks coverage shrinks after new research rules' (Reuters, 29 June 2018).

[50] FSA, 'Implementing MiFID II - review of research unbundling reform' press release September 19,2019.

[51] Zheng Liu and Ari Yezegel, 'Was MiFID II effective in unbundling execution and research services?' (April 20, 2020). SSRN: <https://ssrn.com/abstract=3525201> accessed 18/6/2020.

[52] *Kelly v Cooper* [1993] AC 205; *Crema v Cenkos Securities plc* [2010] EWCA Civ 10, (2011) 1 WLR 2066.

question as is raised by other practices involving dilution of fiduciary duty, including those that are described in this chapter.

Soft commission is an example of the interplay between market forces, market developments and regulation in the face of perceived failure of the law and market to protect the Client and investors generally. Initially market and political forces, when reacting to the advent of independent managers, failed to deliver what, in retrospect, would have represented sufficient and adequate protection for the investor. The reasons probably included that the sums involved for any individual investor were small. In due course the industry exemptions from competition law were revoked and regulators identified the need and the means, control through regulation, to redress the balance between managers and Clients until such time as the regulators decided that conflict management should be augmented by transparency.

The task for the regulators was and remains to balance the need of the investment management industry to remain globally competitive and the need to protect the interests of investors. The result was regulation that permitted practices but subject to conditions prescribed by regulators that sought to prevent, or at least minimise, the risk of manager misconduct. As the market developed the regulation evolved to reflect new developments, including technological, for example electronic communication and computer capacity, as well as the growth in the asset management industry and the accompanying changes to investments and investment products. Eventually the UK and other European regulators considered that the market had reached a stage where the original basis for permitting soft commission - in the interests of competition between brokers, with increased investment research leading to improved investment performance – was no longer valid, so heralding a regime involving full disclosure and detailed accounting and recording that may well see the practices ceasing to survive to any meaningful extent.

The process from initial regulation to MiFID II took over 40 years. The history, outlined above, illustrates a process of compromise between market participants seeking to justify current practice and thus to preserve the benefits for the industry that result and commentators who draw attention to the risks of misconduct, particularly after misconduct has been revealed, and seek restriction and ultimately elimination of the practice. The regulator acts to an extent as an arbitrator by introducing regulation that considers the range of different views and implements a compromise suitable for the circumstances at the time. This compromise is then adapted as circumstances change, with a factor that decisions inevitably involve a political element.

It remains an open question whether, had the Courts been given the opportunity, the process might have been shortened as publication of the adverse consequences for investors led to the type of publicity and competition that appears to have led many managers (only now) to abandon soft commission. It equally remains unclear whether soft commission would ever have been permitted, or even considered, if fixed commission had not existed when independent managers first entered the marketplace.

IV- Inducements

This section is concerned with the circumstances in which gifts and entertainments to a manager might give rise to a breach of the manager's duty of loyalty. Concerns about the potential for misconduct in the context of soft commission led to the topic being initially covered in a separate series of rules specific to that practice, as described in the previous section. Gifts and entertainment involving no direct charge to a client portfolio were until recently treated separately, with detailed management only considered appropriate when the wide differences in practices and the relative absence of conflict management became apparent to the regulator.

The principle is well understood and remains unchanged. A gift or entertainment should not have an influence on the actions of the manager that operates against the best interests of any Client by leading the manager to repay the benefit by providing the donor business which, but for the gift or entertainment, would not be provided. On the other hand, a complete ban on gifts or entertainment between individuals involved in financial services is not practical, not least as many will have contacts that go well beyond business in contexts where gifts and entertainment form part of the ordinary course. The issue then becomes what is acceptable. The main difficulty is that experience indicates that if the decision is left to practitioners there is a risk that, first, the range of standards adopted by competitors is wide; second, that herd instinct and competitive pressure moves the standard adopted by the market place steadily in favour of increased relaxation, thereby increasing the risk of misconduct; and third, that an absence of review and management of how the standard is applied leads to wide ranging differences in behaviour.

Fiduciary law provides protection in that conflict of interests in, and profits from, the fiduciary role must have the principal's fully informed consent. However, notification of every gift or inducement with delay for each potentially affected Client to approve is impractical and the issue thus falls under the general regulatory requirement to identify conflicts, to take reasonable steps to avoid them and if avoidance is impractical, to manage them so the clients are treated fairly. In practice a line is drawn between the acceptable (in effect no conflict is deemed to arise) and the unacceptable (where the risk of misconduct is considered sufficient to require prohibition), with regulation providing the demarcation. Regulation initially restricted gifts and entertainment by a general rather than specific restriction to benefits designed to enhance the quality of the service provided by the recipient to its third-party clients which did not hamper the recipient's ability to comply with its duty to act in good faith. The latter requirement is now encompassed within the regulatory duty to always act 'honestly, fairly and professionally …in the best interests of the client'.[53]

In its 2012 Paper the FSA concluded that too many managers had failed to take sufficient care to consider whether the value and frequency of gifts and entertainment they and their employees received would give rise to actual or perceived conflicts of interests, with too many relying on 'market practice' as an acceptable yardstick notwithstanding the FSA's view that in many circumstances disclosure of the gifts and entertainment would have caused concerns as to the objectivity of decisions taken by managers. The paper then set out several policies that represented, in the FSA's view, examples of appropriate controls, with these controls subsequently introduced by most managers where they had been lacking.

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[53] FCA Handbook: COBS 2.1.1.

In 2016 the FCA published the results of another thematic review.[54] The findings included that: (i) hospitality did not always appear to be designed to enhance the quality of service to the client, with examples including invitations to sporting and social events; (ii) inappropriate entertainment was often offered in connection with other permissible benefits, with examples including a conference or training session held at a sporting venue in the morning, with attendees provided with free tickets to a match that took place in the afternoon; (iii) records that set out the manner in which benefits received could reasonably be expected to enhance the quality of the service provided by the recipient to clients were not always kept; (iv) on occasion payments were made for training or educational material to be provided by the recipient that exceeded the costs incurred by the recipient in the provision; and (v) there were multiple failures to give clients any indication of the value of the benefits provided (even though this was required).

As a result, the FCA decided that the regulations concerning inducements required further tightening for managers and independent financial advisers. This coincided with, indeed FCA suggestions seem likely to have contributed to, MiFID II including limits on gifts that could be received by or provided to managers to 'minor non-monetary benefits' (i) capable of enhancing the quality of the service provided to the client; (ii) of a scale and nature which could not be judged to impair the duty to act in the best interests of clients; and (iii) clearly disclosed before providing services to the client (and disclosed to the FCA on request).

The regulations provided a non-exhaustive list of minor non-monetary benefits that included information relating to a financial instrument or investment service; participation in training events on the benefits of a specific instrument or service; and hospitality of a reasonable *de minimis* value. The FCA subsequently added free short-term research trial periods (subject to conditions); and research connected to a primary capital market raising.[55]

[54] FCA 'Inducements and conflicts of interest thematic review: key findings' press release April 18, 2016.

[55] FCA Handbook: COBS 2.3A.

The process thus follows the same pattern as soft commission. The introduction of regulation leads to scrutiny of current market practice and initially leads to restrictions of a general nature. At least some market participants interpret the general guidelines less conservatively than others and on-going review leads the regulator to conclude that increasingly detailed rules are required, together with enhanced procedures for the monitoring of the practical application of the rules by the compliance departments of investment firms.

V - Self-dealing and fair dealing

In *Tito v Waddell (No. 2),* Megarry V C described, and differentiated, the 'self-dealing rule' and the 'fair-dealing rule', that apply to trustees.[56] The self-dealing rule is that if a trustee sells trust fund content to itself or any associate the sale is voidable by any beneficiary however fair the transaction. The fair-dealing rule is that if a trustee purchases the beneficial interest of any of the beneficiaries, the transaction is not voidable but can be set aside by the beneficiary unless the trustee can show that he has not taken advantage of his position, he has made full disclosure to the beneficiary and the transaction is fair and honest.

This description hides considerable controversy surrounding the rules boundaries and operation, with some suggesting, for example, that the two rules encompass a larger number of different rules with different rationales, by no means all of which are relevant to an agent with discretion.[57] That said, the conflicts of interests and resulting risks where an agent acts both as an agent and as counterparty or as agent for different principals are self-evident. There is a conflict between the interest of the purchaser (whose interest is the least consideration) and vendor (whose interest is the opposite) and thus a conflict for the fiduciary in appearing in both roles, either as agent and principal or as agent for different principals.

It follows as a general principle that if a fiduciary deals both for and with its principal in a transaction in the course of carrying out its fiduciary role the transaction

[56] [1977] Ch 106.

[57] James Edelman, 'The Fiduciary "Self-Dealing" Rule' in J Glister and P Ridge (eds), *Fault Lines in Equity* (Hart2012).

can be set aside at the instigation of the principal unless the principal has given consent.[58] Whether the transaction can be set aside does not depend on whether the transaction is at a fair price, it is enough that consent has not been given.[59]

In practice most transactions implementing a decision to change portfolio content will be arranged through a regulated securities market or multilateral trading facility (a 'MTF') with the party providing the market or MTF treated as the counterparty (and thus not a client to whom obligations, e.g. of fairness, are owed). In some cases, however, the facility provider will be an associate of the manager and these transactions would fall within the scope of self-dealing rule, with this also the case if a transaction is with an associate that is a systematic internaliser (a 'SI': a firm that deals on its own account on an organised, frequent, and systematic basis by providing a system accessible to third parties in order to engage in dealings with them).[60] In these cases, the counterparty to the contract in which the investment manager is acting as agent for a portfolio owner may be an associate, which still constitutes self-dealing and so it will be necessary that the IMA expressly permits such transactions, as will all but invariably be the case.

Even where consent has been given, the 'rule of fair dealing' provides the principal with a right to have the transaction set aside if the fiduciary cannot establish that the price was fair, that the fiduciary took no advantage of the fiduciary position and the principal received full value.[61] In practice the rule is concerned with consent and assumes this can, or perhaps would, only be given on the basis of a fair price, so that if a principal is made aware that the price is or may not be the optimum that is or might be available and gives consent then the general assumption is that the right to have the transaction set-aside is lost.

As a practical example, in the early days of investment in catastrophe bonds and weather derivatives, which are investments the return on which depends on specific

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[58] In the IMA.

[59] Francis Reynolds, Peter Watts and William Bowstead, *Bowstead & Reynolds on Agency* (21sted, Sweet & Maxwell 2017),6-062 et seq.

[60] FCA Handbook: Glossary .

[61] *Tito v Waddell No 2* (n 56).

weather related events, for example the average temperature in a specified geographic area over a specified period, there were very few managers operating in the new sector and a very thin, if any, secondary market.[62] These investments are now commonly used by companies to hedge weather related risk: an oil or gas supplier in a city district might seek protection against unseasonal weather by acquiring an investment that paid a return that would bolster income in a winter in which demand was low because of high temperatures (so reducing demand for central heating) while also providing income in the summer if the weather was unusually cold (so reducing demand for air conditioning). The providers of these bonds and derivatives now include insurance companies seeking to protect against weather related claims, institutional investors seeking a new 'alternative investment' asset class and investment banks seeking to profit from a combination of detailed analysis and brokerage between purchaser and vendor.

Although there were a small number of firms willing to quote prices for secondary market purchases and sales, a number of market participants were keen to maintain the confidentiality of their client base and the practice developed that the average of several 'indicative quotes' would be used to price purchases and sales between a firm and its clients. As instructions on transactions only rarely followed an indicative quote the firms became wary of the analysis and work involved in making quotations where no transaction followed and the range of quotations became increasingly wide and unjustifiable, inconsistent (and often well in excess) of the valuation models being used by the firm making the inquiry. Furthermore, if a firm that gave such an indicative quote was approached to enter a contract based on the quote the quotation was often withdrawn. The market thus became increasingly illiquid - with existing investors increasingly concerned that holdings could not be realised and potential investors increasingly reluctant to become involved.

The solution was that the managers and investment advisers explained to the Clients the liquidity issues and offered, if the Client still wished to proceed, to arrange a purchase of the investments from the portfolio by an associate of the manager based on a valuation derived from the manager's own in-house valuation model. The Clients were

[62] The author was a legal adviser to one of the parties involved, though identities are protected by confidentiality obligations.

also offered, if they wished to proceed, a confirmation from an independent accountancy firm that the valuation was accurately based on the firm's proprietary model - the exact details of the model remaining confidential as ultimately this was the basis for the firm's pricing strategy. All investors were professional investors and each had access to legal and professional advice. The contract between the manager's associate (typically an investment bank) and those who elected to acquire investments set out very clearly the basis for the consideration and the absence of any warranty that this was more or less than might be achieved in the secondary market.

The legal advisers agreed that it was a fair assumption that, absent fraud, no party would have the ability to rescind the contract, which was governed by English law where the transaction was arranged in London, although the bonds and associated instruments were typically subject to the law of an offshore jurisdiction. This reflected the concern that the weather bond or derivative might constitute a 'contract of insurance', with multiple adverse consequences including the need to be regulated to carry on insurance business: certain offshore jurisdictions had, however, been willing to confirm, indeed in some cases to legislate, that under local law this would not be the case.

This is an example of a process where a new financial instrument was constructed by market participants so as satisfy the requirements of the potential investors without the intervention of the regulators: first by circumventing the fiduciary default rules through procedures based on investors being required to give fully informed consent as a pre-condition to participation; and second by structuring the new investment as a financial product that was not insurance, which would have restricted the issuer to regulated insurance companies and significantly increased the prices available to other investors because of the additional capital requirements such contracts would trigger.

A criticism often aimed at regulators is that too prescriptive and detailed regulation operates as a disincentive to innovation because of the costs of securing compliance with rules designed for existing products.[63] The process described above is an example as the time and costs involved in devising a solution, obtaining clearance

[63] e.g. OECD, *Regulatory Reform And Innovation* (OECD 1997).

from the regulator (or a waiver from the rules, or simply comfort that no waiver is required), materially increases the time and costs involved in creating the new product. While this can be justified in the case of products that may be acquired by retail investors for whom special protection is appropriate, it is harder to justify in the case of professional investors unless the risks involved in the proposed product could damage the interests of other investors or the smooth operation of the market. A prime example of the latter is the growth of securitisation and related products which, when adversely affected by issues in the US mortgage market, were a major reason for the loss of confidence that led both to the GFC and the very substantial increase in regulation that followed.

-*agency cross*

The second category of transaction where the manager is acting on both sides of a transaction is where the manager is acting in neither case as principal but as agent for different Clients. In practice it is not unusual for decisions involving the portfolios under the management of the same portfolio manager to involve the same security or financial product, in some cases with the decision involving one or more portfolios acquiring and another portfolio or portfolio(s) selling. The larger the assets under management and the range of overlapping investment mandates the greater the likelihood this situation will arise[64].

In these circumstances the manager will typically arrange the transaction internally by means of what is commonly referred to as an 'agency cross', whereby the manager 'matches' the buy and sell orders for the different Clients. This can be achieved either internally, for example if the investment is not regularly traded and the price is based on independent valuation with the manager notifying the custodian(s) to complete the transaction and responsible for reporting the transaction to the regulator; or externally, for example by instructing a broker that the transaction is to be completed at an agreed price, perhaps the most recent or mid-market price or possibly an average

[64] This sub-section is based on the author's experience, including in the context of the split investment trust crisis and subsequent regulatory investigations and rule changes. The identity of the clients is protected by confidentiality. The crisis is described in Andrew Adams, *The Split Investment Trust Crisis* (Wiley 2004).

over a specified period where the security is not regularly traded. The broker will then arrange completion and satisfy any notification obligations, for example to the exchange on which the securities are listed. These trades, which are defined as 'cross-transactions' in the FCA rules,[65] may involve a change in beneficial ownership, for example a sale from one CIS to another; or no change, for example a transfer between sub-funds of the same CIS.

The advantages of executing orders by matching, for both vendor and purchaser, include no or substantially reduced transaction costs and reduced market risk from exposure to the market (for the time necessary to identify a counterparty at an acceptable price). Transaction costs involve not only express costs such as broker commission, fees and other charges but also implicit costs, such as the difference ('spread') between bid and offer price (which covers order processing expense and asymmetrical information costs) as well as other potential indirect costs such as market impact costs (i.e. if the order itself affects the price), delay costs (where no counterparty becomes immediately available and the price moves in the interval) and the opportunity costs of unexecuted trades (as the consideration involved cannot be realised and used, for example for investment elsewhere). There are also disadvantages, in the case of securities in which there is limited liquidity, i.e. limited demand for sales or purchases, as the 'matched' transactions are removed from the marketplace and, even if reported post trade, play a reduced part in the price formulation process, which may be distorted as a result. There are also increased risks of misconduct considering the actual and potential conflicts of interests involved.

An example of price distortion because of matching is what has come to be called the split capital investment trusts crisis in the UK that broke in 2001. The details of the crisis are not relevant but the end of a period of significant LSE price rises, particularly in the 'tech' sector, was followed by a sharp decline. This meant that several highly geared investment companies could only provide an expected and/or promised return to certain classes of their shareholders by investing in similarly structured companies and hoping that, in time, the market fall would be reversed. These transactions were achieved by a combination of agency crosses and 'matched bargains' - transactions

[65] FCA Handbook: Glossary 'cross-transaction'.

between two managers, each as agent for a separate client, that had agreed that the price will be the price quoted in the market on the day of the transaction. In practice many of these trades assisted the liquidity of the vendor, for example to enable it to meet interest or debt repayment obligations, but were based on prices quoted for shares for which there was no independent demand. This meant that that the prices quoted were based on historical small volume transactions and bore little relationship to the value realisable for the securities in a sale between independent parties.

When the hoped-for rally failed to materialise several of the more highly geared companies became insolvent, with the result that other companies that had acquired now worthless shares in those companies incurred significant losses on share purchases which had preserved, if only for a time, the solvency of the now insolvent company. Many of these companies then failed as a result. In the end the collapses caused retail investors to incur losses estimated at £700 million, although only some £140 million was subsequently paid by way of compensation by the brokers and managers involved as part of a settlement of an action for regulatory breach that involved no admission of guilt.[66]

The starting point, in the context of fiduciary law, is that these trades are 'self-dealing' where the manager is both vendor and purchaser (and 'market abuse' if the parties - managers and brokers - are different but both) are aware that the price is not a market price fair to both principals. As the fiduciary is acting only as agent the issue of voidability does not arise as, while this would allow one principal to avoid the transaction, the other would be deprived of a transaction from which it would potentially derive a benefit. Instead, fully informed consent must be obtained and if obtained the 'inhibition principle' applies : the manager must not favour one client over another. A matched trade is thus acceptable, as satisfying the duty of loyalty, provided the trade is beneficial to both purchaser and vendor and the price at which the transaction has taken place is both fair and capable of being shown to be fair to both parties: it is not enough that both parties make savings through reduced transaction costs.

[66] Adams (n 64) parts 1 and 3.

The SIB approved, in 1988, the regulations that appeared in the initial IMRO rulebook and formally permitted agency crosses for the first time. They and their successors sought and seek to minimise the possibility of misconduct by requiring record keeping that sets out the reasoning for both transactions as well as the justification for the consideration. Over time the regulations have become more prescriptive, for example by requiring the justification to be recorded in advance of the agency cross and the price analysis also specified and confirmed as accurately reflected in the trade. The FSA 2012 Paper nevertheless highlighted cases where agency crosses could not be shown to be beneficial to both parties, even if executed at a fair price, as well as general inadequacy in record keeping combined with little and insufficient senior management oversight of the records and agency crossing procedures.

A primary concern was that the decision to change the portfolio of both parties was reached in the interests of only one party and but for this there would have been no change to the second portfolio, even though that portfolio suffered no loss that could be linked directly to the decision. Several examples were quoted of cases where the transaction assisted the liquidity requirements of the vendor – typically a regulated fund needing cash to meet redemptions - by providing either cash or readily realisable securities which would or might have only been available from the market, if at all, for less consideration than the vendor received. In addition, some transfers gave the appearance of enhancing the portfolio of an already high performing fund (so increasing its attraction to external investors) at the expense of a fund that already suffered from poor performance and so had little or no attraction for investors to lose. In many of these cases the records did not provide evidence that clearly ruled out why the concerns the FSA considered the trade raised had not been the case.

There are two conflicts involved. The first conflict of interests is between the interest of the purchaser in achieving a low price and the interest of the vendor in receiving the opposite – a conflict between the duty owed to two clients. There is also a danger that the original buy and sell decisions may reflect a further conflict - between manager and Client. This arises if the manager is seeking to favour its business at the expense of one of the portfolios by favouring another portfolio. This reflects that a CIS for retail investors that cannot meet redemptions must temporarily close. This represents a potentially significant adverse event for the reputation of the manager, as well as for the investors who cannot realise their holdings until circumstances improve, or, *in extremis*, the fund closes and liquidates its investment before distributing the net proceeds. The damage to reputation in the event such conduct leads to regulatory enforcement is illustrated by the experience of Martin Currie.

In 2009 Martin Currie was a successful independent discretionary portfolio management firm with headquarters in Edinburgh. It was responsible for several CIS whose mandate included investments in China. In April 2009 one CIS invested £15 million in an unlisted bond issued by a Chinese firm. A subsequent inquiry by the FSA found that the firm had not properly investigated the rationale for the investment or its valuation. The value of the bond halved in the next two years, but the investment proved to have extremely beneficial results for another fund of which Martin Currie was the manager. This fund was suffering considerable liquidity issues, in part because of its significant exposure to unlisted bonds. Nearly half of the proceeds of the £15 million investment by the first fund were used to make repayments on these bonds. This solved the second fund's liquidity problems while also helping to avoid the reputational damage to Martin Currie that might have been suffered if the first fund had continued to suffer liquidity problems and had become unable to meet redemptions.

While technically a connected transaction (a transaction between connected parties, in this case with the same portfolio manager) rather than an agency cross the conflicts of interests involved were similar. The failure to manage the conflict the transaction involved led to the FSA imposing the then largest fine on a manager, which was also required to pay compensation to the investors in the CIS that made the investment.[67] The publication of the regulator's decision, in May 2012,[68] led to an immediate and rapid withdrawal of assets under the firm's management by many of its institutional clients and the subsequent sale, in July 2014, of the, by then much reduced (in size and value), business to a US based investment company.

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[67] The FSA imposed a fine of £3.5 million, but as the fund was marketed and sold to US investors the firm was also fined by the SEC: the total fine was the equivalent of £8.6 million at the then $/£ exchange rate.

[68] The FSA final notice detailing the regulatory failures is available at <https://www.fca.org.uk/publication/final-notices/martin-currie.pdf>.accessed 21 September 2020.

A more recent illustration is the reputational damage suffered in 2019 by Woodford Investment Management Ltd ('WIM') after a CIS under its management was forced to close to redemptions because of the increasing proportion of the portfolio held in illiquid assets as the more liquid assets had been sold to fund redemptions because of poor performance over a protracted period. An additional aggravating factor was that several investments were reported as listed, which implied that they were readily realisable,[69] but in practice the listings were on stock exchanges on which there was a very low level of trading activity so leading to suggestions that investors had been misled. The announcement triggered significant withdrawals from other CIS under the management of WIM, as well as a review of the regulation of the liquidity of open-ended retail investment funds with a view to developing new rules which remains ongoing.[70]

It is arguable that agency crosses should be encouraged because of the cost reductions that are almost invariable involved. The counter argument is that, in an era where assets under management represent an increasing proportion of investments, the removal of a large number of transactions, including through agency crosses, when combined with the shift to investment in ETP and other passive investments and the growth in so called 'dark pool' trading (where a large or block trade that could of itself affect the price obtainable adversely takes place off-exchange and is only reported after the trade or series of trades have been executed) reduces the data on which price formation can be based and is therefore likely to contribute to increased price volatility.

Technological advance, in particular electronic trading and computer sophistication and mushrooming capacity, including speed in data sharing and speed and capacity for its analysis, has led both to a significant increase in the venues where trading is possible and an increase on 'off-exchange trading" which is outside the price formation process until, if at all, it is reported 'post trade'. In addition to dark pools other systems developed whereby trades could be completed internally by one or more firms, typically a group of brokers, hence the description 'broker crossing networks', matching trades

[69] FCA Handbook; COLL 5.8.

[70] 'FCA eyes liquidity reforms to avert replay of Woodford crisis', FCA press release October 1, 2019 <https://www.ft.com/content/9c0a8f79-dd6e-356b-8c81-d2c13e9b9c9d> accessed 21 September 2020.

received from their clients based on a reference price derived from trading venues in which the price was formed but without contributing to that formation.[71]

Although MiFID had recognized the growth in trading venues and introduced regulation to increase transparency and thus the data contributing to price formation pre-trade, the regulations left broker crossing networks largely unaffected and the volume using this method accordingly surged in the following decade. MiFID II then introduced new constraints on trading which is only disclosed post trade rather than being executed through third parties operating as, in effect, a form of market maker and risking their own capital. This effectively ended 'broker crossing networks' but at the same time made agency crossing potentially subject to regulation (as a Systemic Internaliser, or 'SI', or a multilateral trading facility or 'MTF') thereby materially increasing the administration required.

While agency crosses remain permitted without becoming directly regulated, it has become a much more complicated procedure and as a result a number of firms have decided to abandon agency crosses in favour of using external trading venues, thereby avoiding the conflict of interests involved (and the steps necessary to identify and to manage them) and the costs and expense of operating internal matching and having to qualify as a SI or MTF (which would involve being willing to deal with independent third parties using proprietary capital). While this decision is understandable from the perspective of the manager, the consequences include the loss of the potential benefits of reduced transaction costs for Clients who as a result deal with third parties and meet their fees, which could even be argued to be a failure to achieve 'best execution'.

VI - aggregation of orders

A manager will often decide that more than one portfolio under its management should sell or buy the same security. If there is no matching possibility an issue will be the order in which each transaction should be executed or whether, as is normally the case, there are likely to be advantages to at least some portfolios if the order is

[71] JL Maginn and others, *Managing Investment Portfolio; a Dynamic Process* (3rd ed, Wiley 2007); R Lee, *What is an Exchange? Automation, Management and Regulation of Financial markets* (OUP 1998).

aggregated. This based on the assumption that, over time if not in every case, a larger transaction will be able to achieve a better price per unit and thus a better price for each portfolio. The process again involves conflicts between the interests of the Clients which the manager is required to take reasonable steps to treat all clients involved fairly. This is achieved by the IMA containing consent to the Order Execution Policy : a written statement summarising the steps the manager takes to obtain best execution for its clients that the manager is required to adopt and to keep updated.[72]

In the case of each order aggregation, however, some portfolios may be shown, in hindsight, to have been disadvantaged, for example if an order, if it had not been aggregated, could have been completed more speedily at a better price, while others may have benefitted but by less than other portfolios. The solution is to accept that the gains from aggregation may be split unequally on a case-by-case basis but by applying the same policy to all transactions and portfolios the system for distribution should, over time, be as fair as practice permits.

This principle is then expanded by regulation requiring that a manager that aggregates always has a written policy for the aggregation of client orders which must be applied consistently so that portfolio owners are treated equally (and thus fairly). A typical policy might provide that if orders in a specified security for more than one portfolio under management (each of which permits aggregation under the IMA) that emerge within a specified period (including orders to the extent not yet executed at the beginning of the period) total above a certain limit they should be aggregated and treated a single order for execution purposes. The results of each order executed to fulfill the single order are then distributed between the portfolios on a pro rata basis. Although not always in the interest of the individual Client the rationale is that the process is, over time, in the interests of the market through increased market transparency and reduced costs per unit, to the investors, while also being, over time, as fair as is practical to each of them.

VII -Collective investment schemes

[72] FCA Handbook: COBS 11.2.

Authorised unit trusts and other open-ended CIS available to retail investors issue shares or units and use the sums subscribed, net of fees and expenses, to acquire a portfolio of securities to be managed within the investment mandate described in the marketing documents (and included in the IMA). The CIS also redeems shares or units to meet redemption requests from investors using cash held in the portfolio[73]. The relevant FCA regulations are set out in the Collective Investment Scheme Sourcebook ('COLL') section of the Handbook. Until the UK left the EU the UCITS regulations were incorporated in full, but there has since been some divergence. [74]

The subscription and redemption prices are based on the net asset value of the CIS portfolio, which is calculated periodically at a 'valuation point', typically a fixed time on each day on which units or shares can be issued or redeemed. The detailed mechanics and valuation assumptions vary but 'dual pricing', a traditional method in UK authorised unit trust industry,[75] leads to calculation and publication of a bid/issue price and a sale/redemption price. Many modern funds adopt 'single pricing', whereby a single price based on NAV is published. This price is, in practice, the price to which a fixed and published 'subscription fee' is added to reach the price for subscriptions; and a fixed and published 'redemption fee' is subtracted to reach the redemption price.

The dual price calculations assume that units being redeemed will be cancelled and units being subscribed for will be issued rather than be filled by matched bargains. In the period between valuation points both requests for subscriptions and requests for redemptions will often be received and if these can be matched the number of new issues or redemptions will be reduced through netting off, so reducing the costs involved as fewer issues and redemptions are required. The box is a reference to the hypothetical 'box' into which all redemption and subscription applications to a dual price fund are

[73] This section reflects the author's experience advising managers of CIS and as a non-executive director, as well as the sources identified.

[74] Principally the revision of rules concerning information to be provided to potential investors which the industry in the UK felt were potentially misleading.

[75] Authorised unit trusts are regulated funds authorised by the FCA for the direct sale or purchase of units to the retail investor.

placed, with the funds or units required to satisfy them emerging from the box after processing by way of either matched bargains, or the more expensive redemptions or new issues. The savings are referred to as 'box' profits.

- *box management*

The manager is responsible for the issue and redemption of units or shares and the process is referred to as 'managing the box'. When unit trusts were first permitted,[76] the sums involved in box profits were small and retained by the manager to reflect its box management role. This was considered fair, with one argument put forward by the managers that if the profits were added to the trust fund this would enhance the perceived performance of the manager and potentially mislead investors. The counter argument was that this involved a conflict of interest as well as a profit that was derived from the managerial appointment and thus any profits should be transferred to the portfolio. Furthermore, the profits derived from what is essentially a 'risk free' activity depend entirely on the activities of investors and only indirectly, if at all, on the manager.

Another feature of box management was that the manager could itself acquire and sell units 'in the box', thereby reducing the need for issues and redemptions, as well as increasing the box profits. The managers argued this was in the interests of investors as one result was that the cash flow of the CIS would be smoother, so reducing the cash required in the portfolio. This would, in turn, increase the proportion of the portfolio that could be invested, thus enhancing performance. While true, this failed to consider that the manager might base its decision to buy or to sell more on an immediate short-term profit than the interests of the investors. This was easy to forecast with accuracy if, as was traditionally the case, transactions were based on the prices set at the most recent valuation point, as the manager had knowledge of subsequent events when deciding whether to transact in units. This system is known as 'historic pricing' in contrast to 'forward pricing', where transactions take place based on the prices set at the next valuation price. The latter reduces but does not eliminate the use of subsequent events to forecast whether a transaction at the end of the valuation period will deliver an almost immediate profit.

[76] Chapter I, note 30.

Over time market practice and competitive pressure led to some managers deciding whether to deal in units based only on whether there would be an immediate profit. If there was doubt the manager would not intervene and the balance of the units would be redeemed or cancelled. In the reverse situation, when subscriptions exceeded redemptions, the manager would intervene, by meeting the subscriptions through sales from its own holding of units, less often as the likelihood, albeit there was no certainty, was that prices would rise as demand exceeded supply given investor optimism as to prospects for the relevant sector.[77]

The introduction of regulation in 1988 led to box profits coming under greater scrutiny. Increasing concern was expressed by commentators that managers rather than investors were benefitting from the practice as the number and aggregate AUM of dual priced unit trusts increased.[78] A further spur was the introduction of open-ended investment companies to the UK in 1996.[79] This was in part because investors elsewhere in the European Union were wary of the trust structure, for which there was no local equivalent, so hindering sales on the continent by UK based managers. Common features of the continental structures included both forward and single pricing, leading to many managers adopting the same system for all their retail investment structures.

Although the principle was clear there was, as the IMA noted in its 2004 Review,[80] no specific prohibition on managers taking a more aggressive approach and accepting more substantial box positions than the administrative convenience of the portfolio justified. The review found no evidence of malpractice, though this may have reflected that there was no obligation to publish dealings by manager or associates at that time. In any event the practice of the manager itself buying and selling units seems not to have survived the depositary, independent of the manager, becoming responsible for

[77] Investment Management Association, 'Review of Governance Arrangements of United Kingdom Authorised Collective Investment Schemes' (IMA, 2004).

[78] Christopher J Traulsen, 'Finding Hidden Fund Fees' (Professional Investor, CFA,29 March 2017).

[79] Introduced under the Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996.

[80] Investment Management Association, 'Review of Governance Arrangements of United Kingdom Authorised Collective Investment Schemes' (IMA, 2004).

overseeing box management and the manager being obliged to include details of transactions by it and associates in the annual accounts after the review's recommendations were adopted through amendments to the FSA regulations.

Further calls for reform seem likely to have resulted from the late trading and market timing issues described below. In any event, after a series of voluntary limitations on the size of box profits that a manager could retain under a Code introduced by the Investment Association, the FCA, as part of the implementation of MiFID II, announced a prohibition on a manager retaining box profits with the profits instead to be added to the portfolio with effect from April 1, 2019.[81]

Box profits is another example of a market practice that runs counter to the fiduciary principle, with initially no disclosure of the sums involved and only later a consent to box profits being retained by the manager being required, but without disclosure of the profits involved, in the prospectus (to the contents of which investors acquiring units agree under the subscription contract). Over time the practice became investigated and the dilution of the fiduciary principle involved was reduced until, eventually, the practice was prohibited.

- *late trading and market timing*

In 2003 the US authorities published the findings of an investigation into misconduct in the mutual fund sector, which is the US equivalent of the open-ended retail CIS market in the UK.[82] The principal practices constituting the misconduct were connected to late trading and market timing. Late trading occurs and is legitimate when a subscription or redemption order is received before a valuation point – the point at which the price for buying and redeeming units changes to reflect market movement since the last valuation point - but for administrative reasons cannot, or is not, executed until after the valuation point. The trade is executed at what at the time of execution is a

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[81] FCA, 'Asset Management Market Study: Final Report'(Market Study MS15/2.3,FCA, June 2017).

[82] Patrick E McCabe, 'The Economics of the Mutual Fund Trading Scandal' (FEDS Working Paper No. 2009-06).

historic price but if the failure was not the fault of the investor the execution proceeds at that price.

If, however, the investor has decided to trade after the valuation point then the investor has the advantage of knowledge whether the price is likely to have risen or fallen in the interim, so providing an opportunity for short-term profits. In these circumstances, if the practice involves cooperation between investor and manager, the manager is operating unfairly against the interest of the long-term investors and so breaches the fundamental principle that investors should be treated equally in duty/duty conflicts.

Market timing refers to the practice whereby investors place orders based on prices that do not reflect developments since a market has closed. For example, there is normally a time difference of eight hours between Japan and the UK. If a UK fund that invests in Japanese securities has a valuation point at noon in London the time in Tokyo is 2000. The Tokyo stock market closing prices will not have reflected developments in the period since 1500, in London, when the Tokyo market was closed. An investor who is aware of developments in the interim can use the information to predict the movement on the following day and decide whether to buy or to sell. Once more, if there is collusion between the manager and investor the manager is in fiduciary breach of the IMA. Good practice involves the manager taking steps to prevent late trading and market timing, not least as increased liquidity is required to deal with higher levels of trading, with the cash held in the portfolio unable to be invested. At the same time the profit extracted by short-term investors causes a dilution in the performance of the fund for longer term investors.

There was concern that the practices that the US authorities had detected would be present in other financial markets and the FSA was one of the many regulators that initiated investigations to determine whether this was the case. Although little evidence of misconduct was found, areas were identified for improvement and managers were required to introduce enhanced internal mechanisms for the detection of investors indulging in market timing and other short-term trading practices as well as to improve record keeping so late trading after the valuation point can be clearly shown to reflect an order received in advance. Ongoing improvement in computer technology and electronic communication are continuing to assist this process.

- seeding new funds

A manager whose target market includes retail investors will typically offer, through a CIS that complies with UCITS, a range of investment funds covering a series of sectors, with each fund being managed by a portfolio team that may be responsible for one or many portfolios within one or several sectors, although there may be some overlap between the mandates for which the team was responsible, as well as between the experience and expertise of the different team members. The most common structure is for the firm to have a single UCITS with multiple sub-funds, with each sub-fund consisting of a separate portfolio in respect of which the UCITS issues shares that carry rights to the income and capital of that portfolio as well as the right to redeem the share for a price based on the net asset value of the portfolio and calculated on every day when shares can be issued or redeemed. A sub-fund has a single portfolio but may issue shares based on different currencies with each share class denominated in a currency other than the base currency of the portfolio using often quite complex currency hedging techniques.

This structure allows the fixed costs of administering the structure to be shared between the funds, typically (but not always) on a basis reflecting AUM in each fund, so permitting a new fund to be economical which would not be the case if a new UCITS was required as part of its establishment. This flexibility is a major factor in the decline in new unit trusts, which not only have restricted marketability in countries in which there is no trust structure under local law but also miss out on the significant cost advantages from the economies of scale available in the administration of a single UCITS with multiple sub-funds and a corporate structure.

The firm will have control over the establishment of new sub-funds, which will be a matter for its sole discretion. Reasons for establishing a new sub-fund might include a perception that there is demand for such a fund and the firm has or has recently acquired the resources to manage the proposed mandate successfully. Alternatively, the new fund might represent an opportunity for an employee to take charge of a portfolio for the first time as part of individual career development. Closure of a fund is also at the discretion of the firm but in this event the interest of the investors must be considered, normally achieved by permitting an investor the alternative of redemption or transfer to another fund managed by the firm with a similar mandate at no or reduced cost.

The major practical problem in establishing a new fund is how the initial capital for a new fund can be provided. It is generally unusual for a fund to attract any significant interest from independent investors until its performance has been in the first quartile for an extended period, normally at least a year and often longer, depending on the sector and the size and range of competition. Not least the sums involved will depend on several factors, that the smaller the fund the greater the impact of transaction and other costs on performance making it that much more difficult to maintain a first quartile performance. At the same time investors may be unwilling to invest in a small fund even if the performance is and remains strong.

The larger the firm the more likely that reserves will have been set aside to provide capital for new ventures, alternatively investment may be available from associates or through relationships with institutional clients. The management fee might also be held at a reduced level for an initial period to encourage investment. One common form of investment is for a portfolio with an overlapping mandate to provide some of the seed capital. Thus, a firm with a large and successful emerging markets fund might establish a single country fund for a newly emerging market and then allocate part of the portfolio of the larger fund as an investment in the new fund and its fund manager. This might reflect that the new portfolio manager had been given responsibility for that allocation as part of the portfolio team covering the larger fund and is deemed to merit promotion to lead manage a single fund.[83]

The issue arises whether the allocation to the new fund can be justified on the basis that, if an allocation to a country fund is appropriate, should that allocation not be to a fund with an established track record notwithstanding that the fund is managed by

[83] UCITS restricts the holding in the smaller fund to a maximum of 5% of the net asset value of investing fund and 25% of the net asset value of the fund in which the investment is made.

a third party? The justification is normally based on the investors in the larger fund not meeting any additional charge, in effect the fee in the smaller fund is deducted from the fee charged by the investing fund, combined with the manager remaining for most practical purposes unchanged and the fixed costs being allocated only to the investment in the smaller fund.

The FCA indicated in its 2017 report that some managers had failed to identify the conflict between the interests of the firm in establishing the new fund and the interests of the investors in the investing fund in the performance of that fund and had thus not taken steps to manage the conflict to ensure fair treatment.[84] The issues are not easy to resolve and while the conflicts may be clear their management may prove complicated. If a new fund is seeded by institutional investors they will normally require special treatment to reflect the need for the manager to maintain goodwill; or, where the funds are provided by the manager, the firm, giving its additional interest in the performance, may provide additional resources to that where its role is restricted to management with no indirect ownership by its employees. The consensus is that where the sums are small both in the context of the manager's and the institutions assets the risks are manageable, though this is less arguable where the manager is small or new, when the regulatory bar on one UCITS holding more than 5% of the units issued by any other fund under the same management is considered to provide sufficient safeguard

VIII - Summary

The examples of business practice that have been described in this Chapter illustrate a policy decision that, notwithstanding the purpose of the fiduciary doctrine is to protect against the opportunism for improper motive that the fiduciary role offers,[85] it is necessary to reduce the stringency of the fiduciary principle of prohibition to allow investment business to be carried out and remain internationally competitive. The Chapter has established that, in the case of the discretionary portfolio management, the strict fiduciary rules are modified by a combination of regulation and market practice to

[84] FCA, 'Asset Management Market Study' (access to interim and final reports (2015-2018),FCA 2019).

[85] HE Smith, 'Why Fiduciary Law Is Equitable' in Gold and Miller (eds), *Philosophical Foundations of Fiduciary Law,* 282.

accommodate a wide range of dilutions, some of which potentially benefit the interest of the manager or the public interest over the interests of the Client. The danger of this approach is illustrated by the examples of misconduct that would not have been permitted if the default rules applied and notwithstanding the regulatory steps taken to protect against them. Relaxation involves increased risk of misconduct, whether by failure to apply the management rules efficiently or applying by reference to the letter rather than the spirit of the rules.

Chapter Four – Causes of Action and Remedies

I - Introduction

This chapter considers the potential causes of action and remedies available to an investor who is dissatisfied with the performance of a managed portfolio in which she has an interest. The cause is typically that the investment performance has not come up to expectation, whether in absolute terms or when compared to similar investments. In either case the duties of the portfolio manager (or 'manager') will be set out in an investment management agreement (the 'IMA') between the manager and the portfolio owner(s) (the 'Client').

Investors with an indirect interest in the portfolio have rights based on the relationship between them and the Client. The relationship could be through the investor holding through a collective investment scheme (a 'CIS') and thus based on the structure and governance of the CIS, or being a beneficiary of a trust of which the trustee is the Client, whether a private express trust or some other form such as an authorised unit trust[1] or employee pension fund. Where the CIS has no separate legal personality, the investors will be collectively or jointly the Client and their rights against the Client will be the subject of a separate contract to which the manager will not be a party. This thesis is concerned primarily with causes of action arising under the IMA and the potential remedies available to the Client.

The most common response to dissatisfaction is to terminate the manager's appointment. An investor holding through a CIS achieves this by redeeming the investment where this is permitted, which includes all CIS eligible for direct investment by a retail investor,[2] or selling if a buyer can be identified at a satisfactory price. This does not of itself affect the IMA. In contrast if the investor is the Client the cessation requires the termination of the IMA, often with the manager appointment being transferred to one or more replacements. In other cases, including where the investor

[1] Authorised by the Financial Conduct Authority (the 'FCA') under the Financial Services and Markets Act 2000 as amended ('FSMA) to permit direct investment by a retail investor.

[2] Any investor who is not a 'professional investor'- see Ch 1, page 9.

holds an interest through a trust or a CIS that contains no redemption facility, the investor may be unable to find a buyer for the indirect interest and the remedy for dissatisfaction may be limited to expressing dissatisfaction to or through the Client or other entity through which the investment is held.

A feature of the asset management industry is that is rare for the cessation of the relationship between a Client and a manager to lead to litigation and all but unheard of for the dispute to reach the Courts. In part this reflects that the IMA will include an express disclaimer of any obligation in respect of investment performance. The manager's obligations are instead primarily encapsulated in a duty of care, which provides, subject to the detailed language in the IMA, for decisions concerning portfolio content and implementation of decisions to change content to be taken by the manager with the application of a level of knowledge and skill that is, to paraphrase, reasonable in the circumstances. Even if there is a breach of this duty a claim for damages will require the Client to establish a causal link between breach and damage, the amount of which may also be limited by remoteness.

These uncertainties seem likely to be a significant contribution to the paucity of litigation, with the alternative means of settlement, including negotiation, mediation, arbitration and for retail investors a claim under the Financial Ombudsman Scheme (the 'FOS'), part of both the cause and the result. The Financial Conduct Authority (the 'FCA') and its predecessors have also contributed by regulatory enforcement taken on the basis that all profits gleaned from misconduct should be forfeited, with all investors who suffer as a result of misconduct receiving compensation.

The chapter continues with an analysis of the circumstances in which the manager may commit a breach of the IMA, in particular the requirements for breach to be a breach of fiduciary duty. The chapter then considers the remedies available to the Client: first damages for breach of the IMA; and second, on the basis that the manager is a fiduciary, the 'equitable remedies' available for breach of fiduciary duty. Analysis of the rights of investors not party to the IMA will depend on the exact legal structure of their interest and are outside the scope of this thesis, which is concerned with a manager providing portfolio management services under an IMA that is not providing any other services to the Client or investors with indirect interests in the portfolio.

The obligations of the manager are contained in the express and implied terms of the IMA. These incorporate the manner in which the fiduciary rules covering conflicts of interests and secret profits (the 'no conflict' and 'no profit' rules) have been modified by the FCA regulations. These permit conflicts of interest provided that the manager takes reasonable steps to ensure fair treatment for the Client. If a manager does not comply with the modification when exercising the discretion provided by the IMA the presence of a conflict of interest would be enough to constitute the exercise a breach of fiduciary duty, giving the Client potential access to equitable remedies. The motive of the manager in so failing is irrelevant: honest incompetence is no excuse. Other breaches may constitute fiduciary breach, including failing to act in good faith, but it remains uncertain whether this would apply if a conflict of interest was not present.

The chapter then reviews the range of remedies available if breach is established, in particular the requirement for a causal link between breach of the IMA and damages, in terms of portfolio performance, for which the Client might claim compensation for breach of the IMA. The judgments in *Nestle v National Westminster Bank Plc,*[3] are reviewed in light of current market conditions and practice. The conclusion is that if the case were decided in current conditions there would be a different rationale and potentially a different outcome based on the arguments put forward in the Unilever dispute, which is also reviewed.

The following section reviews the scope for the remedies for breach of the IMA to include non-compensatory damages and considers whether, as a practical matter, those 'legal consequences differing from those of a breach of' duties that are not fiduciary'[4] might provide actual, rather than theoretical, benefit to a Client and if so in what circumstances. The section also considers the consequences of the statutory right of the retail investor to recover losses that result from a breach of the Financial Conduct Authority ('FCA') regulations pursuant to FSMA s.138D (a 'Statutory Claim') when

[3] [1992] EWCA Civ 12, [1993] 1 WLR 1260 (CA Civ).

[4] Millett l J, *Bristol and West Building Society v Mothew* [1998] EWCA Civ 533, [1998] Ch 1, 18.

combined with the ability of the FOS to adjudicate claims by and make awards in favour of retail and certain other 'small' investors. An issue is the extent to which the FOS has, in practice, replaced the Courts as the adjudicator of claims by retail investors.

II - The obligations of the discretionary investment manager

The obligations of a manager are contained in the express and implied terms of the IMA. Obligations may, however, arise before the IMA is signed. These can be divided between obligations in relation to information about the services to be provided; and information provided to the investor in circumstances that allow the investor to rely on the information as investment advice, for example as to the suitability of the proposed investment strategy for the investor. A further possibility is that the appointment develops from an existing relationship without the exact terms of the new relationship being settled.[5] This would be a breach of the FCA regulations that require the Client to be given a written term of business and, in practice, an IMA is provided, either before portfolio management services are provided (in the case of a retail client) or immediately after agreement is reached, and so, while not impossible, is highly unlikely.[6]

Prior to signing an IMA, the investor and discretionary manager will exchange information. The investor will provide information concerning the investor's role, circumstances and investment objectives. The manager will provide information about the services that the manager can provide and the options that are available. The manager faces potential liability under the Misrepresentation Act 1967 if information is provided that (i) the manager does not have reasonable grounds for believing is correct; (ii) the information is material to the investor's appointment; and (iii) the investor relies upon it when becoming party to the IMA. The knowledge and sophistication of the investor will be a factor in determining whether the Client's reliance on a statement was justified.[7]

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[5] *Australian Securities and Investments Commission v Citigroup Global Markets Pty. Ltd (No. 4)* [2007] FCA 963, 160 FCR 35.

[6] FCA Handbook; Conduct of Business Sourcebook ('COBS') 8.1.4 and 8A.1.4.

[7] *Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2018] EWCA Civ 355.

In practice the IMA include provisions excluding any obligation not expressly set out in the IMA and liability for breach of any such obligation.[8] Provided the steps already described are taken before the IMA is signed,[9] it seems highly unlikely that any of these provisions would be found to be unenforceable. The only potential exception derives from a manager having a regulatory duty to advise a retail investor in relation to the suitability and appropriateness of an investment mandate proposed for an IMA between them.[10] The manager may only advise after first obtaining detailed information about the investor's financial position and knowledge and in most circumstances this obligation to acquire detailed information will be sufficient for the manager to be obliged to provide investment advice based solely on the interests of the investor, that is as a fiduciary, unless a professional investor agrees otherwise, for example in the terms of the IMA.[11]

The practical steps taken in advance of an IMA being signed are now adopted as a matter of routine. They are designed to establish that the investor has not only been fully informed but also has warranted the information the Client has provided to be true, complete and accurate. The manager is also obliged to carry out verification of the information, for example obtaining evidence of the client's financial position (such as confirmation of salary and other sources of wealth). As a result, a successful claim for misrepresentation or breach of fiduciary duty would inevitably involve a breach of regulation, which would give the investor the right to a Statutory Claim. Although a successful claim under the Misrepresentation Act 1967 or for breach of fiduciary duty in relation to investment advice might give access to additional remedies, in particular rescission, in practice the sums recovered would be the same as available under the FSMA,[12] with the same basis of calculation. An increased award of damages is potentially available for fraudulent misrepresentation or deceit, but this would potentially be

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[8] See generally Chapter I, section IX.

[9] See generally Chapter 2, section II.

[10] FCA Handbook, COBS 9.0 et seq.

[11] *Daly v Sydney Stock Exchange Ltd.* [1987] HCA 25, (1986) 160 CLR 371 (HC) : Paul Finn, *Fiduciary Obligations 40th Anniversary Republication with Additional Essays* (The Federation Press 2016), para 741 et seq.

[12] s.138D FSMA.

mirrored by a claim for breach of fiduciary duty by the manager, but in its role as investment adviser, not manager.[13]

It is fair comment that the extent of the modification to the common law prohibitions goes considerably further than the relatively narrow issues to which consent has been accepted as 'fully informed' in caselaw. The principle is that the manager must make 'full and frank disclosure of all material facts'[14], with the burden of proof that this applies placed on the manager[15]. This does not mean the principal needs to understand that a fiduciary breach would occur absent consent, simply what the facts of the consent will permit.[16] Furthermore consent alone may suffice if no fiduciary relationship has arisen before the IMA is signed, albeit the detailed market practice is designed to avoid claims of misrepresentation as well as procure compliance with FCA rules as to pre-appointment dealings, especially with retail investors, as well as to comply with FCA rules designed to ensure procedures to provide fair treatment are followed, would be sufficient to validate the apparently wide-ranging scope of the modification.

Contact between a manager and a retail investor in a CIS would be unusual. Investment is instead based on the contents of a prospectus or equivalent offering memorandum issued by or on behalf of the CIS.[17] The investor may also receive investment advice, but this would be provided by an independent financial adviser (an 'IFA'), not the manager of the CIS. The investor could also acquire a holding in a CIS as a result of a manager exercising its discretion under an IMA, but any associated obligation would arise under the terms of the IMA that already existed between investor and that manager. An IMA with a professional investor will, as standard practice, include an

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[13] *BV Nederlandse Industrie Van Eiprodukten v Rembrandt Enterprises, Inc.* [2018] EWHC 1857 (Comm); *Smith New Court Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1996] UKHL 3, [1997] AC 254.

[14] *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] UKPC 7, (1973); 1 WLR 1126 (PC); *Boardman v Phipps* [1967] AC 46; [1966] 3 WLR 1009; [1966] 3 All E R 721 (HL).

[15] *Hurstanger Ltd. V Wilson* [2008] Bus L R 216.

[16] *Sharma v Sharma* [2013] EWCA Civ 1287, [2014] BCC 73.

[17] The content of all these documents is closely controlled by prescriptive regulation, with the contents incorporated into the contract under which a holding in the CIS is acquired.

‘entire agreement’ clause that will constitute the clear drafting required to exclude liability for misrepresentation or collateral warranty.[18]

In summary obligations may arise before an IMA is signed but these will normally be excluded by the express terms of the IMA. The only potential exception is where the investor is a retail investor and the manager fails to follow current market practice. In this case there are remedies available under the Misrepresentation Act 1967 or under the common law, with the statute placing the burden of proof on the representor if it is established loss was caused by the misrepresentation. These would not, in practice, provide any additional benefit to the damages available under a Statutory Claim for loss suffered by a retail investor as a result of a breach of FCA regulation.

The obligations of the manager contained in the IMA terms will be interpreted in light of principles applicable to the agency appointment that derive from tort, contract and fiduciary law. Interpretation will also reflect the particular circumstances of the relationship between manager and Client and, in the context of an investment in a CIS, the relationship between the investors in the CIS as set out in its constitution and the relationship between CIS and manager as set out in the IMA.

Tort is relevant as the manager assumes responsibility for the management of the portfolio and accordingly owes the Client a duty of care. As the manager holds itself out as possessing special skills and knowledge, if only by virtue of its authorisation to carry on investment business pursuant to FSMA, the duty of care requires that the investment manager apply the degree of knowledge, skill and care reasonably to be expected from a manager with the level of skill knowledge and experience of an ‘average’ manager. Where the manager purports to provide some special skill and competence, for example in a specific asset class or geographic region, the test will be the standard of the ordinary skilled person professing to have that special skill.[19] In practice the standard of care will be described in the IMA express terms, typically in a format that provides for the manager to act ‘in good faith’ and ‘with reasonable skill and diligence, managing the

[18] *Axa Sun Life Services plc v Campbell Martin Ltd & ors* [2011] EWCA Civ 133, [2012] Bus LR 203.

[19] *Henderson v Merrett Syndicates (No. 1) Ltd* (1995) 2 AC 145(HL).

portfolio in a manner that, in the manager's opinion, is likely to achieve the investment objectives within the restrictions set out in the mandate and the rest of the IMA'.[20]

The IMA express terms amend, however subtlety, any obligation that tortious principles would otherwise apply.[21] 'Good faith' is used rather than the regulatory duty to act 'honestly, fairly and professionally in accordance with the best interests of the client' contained in the FCA regulations and derived from MIFID II Article 24(1) in an attempt to restrict the contractual obligation to a professional investor to a subjective rather than objective test, although the regulatory (objective) duty will also apply where the investor is a retail investor.

The relationship between manager and Client and the IMA terms are also subject to law of general application, for example the rules concerning contract terms, illegality and public policy. These include the implied duty of care owed by the manager as a supplier of services pursuant to the Supply of Goods and Services Act 1982, although the latter will be amended, both expressly and by implication, if the IMA specifies a higher level of duty; regulations applying to the conduct of the manager as a provider of financial services, principally arising under the FSMA and the FCA regulations; the potential unenforceability of certain contract terms against professional investors under the Unfair Contract Terms Act 1977; and the protections for the private investor or consumer, principally under the Consumer Rights Act 2015 but including the Statutory Claim.

The manager's role as an agent with discretion typically involves a duty of loyalty: the exact duty will be provided by the IMA terms which modify the strict common law prohibitions. Typically the effect is that conflicts of interest that would otherwise be prohibited are permitted provided that the manager takes reasonable steps to ensure the fair treatment of the Client (or as otherwise as specified in the IMA). This effectively applies a duty of care to the identification and management of conflicts with compliance

[20] The words quoted are a standard form in common use in the industry.

[21] Lord Goff in *Henderson* (n 19); Lord Hoffman in *South Australia Asset Management Corp v York Montague Ltd*. [1996] UKHL 10, [1997] AC 191.

with the FCA rules and guidance for conflict management included within what it is reasonable or a Client to expect.

The obligations of a manager can accordingly be seen as falling within three potentially overlapping categories. The first involves situations in which compliance with the IMA terms is established as a straightforward matter of verifiable fact, for example a breach of the investment mandate that can be confirmed solely by identification whether any holding in the portfolio could never in any circumstances be within the mandate or whether the portfolio content as a whole satisfies the mandate's statistical restraints.

The second involves a judgment as to the standard of services provision: whether services supplied in the course of the exercise of the discretion granted by the IMA have been provided with the requisite application of knowledge and skill. The test for breach in these cases is objective – were, in the particular circumstances, the services provided to the requisite (minimum) level.

The third is concerned with the fiduciary principle, principally in the form of the no conflict and no profit rules but possibly also covering egregious failure to satisfy contractual duties, including to act in good faith. The issues include whether, if the manager has an actual or potential conflict of interest, the manager has complied with the modification. The test is similar to the second category test but limited to individual investment decisions and transactions that result from such a decision. If this test is not satisfied the manager will have breached its fiduciary duty. The test is objective based on the circumstances in which the matters to which the conflict relates have arisen and how the conflict has been managed.

The third category may be combined with either of the others, though more probably with the first, in which case there is a single breach of the IMA which is a breach of fiduciary duty. There remains the issue whether fiduciary breach can occur outside the no conflicts and no profits rules, for example in the circumstances discussed in Chapter 2.[22]

[22] See *'proscriptive v prescriptive'* Ch 2, page 90 et seq.

As a general rule the obligations of a party to a contract will terminate on the termination of the IMA except as specified, for example in relation to confidentiality. Termination of the IMA will, however, typically involve an interim period where the departing manager no longer has discretion over the portfolio content but is instead required, by the IMA terms, to implement decisions to change portfolio content taken by its replacement (acting as agent for the Client). The termination of the departing manager's discretion will terminate the fiduciary duty.

Where the relationship between manager and investor is terminated by the sale or redemption of a holding in a CIS which has separate legal personality the IMA will not be affected and the process will be governed by the constitution of the CIS and subject to regulation. The duty of loyalty will not be affected and will continue to be owed to the Client (i.e. the continuing investors) collectively, even though the identity of the individual investors in the collective will have changed.

III - Breach of the IMA by the portfolio manager

A Client who is dissatisfied with the performance of a manager will typically be concerned that the value of its portfolio is less than it should be and thus that a monetary loss has been suffered. The Client may seek compensation for the difference between the actual value and the value that the Client considers it should be if the (alleged)IMA breach by the manager had not occurred. Even where the portfolio management itself is not at issue, for example a breach of confidentiality obligations,[23] the Client may be seeking a monetary award for compensatory damages.

As the manager is acting as the agent for the Client losses to the portfolio deriving from transactions by the manager are the losses of the Client, with the issue whether the manager is liable to compensate the Client for the loss. If breach of the IMA by the manager can be established then, in principle, the Client is entitled to compensation if the loss was suffered as a result of the breach. Other remedies may be available if the breach is a fiduciary breach and these issues are considered later in this Chapter.

[23] The IMA with a professional investor will commonly exclude liability for losses other than the result of portfolio performance.

Complaints concerning portfolio management can be divided into two categories; first alleged failure to manage the portfolio in accordance with the investment mandate; and second that the mandate was unsuitable for the Client or otherwise not what it was reasonable for the Client to expect. The latter relies on a claim for misrepresentation or breach of a duty of care to advise the Client that the mandate is unsuitable and has been discussed.[24] The former relies on investment decisions being found to be in breach, either individually or collectively, of the IMA. An individual transaction the subject of a claim is potentially either prohibited by the investment mandate or in breach of the modified fiduciary duty. A claim relating to a series of transactions and decisions to change and not to change portfolio content over a period will be based on an allegation that the level of knowledge and skill applied by the manager to the portfolio management failed to satisfy the manager's duty of care.

A transaction in breach of the investment mandate is normally a straightforward matter of fact, although in practice breach of the investment mandate occurs most often as a result of actions over which the manager has no direct control.[25] Where the cause is a transaction in breach of the IMA, complications as to the quantum of loss may arise if a breach is discovered only after a lapse of time. The most common example is the acquisition of an investment that is in no circumstances permitted by the investment mandate. This is easy to detect and occurs as the direct result of the manager entering into a contract as agent of the Client. Although the manager has no actual authority its ostensible authority will, absent the counterparty having actual knowledge of the lack of authority, mean the transaction is binding on the Client. In practice the remedy, when detection is discovered, is commonly referred to as a 'reverse trade'[26] whereby the manager acquires the security or investment from the Client at the then prevailing market price and pays into the portfolio whatever is required to ensure the portfolio has suffered no loss after taking into account transaction costs. If the purchase and sale by the portfolio realise a profit after all costs have been taken into account the profit remains in the portfolio.

[24] Lodewijk Van Setten, *The Law of Institutional Investment Management* (OUP 2009), para 3.6.

[25] See Chapter 1, section VII.

[26] In contrast to the expression 'reversing trade' which commonly refers to a similar combination of trades trade in the futures market.

In the normal course of events such a transaction is almost always the result of an error, for example the name of the investment to be acquired is misspelt or misidentified, at some time between an investment decision and its implementation. Errors or omissions do occur and may only be spotted when the portfolio content is first reviewed after the acquisition is completed, though this is unlikely to be later than the following business day. Errors may also involve the amount or acceptable price range for an acquisition of securities which are themselves permissible but not in the quantity acquired. In most cases both identification and remedy are straightforward with the reverse trade completed within one or two business days.

Problems can occur if there is a delay before the breach is discovered, for example if an investment is incorrectly considered as permitted when it is not and the error is only spotted after a delay. One example is certain Exchange Traded Products ('ETPs') that are used for passive investment but which, as no portfolio management is involved, do not qualify as investment funds for UCITS regulatory purposes.[27] In a number of cases, the relevant UCITS regulations have been incorporated into an investment mandate and holdings in the ETFs acquired in breach of the IMA, with the error only discovered some months later. In these cases not only will a reverse trade and potentially compensation for the portfolio be required but the Authorised Corporate Director (or 'ACD', the FCA authorised entity that is responsible for the UCITS's regulatory compliance),[28] will be required to procure the recalculation of every NAV on which the price of units was based during the period the investment was held (replacing the value of holding with the cash with which it was acquired) and to compensate any investor who incurred losses as a result of subscribing for or redeeming units at what was an inaccurate price. The IMA will normally provide that the manager is responsible for these costs.

The costs involved in 'straightforward' errors are typically not material but this is not always the case. By way of an example, a portfolio manager misread a circular in a foreign language and decided not to invest in a rights issue and so took no action.... only to be subsequently informed that as a result of the failure to take action the Client had

[27] E.g. the SPDR structure described in chapter 1, p 43.

[28] FCA Handbook: Collective Investment Schemes ('CIS') CIS 7.3 Functions of the ACD.

been deemed to have agreed to underwrite the issue.[29] As a result, the portfolio had acquired 30% of the shares available, with the aggregate holding representing over 10% of the portfolio's NAV, both significant breaches of the investment mandate. Furthermore, payment for the shares was immediately due and payable and well in excess of any liquid funds which the portfolio could access. The result was that the manager had no option but to cure both breaches and fund the debt by way of an immediate 'reverse trade' of the newly acquired shares, which were then sold at a price below the rights issue price with the manager incurring a material loss.

The second category of breach involving individual portfolio transactions is an allegation that the manager had one or more conflicts of interests but failed to take reasonable steps to ensure fair treatment for the Client. This modified version of the duty of care is decided on an objective basis based on the evidence adduced, which seems likely to consist of both Client and manager producing one or more conflicting expert opinions as to whether the manager satisfied the 'reasonable steps' test, with compliance with the applicable FCA regulations an important, but not conclusive, determinant.[30]

The test of fairness is elusive and the extensive and increasingly detailed records required under FCA regulations are intended, amongst other objectives, to establish more clearly the manner in which the conflict of interests was managed and whether reasonable steps were taken to provide fair treatment for the Client. Failure to satisfy the recording obligations, including as to timing and accuracy, will be a factor to be taken into account when deciding, based on the (lack of) evidence adduced, whether the management of the conflict satisfied the modified common law prohibitions. The issue will not be whether the result was fair, but rather whether the management of the conflict was reasonable. If the reasonableness test is not satisfied the duty of loyalty will have been breached even if the investor has not suffered as a result. There will also have been a breach of FCA regulation that could lead to enforcement action, as well as, for a retail investor, a Statutory Claim.

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[29] This is based on the author's experience: the identities of the manager and client remain confidential (although the breach was reported to the regulator as the regulations continue to require).

[30] *SPL Private Finance (PF1) IC Ltd v Arch Financial Products LLP, SPL Private Finance (PF2) IC Ltd v Farrell* [2014] EWHC 4268 (Comm).

Breach of the IMA in the context of a series of unrelated transactions is likely to involve a claim that the manager has breached its duty of care. This involves an objective judgment whether the level of skill and knowledge applied to the management of the portfolio over the period covered by the claim satisfied the level called for by the duty of care as specified in the terms of the IMA. Disputes will typically be based on conflicting opinions from 'experts' as to first what was required to satisfy the duty of care and secondly whether the manager's activities satisfied the requirements. As the next section indicates, the very few cases in which this claim has reached the Courts demonstrate that the clash between experts is likely to involve considerable court time. As a result practice is for professional investors to seek a resolution by negotiation, mediation or arbitration rather than the Courts,[31] with retail investors referring complaints to the FOS.

The manager's professional duty of care, even if sometimes referred to as a 'fiduciary' duty of care, is not strictly a fiduciary duty but rather a non-fiduciary duty owed by a party fulfilling a fiduciary role. The professional duty derives from the tort of negligence and requires that the manager applies the level of knowledge and skill that the portfolio owner can reasonably expect, in the particular circumstances, will be applied to the management of the relevant portfolio.[32] The exact scope of the duty must accommodate the terms of the IMA,[33] but the duty will be breached if the manager fails to take those actions (including decisions not to change portfolio content) necessary for the requisite level of knowledge and skill to be applied: honest incompetence is no defence.[34]

Breach of the duty of care may not involve any breach of the investment restrictions in the investment mandate. Any mandate breach, in particular when combined with other breaches of the IMA and if numerous or serious, may, however, be a factor in establishing that the manager has breached its duty of care. The contents of

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[31] As negotiation, mediation and arbitration are private and confidential this is based on the author's experience and private discussions with portfolio management executives and professional investor representatives, as well as the very large number of legal firms offering advice based on prior experience.

[32] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465: *Henderson* (n 17).

[33] *Hospital Products Ltd v U.S. Surgical Corp* [1984] HCA 25, (1986) 156 Commonwealth Law Reports 41.

[34] *Armitage v Nurse* [1997] EWCA Civ 1279, [1998] Ch 241.

(rather than restrictions in) the investment mandate, for example setting out the risk management criteria or targets in terms of 'beating' the benchmark index or not underperforming by more than a specified percentage over a specified period, may also be relevant to deciding the scope of the duty and whether there has been breach.[35]

The manager's duty of care has two aspects: first the monitoring of portfolio content and making decisions when and within what parameters to alter the portfolio content; and second the use of the agency authority to contract as agent for the Client, including the obligation to obtain 'best execution'. Breach is not concerned with individual investments in the portfolio but instead depends on the totality of individual investment decisions and the processes that led to them being taken and implemented, including the methods adopted for portfolio content analysis, for assessing individual investment acquisition and disposal proposals and the choice of portfolio content change implementation decisions. These are all factors relevant to the question whether the level of knowledge and skill that the manager applied to the portfolio management, on an ongoing basis, satisfied the duty of care as described in the express terms of the IMA.

While it is fair comment that a Client can expect that an element of the duty of care would involve compliance with the FCA regulations in accordance with industry practice, the express terms may include additional obligations that go beyond mere satisfaction of the regulations so the duty of care may be both more detailed and potentially more extensive. Furthermore breach of an FCA regulation may give rise to a Statutory Claim if a retail investor can establish that loss was suffered as a result, but there will be no such claim for a professional investor, although the breach may contribute to a finding that the manager's duty of care has not been satisfied.

Although the IMA will include obligations that do not relate directly to portfolio management the combination of an express restriction of losses for which the manager accepts responsibility to losses in the value of the portfolio and provisions that the responsibility for matters not directly related to the portfolio, for example specifying that records to be used for reporting purposes are the records of the custodian not the manager, restricts the liability of the manager, in practice, to breach directly relating to

[35] As featured in the Unilever and MAM dispute described in section IV below.

portfolio management or specific investment transactions. The remedies available to the Client are the subject of the balance of this Chapter.

IV - Remedies for breach by the manager

As a general principle, if a manager has breached its duties under an IMA the Client will be entitled, subject to any valid exclusion or limitation of liability clause if the Client is a professional investor, to be compensated for losses that the Client caused by the breach. The aim is to calculate what the value of the portfolio would have been had the manager satisfied the duty of care, with the manager to make good any difference. The principles are no different to the principles that apply where the breach is of a duty of care owed by a party that is not a fiduciary: the duty of care of a fiduciary is, for the purposes of English law, not a fiduciary duty.[36]

If, however, the manager has breached its duty of loyalty and committed a breach of fiduciary duty the Client has potential access to a series of remedies that are based in equity on the basis that compensatory damages may not provide an adequate remedy. These remedies are rescission and its close ally, pecuniary rescission; equitable compensation, which is intended to place the claimant in the position in which he or she would have been for the breach; an account of profits giving rise to a personal claim against the fiduciary; and proprietary remedies against third parties other than ‘equity’s darling’ (a *bona fide* purchaser for value without notice) based on the imposition of a constructive trust on property of the claimant wrongly removed or transferred by the fiduciary.

The issues for the next two sections are: first, how would damages for breach of the IMA be assessed if a breach of the IMA is not a fiduciary breach; and second whether and in what circumstances could equitable remedies provide additional benefit for the Client to compensatory damages for (non-fiduciary) breach of the IMA.

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[36] Millett L J ‘Not every breach of the duty of care is a breach of fiduciary duty’ in *Mothew* (n 4) 16. There are other views, see e.g. the theories referred to by Heydon, 'Modern fiduciary liability: the sick man of equity?’ (2014) 20(10) Trusts & Trustees 1006-1022.

V - Common law damages for breach of contract

As a practical matter a disgruntled Client may seek financial compensation for loss in the form of a monetary payment equivalent to the damage suffered as a result of the manager's breach. The claim will be based, in principle, on establishing the difference between (i) the value of the portfolio; and (ii) the value of the portfolio if the manager had not committed the breach. The entitlement to compensation will not, however, extend to losses that are too remote, including damage not caused by the breach[37] or outside the areas of activity for which the manager has undertaken responsibility under the IMA.[38]

As the manager has taken responsibility for management of the portfolio, damages not caused by breach of the IMA seem likely to be restricted to *force majeure* events as described in the IMA and limited to events that a manager could not reasonably be expected to cater for in light of the continuity of business plans required by FCA rules.[39] If the manager engaged in, or was vicariously liable for, fraudulent or wilful misconduct in committing the breach the manager will lose the right to reduce the damages award for remoteness or causation.[40] In principle, a failure by a Client to take reasonable steps to mitigate damage may lead to a reduction in the compensation payable.[41] Mitigation is, however, generally not practical in portfolio management except, perhaps, where the Client is a professional investor that has made arrangements for the portfolio content to be reviewed on an ongoing basis by persons with the requisite skill both to understand the investment mandate and to monitor compliance and portfolio performance and thus is in a position to raise queries with the manager beyond simply complaining about (and only) criticising performance.[42]

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[37] *Hadley v Baxendale* (1854) 9 Ex 341.

[38] *South Australia Asset Management (*n 21).

[39] FCA Handbook: SYSC 4.1.

[40] *Smith New Court* (n 13).

[41] *Linklaters Business Services v Sir Robert McAlpine Limited*,[2010] EWHC 2931; *Bulkhaul Ltd v Rhodia Organique Fine Ltd*, [2008] EWCA Civ 1452.

[42] Failure to mitigate was raised against Unilever in the Unilever dispute discussed below.

It is general knowledge that the performance of the portfolio will, in certain circumstances, have consequences for the performance of the Client under contracts that the owner has with third parties: for example, if the portfolio owner is an insurance company the portfolio performance will affect the sums available to meet claims by holders of those policies the value of claims under which are linked to the value of the portfolio. The Client is, however, the insurance company so any claim against the manager can only be made by the insurer, with investors left to claim under the terms of the insurance policy.

This result, that the policyholder has no recourse against the manager unless the insurer takes action against the manager, has recently come under scrutiny as a result of losses incurred by policyholders (including in particular pensioners) directing the insurer to invest in investments unsuitable for retail investors.[43] Fiduciary duty is not, however, part of the solution, which is provided by enhanced responsibility for the insurer for the suitability of the funds from which a policyholder may select, combined with regulation that requires an Authorised Corporate Director ('ACD') of an UCITS to monitor whether the retail investors invested in the UCITS are those at whom the investment is targeted. As yet there has been no attempt to widen the duties of the manager to include obligations to third parties with a holding in the CIS. Regulation thus protects the investor in the UCITS against manager misconduct, not breach of the manager's fiduciary duty of loyalty.

A breach of the duty of care by the manager may not directly be related to investment performance but instead involve obligations under the IMA that fall outside the manager's discretion: examples include breach of confidentiality obligations or failure by the manager to provide data in the format or within the time limits specified in the IMA. The same general principles will apply to the calculation of any award for monetary damages, with the award restricted by the rules of causation and remoteness. In practice it would be unusual for such a breach to lead to a claim for damages because of the standard restriction of damages to loss in portfolio value (including reduction in gain) in the IMA, while the losses incurred by the Client are likely to be inconvenience

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[43] Defined as 'unregulated collective investment schemes' under FCA rules: examples include investment in ostrich farming in Canada and other schemes than proved to be highly speculative or fraudulent.

and irritation rather than measurable in terms of economic loss. It is however possible for a professional investor to seek to amend the terms to permit such claims, although the manager can be expected to be reluctant to agree. A retail investor also has protection, by virtue of a potential Statutory Claim.

- breach of investment mandate

The most straightforward breach is the acquisition of an investment that is not permitted by the investment mandate. Typically, the breach of the IMA is identified and resolved within one or two dealing days by way of a reverse trade. Where there is a delay in identifying and/or remedying the breach issues may arise as to opportunity cost. The sums involved in a diversified portfolio are normally relatively small, so that opportunity cost is rarely, in practice, an issue. Where the issue does arise and the IMA does not include a clause excluding loss through opportunity cost (which clause is likely to be unenforceable if the Client is a retail investor pursuant to the 'unfair terms' provisions in the CRA) the issue is what the manager's likely course of action would have been if the mandate had not been breached, with this to be judged based on the available evidence.[44] This could include a claim based on the loss in value of the sums invested in breach if it can be established that the sums invested would, on a balance of probabilities, have been invested in a manner that would have resulted in reduces loss or even gain.[45]

Although the manager will not be required to meet any claim for compensation if no loss (including reduction in gain) has occurred, a breach of the IMA will nevertheless have occurred and in theory a right to terminate the IMA without notice may have been triggered. The investor will, however, often be unaware that a breach has occurred as there will be no obligation to notify the investor if no damage has been suffered. It is also normal practice for the Client to be obliged to give either no or only a very short notice of 'no fault' termination.

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[44] *Wemyss v Karim* [2016] EWCA Civ 27; *Tai Hing Cotton Mill Ltd v Kamsing Knitting Factory* [1979] AC 91 (PC), 106.

[45] *R (on the application of IFG Financial Services Ltd v FOS* [2005] EWHC 1153 (Admin).

There is an obligation under UCITS for the ACD of a CIS that is an UCITS to notify the FCA of any breach of the investment mandate or other FCA rules.[46] This will typically require a report by the manager explaining how and why the breach occurred and what steps are being taken to reduce the risk of repetition. Further regulatory action is unlikely unless the explanation is unsatisfactory or there are multiple repeats, but this will not involve payments to investors as long as they are compensated in the manner described and thus suffer no loss.

This method of remedying the breach represents a breach of the rule against fiduciary self-dealing to which there is not normally any specific consent in the IMA. The method is generally assumed to be a custom of the market that is binding on the Client under the principles underpinning *Kelly v Cooper*[47] and in accordance with the guidance on the scope of conflicts on interests in the FCA regulations because the Client suffers no loss. The manager could repair the breach without breach of the self-dealing rule by a sale, as agent, to a third party. The market custom allows immediate remedy of the breach without the risk of further price movement increasing the loss to be met by the manager while disposal to a third party is implemented.

At the same time the manager or any associate purchaser would take the benefit of any gain realised from a subsequent sale on its own account notwithstanding that it could be argued that the profit derives from the manager's (breach of its) role as agent. The decision to retain the investment after the portfolio has recovered any loss notwithstanding sale to an independent third party was available is considered to break the causal chain and subsequent actions by the manager are taken independently as principal. There is no risk of loss to the investor so the FCA guidance that this is not unauthorised profit applies, both as matter of regulation and contract.[48]

In the case of 'inadvertent breach' there is breach of the IMA only if the breach is not remedied in accordance with the terms of the IMA or, if there is no express term, market custom. Where an inadvertent breach is remedied within these limits (as is all

[46] FCA Handbook: Collective Investment Scheme Sourcebook ('COLL') 6.6.

[47] *Kelly v Cooper* [1993] AC 205.

[48] FCA Handbook: COBS 10.1.5G.

but universal practice) no breach of the IMA by the manager will have occurred and the issue of damages or other remedy will not arise. If this is not the case the same principles apply as those described above. The task of establishing that a delay in remedying an inadvertent breach was a breach of the IMA would be considerable if the manager had recorded the reasons for the delay and a reasonable manager acting reasonably would consider the delay justified.[49] A failure to do so would also constitute a breach of FCA regulations triggering both a Statutory Claim for a retail investor and potential regulatory enforcement by the FCA.

- *breach of fiduciary duty*

The second category of breach relating to individual transactions arises where an individual transaction is entered into by the manager as agent for the Client in circumstances that fail to comply with the IMA terms that permit conflicts of interest . This is a breach of contract entitling to Client to compensatory damages calculated on the same basis as described above, that is loss suffered as a result of the breach subject only to reduction for causation or remoteness. A further issue will then be whether the availability of equitable remedies could lead to any additional benefit becoming available to the Client, which is discussed in the next section.

By way of an illustration, consider a manager that has two Clients for each of whom the manager decides investment in the same security is appropriate in amounts of £10,000 and £20,000, with the manager's execution policy calling for transactions to be shared in the ratio 1 to 2 until £30,000 has been disbursed. The money is spent in two tranches, the first acquiring 900 shares for £10,000 and the second 1860 shares for £20,000. This should result in the first client receiving 1840 shares for £20,000 and the second 620 shares for £10,000. Allocation errors by the manager result in the first Client receiving 1800 shares and the second 660 shares. If the price for the shares rises by £1 before the error is discovered the first client has suffered a loss of £40 and the second a gain of £40 and the manager will be liable to compensate the first client accordingly. If the price has fallen by £1 the second client will have suffered a loss of £40 and be entitled

[49] The principle is discussed in the review of *Nat West v Nestle* that follows.

to compensation. The Clients will not have breached the IMA so the manager will not be entitled to recover any gain that accrues as a result of the error.

- breach of the duty of care

The availability of damages for breach of the manager's duty of care has been addressed, even if only indirectly, in only a very small number of cases. The judgements of the Court of Appeal and at first instance in *Nestle v National Westminster Bank PLC* are of particular significance even if the reasoning was relatively sparse.[50] The issue of damages for breach of the investment mandate was also the subject of the important *Unilever* dispute, where the claimant occupational pension scheme trustees put forward a case based on an analysis that differed from that of the Court of Appeal in *Nestle* which is now generally considered to be the approach that would be adopted if the issue comes before the Court.[51]

A further example is the cases linked to the 'Arch Cru' investment fund collapse, which is of interest as a rare example of the processes the Court will, in practice, adopt to reach judgement. The collapse was already the subject of a finding of regulatory misconduct by the FSA. The finding was, however, under appeal,[52] so the Court ignored the findings, with the use of expert opinions guiding the Court both as to the manner in which the manager should have addressed the balance between risk and reward when deciding whether to proceed with a transaction and the steps that should have been taken to ensure fair treatment for the investors in light of the conflicts of interests involved. The case also indicates another reason why litigation is so unusual - the defendant firms and their officers were insolvent, with the individuals subsequently declared bankrupt and thus unable to meet any of the claimants' legal costs, let alone pay

[50] *Nestle* (n 3): the first instance judgment is at [2000] WTLR 795; Nigel A Clayton, 'The duty of a trustee to be prudent and fair' (1988) 3(6) IBL 284-286.

[51] Lodewijk Van Setten, *The Law of Institutional Investment Management* (OUP 2009), para 3.104 et seq.

[52] The appeal was subsequently rejected, *Arch Financial Products LLP v Financial Conduct Authority* [2015] UKUT 13(TCC)).

any damages award.[53] Quite why the proceedings continued is a matter of speculation, although it seems possible that the validity of insurance claims may have been an issue.[54]

Nestle concerned a trust fund of which the bank was trustee that had been established following the death of the settlor in 1922. The fund initially comprised the deceased's family home and a portfolio valued at nearly £54,000. The claimant was the settlor's granddaughter, who became solely entitled to the trust fund, with a value of some £269,000, following the death of her father in 1986. The impact of inflation in the intervening decades meant the value of the portfolio needed to retain the initial purchasing power was estimated to exceed £1 million. The claim alleged that if the original balance between equities and gilts had been maintained the portfolio would have had a value in the order of £1.8 million.

As Dillon LJ noted in the Court of Appeal, the case necessarily covered matters of general legal importance although the outcome had to depend on applying accepted legal principles to the particular circumstances at any particular time.[55] The principles had been succinctly described in the earlier judgment of Brightman J. in *Bartlett v Barclays Trust Co. (No. 1),* where he set out the questions: '(1) What was the duty of the bank? (2) Was the bank in breach of duty and if so in what respect? (3) If so, did that breach of duty cause the loss suffered by the trust estate? (4) If so, to what extent is the bank liable to make good that loss?'.[56]

The litigation reflected the bitterness of the disputes, with seven days in Court for the first hearing in 1988 followed by eight days in the Court of Appeal in 1992, some six years after Miss Nestle had become the sole beneficiary. Among the points of interest is the extent to which the Court of Appeal disagreed with Hoffmann J, the judge at first instance, on the application of the legal principles to the facts. All were agreed as to the

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[53] *SPL Private Finance* (n 30).

[54] The hope that funds might become available by reversing transfers to third parties by a bankrupt individual manager may also have been a factor *Re Farrell (A Bankrupt)* [2019] EWHC 119 Ch.

[55] *Nestle* (n 3), 1263.

[56] *Bartlett v. Barclays Trust Co. (No. 1)* [1980] Ch 515, 530.

principles, adopting, albeit with various addenda,[57] Lindley J's description: 'to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide'.[58] Hoffmann J found that, on the basis of the evidence (which included contradictory opinions from the expert witnesses called by each party), the bank had acted 'conscientiously, fairly and carefully throughout its administration of the trust'.[59] Thus, the claim failed at the second stage of the Brightman J analysis in *Bartlett*.

With hindsight the analysis applied by Hoffmann J would be unlikely to be applied today, over thirty years later. He relied to a material extent on the then relatively new Efficient Markets Hypothesis[60]: that investors respond rationally to publicly available information. Despite continuing refinement by commentators including Jeffrey Gordon,[61] the hypothesis has faced criticism that it fails to take into account investor responses to short term price movements which are unrelated to long term value.[62] This criticism increased significantly after the Global Financial Crisis with one commentator going so far as stating that, in its aftermath, only a fanatic could 'believe in the literal truth' of the hypothesis.[63] In contrast to Hoffmann J , the Court of Appeal concluded that the bank had misunderstood the powers of investment granted it by the Trust Deed, had failed in its duty to review the investment portfolio regularly and, being under a duty to acquaint itself with the scope of its powers, should have taken legal advice about them.

The unanimous decision was that Miss Nestle had failed to establish that these

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[57] Hoffmann J providing, for example, that a higher standard should be expected required of the Bank as a 'professional trustee' as per Brightman J in *Bartlett* (n 67).

[58] *In re Whiteley; Learoyd v Whitley* (1886) 33 Ch D 347, 355.

[59] Quoted by Staunton LJ in the Court of Appeal in *Nestle* (n 3) at 1281.

[60] The hypothesis is often referred to as first propounded by Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25(2) Journal of Finance 383.

[61] Jeffrey N Gordon, 'The Puzzling Persistence of the Constrained Prudent Man Rule' (1987) 62 NYU Law Review 52.

[62] Tom Stevenson, 'Investors are finally seeing the nonsense in the efficient market theory' The Telegraph, June 17, 2009; Paul Woolley, 'The Fallibility of the Efficient Market Theory: A New Paradigm' (CFA Institute 2014), 2.

[63] Laurence Siegel, 'Black Swan or Black Turkey? The State of Economic Knowledge and the Crash of 2007–2009' (2010) 66(4) Financial Analysts Journal 6, 7.

breaches of duty caused loss to the trust fund. The burden of proof was on the claimant and this had not been satisfied. The claimant needed to establish that the trustees made decisions that they should not have made or failed to make decisions that they should have made. If this was established and, at first sight, loss resulted, it would be appropriate for the Court to order an inquiry as to the loss suffered by the trust fund. The evidence had failed to establish any such decision or omission, so the claim failed at the third hurdle and it was unnecessary to consider the fourth question.

The case concerned the duty of a trustee when exercising the duty of investment rather than a portfolio manager providing services under an IMA. The Court's approach, which concentrated on examining the conduct of the trustee rather than the results of the trustee's investment decisions, is, however, apposite to a claim against a manager, not least given the absence of any warranty as to investment performance. Other aspects of the judgments also remain uncontroversial, including recognition that expectations as to conduct should be judged by reference to contemporary standards.

Some of the reasoning in the Court of Appeal judgments is not entirely consistent and has been interpreted in different ways. The simplest analysis sees the judgment resting on the claimant's failure to prove, based on the evidence adduced, any loss that could be linked to breaches of duty by the trustee. Certain passages in the judgments have, however, been interpreted as setting an almost impossibly high standard for establishing causation, in effect that the error or omission by the trustee was the cause of loss to the trust fund: the third hurdle in *Bartlett*. This appears to some extent to have resulted from reliance on the now often questioned, if not discredited,[64] judgment of Sir Robert Megarry V.-C in *Cowan v Scargill*[65] to the effect that, whatever the conduct and reasons that preceded a decision by a trustee, liability for breach of trust could not attach if there were, in his words quoted by Dillon LJ, 'good and sufficient reasons for

[64] Watchman, Anstee-Wedderburn and Shipway, 'Fiduciary duties in the 21st century: a UK perspective' (2005) 19(3) Trust Law International 127.

[65] *Cowan v Scargill* [1985] Ch 270. The decision has come under considerable criticism, in particular in the context of ESG, but the criticism does not attack the principle, rather the manner in which the principle was applied to the particular circumstances, in particular a bitter coal miners' strike, see e.g. Watchman, Anstee-Wedderburn and Shipway (n 64).

supporting the decision'.[66]

This could be interpreted by analogy as requiring, for an action for breach of duty involving investment management, the identification of investment decisions for which there was no good or sufficient reason (i.e. regardless of the actual reason). On this basis even the manager whose decisions are based on throws at the dartboard escapes liability, whatever loss ensues from an investment so chosen, as long as the portfolio content that results from each of the manager's throws is within the investment mandate and the portfolio content and related decisions can be justified on bona fide grounds. Where the investment mandate is as general and unspecific as in the *Nestle* case, which went no further than the need for the trustee to follow a prudent approach and to provide a fair balance between the interests of the income and capital beneficiaries, there would almost always be a bona fide argument in favour of an investment decision falling within the investment mandate. Hence the result comes close, in practice, to a requirement to identify an investment decision that no reasonable investment manager acting reasonably could have reached.[67] By the same token it becomes all but impossible, whatever the mandate, to be unable to justify a decision to leave the content of a portfolio unchanged.

This interpretation can be criticised as failing to recognise that the judgments followed a detailed examination of the management of the portfolio, including evidence from two expert witnesses and 15 days in the Courts. The Court of Appeal found the particular failures by the bank to be, in effect, twofold: a misunderstanding of the investment powers, which were interpreted to be stricter than they were; and a failure to carry out regular reviews in the period from 1960 through 1986. The Court then concluded that even if the bank had appreciated the wider power of investment there was no evidence that a prudent trustee would have taken advantage of the wider power, not least as this would have involved investing in sectors other than banking and finance which, at the time, were considered to involve greater risk of loss. The Court further concluded that there was no evidence that regular reviews would have led to any

[66] *Nestle* (n 3) 1270.

[67] Gary Watt, 'Is there liability for imprudent trustee investment?' Conv (1998) Sep/Oct Conv. 352; Jeffrey N Gordon (n 61).

decision to change the portfolio content; and that the errors and omissions by the bank had led to 'wrong' investment decisions had not been established: it followed that no recoverable loss had been suffered.

Once an investment mandate becomes more specific and identifies the style and tactics to be adopted by the manager the range of potential investments in any particular situation and portfolio content is more limited, but it is nevertheless the case that this type of analysis - and the need to identify an unjustifiable investment decision (including not to change portfolio content) – places a very high burden on the claimant. This is notwithstanding the range of potential investments, the volatility of investment values and modern practice that sees discretionary portfolio management as involving on-going and all but continuous portfolio review and risk management, both as a regular routine and in the event of any unexpected but potentially material event.

The causation analysis in the Court of Appeal can, and should, be seen as restricted to the facts of the case and reflecting the relatively undeveloped investment management practices and unsophisticated securities market of the times. The *Nestle* judgments seem likely, however, to have led to potential claimants being warned of the risk that a ruling of the House of Lords (now the Supreme Court) would be required to overrule the Court of Appeal before an award of damages against a manager could be obtained.[68] At the same time the judgments provided a source of comfort to the investment management industry that, absent fraud or breach of the investment mandate, there was no, or at least no material, risk of facing liability for breach of contract or tort.

As a result, many a dissatisfied investor may well have felt the options restricted to terminating the IMA or realising a CIS holding and transferring the mandate or investment elsewhere. Even in 2008 the *Nestle* decision was seen as justifying trustees taking into account ethical considerations when taking investment decisions, notwithstanding this could be interpreted as a breach of duty,[69] as they could be secure in the knowledge that they 'stand little practical risk of exposure to claims for

[68] The role of the House of Lords was transferred to the Supreme Court on October 1, 2009.

[69] Following *Cowan* (n 65).

compensation for resultant loss'.[70]

This deterrence analysis is supported by the reaction of the investment management industry to the *Unilever* case, which was reported in the press late in 2001. The claim by Unilever Superannuation Trustees Limited ('UST'), the trustee of the Unilever employee pension fund, against Mercury Asset Management plc ('MAM')[71] was not based on specific breaches of the IMA. Instead UST claimed that the combination of events, including multiple individual breaches and differences between information provided as to how portfolio management would be carried out and actual experience, indicated that the manager had breached the duty of care by failing to apply the necessary and appropriate level of skill and knowledge.

The UST claim contended that this breach of duty entitled UST to damages to be assessed on the same basis as negligence: the difference between the portfolio value and the value assessed and judged by reference to what UST could have expected from a reasonable manager which had satisfied the duty of care, with the damages to be awarded based on the deficit, if any, between the actual portfolio value and that which UST could have reasonably expected.

The reporting of the *Unilever* proceedings in the London newspapers came as a considerable and unwelcome surprise to investment managers generally. The results were described as including 'asset managers around the world … reviewing their investment management agreements'.[72] It seems likely that the UST claim was framed as a claim for damages for breach of the duty of care assessed on the same basis as negligence intentionally to counter, or perhaps circumvent, a defence that relied, following *Nestle*, on the need (in order to establish causation) to identify individual decisions by MAM that were 'wrong', in the sense of not being justifiable by any reasonable investment manager acting reasonably (within the investment mandate).

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[70] Rosy Thornton, 'Ethical investments: a case of disjointed thinking' (2008) 67(2) CLJ 396, 417.

[71] Merrill Lynch, which acquired MAM in 1997, was the named defendant in the legal proceedings.

[72] Robin Ellison, 'Asset managers: What is the duty of care?'(2003) 9 Pensions: an International Journal 14, 21. For a case study see Lodewijk Van Setten, *The law of Institutional Investment Management* (OUP 2009), para 4.92.

Instead the UST claim, once breach of the duty of care was established, called for the quantum of damages to be based on the performance that UST could reasonably have expected of a reasonable investment manager with an allowance for the fees that would have been met from the portfolio under the IMA. This would today probably be argued in terms of the performance of a combination of the Exchange Traded Products ('ETPs') and index funds linked to the benchmarks contained within the investment mandate less an allowance for the investment manager's fees as set out in the IMA.[73]

A key element of the UST claim was a complex, for the time but now commonplace, investment mandate involving active management of a portfolio allocated to a number of specified asset classes with each having a specific portfolio component. UST alleged management failure had resulted in too much invested in 'general industrials' at the expense of, in particular, 'financials', as well as too concentrated a portfolio as it comprised only 20 holdings. On any measure the performance of the portfolio was dire. In comparison with over 1600 UK equity investment portfolios the performance was in the 100th (i.e. bottom) percentile.

UST accordingly claimed damages of £110 million for portfolio value reduction, for the loss of the opportunity to invest these sums in the other portions of the portfolio and for interest (the quantum to be assessed). The surprise to the industry was that the claim was made on the basis of breach of the duty of care rather than any specific breach of contract or misrepresentation, especially as it emerged during the trial that the individual in charge of the portfolio was relatively inexperienced and had been allowed a very wide discretion. The risk management process had also differed significantly from that MAM had put forward in the discussions and negotiations that preceded the contract. It was also far below the 'highest standard' stipulated in the IMA and considerably more relaxed than that MAM applied as a matter of routine to other portfolios under its management.

The decision of Merrill Lynch to settle with a payment reputed to amount to £70

[73] See also Lofthouse S, 'Nestle v National Westminster Bank plc: flawed reasoning?' (1997) Private Client Business 232. The annual investment management fees in the *Nestle* case were based on between 10 and 12% of the trust fund's income, which was payable to the life tenants and so not directly relevant to the value of the capital fund. Note ETP and index fund performance include transaction costs, which benchmark indices may not.

million was welcomed by the judge, who later criticised both sides for failing to utilise mediation or dispute resolution.[74] Although the result left open a number of legal issues, the settlement does seem to have established the principle that a discretionary investment manager owes a duty of care which should reflect any particular skill that the manager claims as part of the appointment as well as any feature of management, for example risk analysis, research or reporting to the client, that appears in the IMA, in particular if these were used to justify the management fee or transaction costs.[75]

The conclusion is that, if breach of the duty of care is established, damages will be payable if the portfolio has a value less than that which would have been achieved if the duty of care had been satisfied by a manager acting reasonably within the mandate. This requires statistical assessment of the average return on a portfolio managed within the specified mandate, with argument likely to revolve around expert evidence as to competing and increasingly complex statistical analyses, a dispute more suitable to arbitrators (and confidentiality) than the publicity, delays and costs involved in litigation.

The length of time that has passed since the *Nestle* case is another reason why its value as precedent is questionable. The portfolio was managed over a period that covered the transition from an era in which capital preservation was a paramount consideration for investment management to the current, where the role is seen as a matter of managing risk and the balance between risk and the potential for reward. Modern computer technology now permits much greater identification and analysis of potential investment decisions and their results, with much improved statistical estimation of the performance that the investor can reasonably expect, based on the average of the multiple possibilities under a specified investment mandate. At the same time the increasing body of regulation, prescriptive and proscriptive, has led to the emergence of an increasingly detailed catalogue of the actions that can reasonably be expected of a discretionary portfolio manager in the course of managing a portfolio - and the corollary that a failure to take such action is an indication of a failure to act reasonably.

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[74] Ellison (n 72) 22.

[75] McNair J in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582, 586.

There have also been structural changes. Investment management for third parties is restricted to firms with the knowledge and skill necessary to be authorised under FSMA: any claim against a manager would be for breach of the terms of an IMA, based on express terms including the duty of care, with breach leading to the value of the portfolio being compared to that which the client could reasonably expect based on the average of the range of potential investment possibilities. It may seem surprising that a case concerning the duty of investment of a trustee in the period before 1987 should be considered in any way relevant to the duty of a portfolio manager appointed under an IMA over three decades later. The *Nestle* judgments nevertheless remain to be overruled in a sector in which there is a dearth of judgments in cases that do not involve wilful misconduct or fraud. This lack of cases to some extent contrasts with that in other commonwealth jurisdictions where those providing financial services have been found to owe a duty of care to those who they are aware will be relying on their services.[76]

Although compensatory damages are the principal remedy for breach of contract under common law, there are circumstances in which non-compensatory damages may be awarded. The most obvious (and unhelpful) case is nominal damages, awarded when there has been a breach of contract, but no damages have been suffered that are recoverable. However the existence of further categories was confirmed by the judgments in *Attorney General v Blake,* although the extraordinary circumstances of that case - a convicted spy who had escaped from prison in London to a Russian state funded apartment in Moscow and sought to profit from publishing his memoirs in London – suggest there is little relevance to portfolio management.[77]

James Edelman has argued the case was the basis for the simple proposition that 'restitutionary' damages should operate to reverse a wrongful transfer of property, while 'disgorgement' damages should be available where a party to a contract has deliberately breached the contract in order to make a profit. He then referred to the account of profits available to the principal who has suffered a breach of fiduciary duty,

[76] E.g. the Australian Federal Court ruling upholding a first instance judgement that a credit agency owed a duty of care to investors who relied on its assessment *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65.

[77] [2001] UKHL 45, [2001] 1 AC 268 (HL).

a topic for the next section.[78] The considerable case law and academic commentary since the *Blake* case have not resolved this issue and it is fair to say that as yet his propositions are not the law. Lord Hobhouse's cautionary warning, in his dissenting judgment in the House of Lords, that the consequences of non-compensatory damages for (non-fiduciary) breach of contract will be far reaching and disruptive for commercial law should also be borne in mind. As Sarah Worthington observed, the case 'might be seen as a hard case making bad law, [the case] being stymied by jurisdictional issues in pursuing what were seen a justified remedies'.[79]

VI -Equitable remedies

The other potential category of IMA breach is a breach of fiduciary duty. Such a breach could relate to individual transactions that fail to comply with the IMA terms that permit conflicts of interests or, possibly, a particularly severe breach of contractual duty in circumstances where no claim of fraudulent or wilful misconduct is made, with the claim not facing the evidential challenges to establishing fraud or wilful misconduct.

Fiduciary doctrine provides that breach of fiduciary duty allows the principal potential access to a series of remedies that are based in equity, traditionally on the basis that compensatory damages for breach of contract may not provide an adequate remedy. The concept is that a breach of fiduciary duty should be seen as similar to a breach of duty by a trustee with the portfolio treated as a trust fund and augmented by whatever has wrongly been removed or withheld. The role of accountability as a response to information asymmetry in agency relationships can, however, be traced back to changes in farming practice in the 13th century , which may themselves have drawn on owe their origins to aspects of Roman and canon law.[80]

78 James Edelman, 'Restitutionary damages and disgorgement damages for breach of contract' (2008) 8 RLR 129.

79 Sarah Worthington, 'Four questions on fiduciaries' (2018) 32(1) Trusts Law International 22.

80 Amir N Licht, 'Lord Eldon Redux: Information Asymmetry, Accountability and Fiduciary Loyalty' (2017) 37 OJLS 770.

The remedies available to the principal whose manager has committed is fiduciary breach are rescission; equitable compensation, intended to restore the claimant in the position that would have been but for the breach; an account of profits with a consequential order to restore to the principal what is judged to have been wrongly withdrawn or withheld; and proprietary remedies based on property wrongfully transferred being held on constructive trust.[81] The question is whether and in what circumstances could any of these remedies provide additional benefit to the compensatory damages available for breach of the IMA.

There are other equitable remedies that a Court may grant if sought by a Client and the Court considers this appropriate in the circumstances, for example an injunction to prevent a breach of the IMA by disclosure of confidential information (not a fiduciary breach as confidentiality obligations are not restricted to fiduciaries). These remedies are not dependent on the manager being in breach of fiduciary duty and so fall outside the scope of this thesis. They are also granted only at the discretion of the Court following principles based on legal precedent applied to the circumstances.

In contrast the availability of equitable remedies for fiduciary breach is available at the election of the principal, but within the potential restraint that, in the words of Fletcher Moulton L J, 'the nature of the fiduciary relationship must be such that it justifies the interference'.[82]

Conflicts of interests are divided into conflicts between the interests of the manager and the Client, 'duty-interest' conflicts; and conflicts between the duty of the manager to different Clients, 'duty-duty' conflicts. The latter involves the inhibition principle which requires an element of intent by the manager for breach, although the IMA amendment provides that breach requires only that 'reasonable' steps have not been taken by the manager to ensure fair treatment for the Client . This raises two questions:[83] first, whether in such cases equitable remedies add anything to

[81] Ben Macfarlane and Charles Mitchell, *Hayton and Mitchell: Text, Cases and Materials on the Law of Trust and Equitable remedies* (14th ed, Sweet & Maxwell 2015).

[82] *Re Coomber* [1911] 1 Ch 723, 728.

[83] Conaglen, 'Remedial ramifications of conflicts of a fiduciary's duties' (2010) 126 LQR 72, 101.

compensatory damages, which is, in the words of Matthew Conaglen, 'unclear';[84] and second whether this might be, in some circumstances, an example of the fiduciary relationship not justifying the interference of equitable remedies, for example where only professional investors have an interest in the portfolio. In practice a judgement by the Court on either issue seems unlikely, leaving two more uncertainties of fiduciary law. A further issue is whether the Client has no duty to mitigate in the event of a fiduciary breach. The cases in Australia and New Zealand on mitigation are inconsistent,[85] while there is no authorative judgement in England. In *Nationwide Building Society v Balmer Radmore* conscious disloyalty prevented a fiduciary claiming failure to mitigate damage but the judgement did not consider unconscious disloyalty.[86]

- Rescission

The contracts involved in the manager Client relationship are contracts entered into by the manager as agent for the Client and the IMA.

- Transactions by manager as agent

There are three principal categories of contract entered into by the manger as agent for the Client in breach of fiduciary duty: a contract with a counterparty which has bribed the manager to procure the contract;[87] a contract with a counterparty that is the manager or its associate in breach of the modified common law prohibitions,[88] which include the treatment of associates operating behind an effective 'Chinese wall' as independent third parties (so moving such associates into the next category); and a contract with a third party that is aware that the manager is acting in breach of fiduciary duty. 'Chinese wall' is the name given to the system of information barriers within a group or company whereby confidential information, in particular price sensitive

[84] Ibid 96.

[85] Ibid 97.

[86] *Nationwide Building Society v Balmer Radmore* [1999] Lloyd's Rep PN 241.

[87] *Grant v Gold Exploration & Development Syndicate Ltd* (1900) 1 QB 233, 248-9; *Logicrose Ltd v Southend United FC (No. 2)* (1988) 1 WLR 1256.

[88] *Tito v Waddell (No. 2*) [1977] Ch 106, 241.

information, can be kept on one side of the barrier so that those on the other side are not deemed to have knowledge and thus are, for example, allowed to deal in affected securities.[89]

In a case falling within the first category rescission, if available against the counterparty, would grant the Client no greater benefit than the damages available for breach of the IMA and breach of the contract. The manager and counterparty would have acted fraudulently and/or with wilful misconduct, so entitling the Client to recover all losses resulting from the breaches without reduction for remoteness or causation.

In practice a transaction between a manager and Client, other than a reverse trade as a means to remedy a breach of the investment mandate, would be highly unusual as a manager does not buy and sell securities or investments for its own account or transact business other than as a manager.[90] This reflects the conflict of interests that would arise and the administrative problems and costs that would be caused by the conflicts management and record keeping that would be required under FCA regulations. Transactions entered into by the manager as agent for the Client will accordingly all but invariably be with a third party, either an independent third party (which includes an associate operating behind an information barrier') or an associate of the manager. The contracts will be subject to the requirement that no materially better terms are available from an independent source, or another client of the manager, although for the breach to be a fiduciary breach there will need to proof. The materiality qualification reflects that comparison is not always an exact science.[91]

If a transaction for a portfolio was in breach of the modified fiduciary prohibitions the Client would have the right to rescind the contract with the result that the contract

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[89] The expression is defined in the FCA Handbook and is used in its technical sense, although some prefer expressions without potential nationalistic connotations, such as 'ethical wall' or 'information barrier' or 'insulation wall'. FCA Handbook; Glossary; Christa Band, 'Conflicts of Interests in Financial Services and Markets. The Regulatory Aspect: Part 2' (2007) 22 JIBLR 88 at 97. 'Information barrier' is used in the rest of this thesis.

[90] Individual employees involved in the management of a CIS investing in private equity or unlisted investments are often required by investors to have a stake in the performance of the CIS in which the manager has a management or advisory role but the investments will not be made by the manager but by the individuals, normally through a separate company or other investment vehicle.

[91] FCA Handbook: COBS 10.1.15 G.

'is treated in law as never having come into existence'.[92] The right exists, however, in equity and there are 'bars' to rescission. These include: the claimant must not have affirmed the contract; 'restitutio in integrum' is not substantially possible, that is to say both sides of the transaction must be capable of being reversed to a substantial extent; a bona fide purchaser for value without notice must not have taken an interest in property which would be affected by the rescission, including, for example, creditors where the contract was for the issue of shares and the issuer commenced liquidation after the contract was agreed;[93] and lapse of time, that is to say that too long has passed between the contract being agreed and the request for rescission, with the length of time flexible and depending on the circumstances.[94]

In portfolio management the most common bar to rescission will be because the securities the subject of the contract have been sold to a bona fide third party for value without notice, for example through a securities exchange. In *Smith New Court Ltd v Scrimgeour Vickers (Asset Management) Ltd,* a security had been acquired as a result of a fraudulent misrepresentation by the vendor.[95] The purchaser sought rescission and the vendor claimed this was impossible because the purchaser had already sold the securities to a bona fide third-party purchaser for value and without notice of the equitable right to rescind.

Lord Browne-Wilkinson, in the House of Lords, expressed considerable doubt at the assumption made by the parties (and the Court of Appeal) that rescission was not available. His view was that rescission was more flexible than this: '[T]he reasons why Smith abandoned their claim to rescind were not explored before your Lordships. I will therefore say nothing about the point save that if the current law in fact provides (as the Court of Appeal thought) that there is no right to rescind the contract for the sale of quoted shares once the specified shares purchased have been sold, the law will need to

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[92] *Johnson v Agnew* [1908] AC 367, 393.

[93] *Oakes v Turquand* [1867]LR 2 HL 325.

[94] *Salt v Stratstone Specialist Limited T/A Stratstone Cadillac Newcastle*[2015] EWCA Civ 745.

[95] *Smith New Court* (n 13).

be closely looked at hereafter'. Since in such a case other, identical shares can be purchased on the market (albeit at a much-reduced price) 'the defrauded purchaser can offer substantial *restitutio in integrum* which is normally sufficient'.[96]

Where the manager has no interest in the transaction but the transaction involves a fiduciary breach, the Client may nevertheless rescind the transaction. A fiduciary breach by the manager is not enough, however, the Client must also establish that the counterparty against whom rescission is sought was privy to the manager's misconduct.[97] Thus the payment of a bribe in connection with a transaction between two parties using the same (fiduciary) agent is not enough to allow either side to rescind a transaction that results, the party seeking rescission must establish that the counterparty actually knew or was wilfully blind to whether the agent had concealed the payment from the [other] principal.[98]

It follows that if the manager enters into a contract as agent for the Client and the other party is another client of the manager but the terms on which the Client gave consent in the IMA (i.e. requiring that reasonable steps be taken to ensure fair treatment for each Client) have been breached rescission is available to either Client only if it can establish that the other Client was aware of the breach.[99] If both Clients have been deprived of the undivided loyalty of the manager in breach of the IMA terms but neither was aware, it would be unfair on either innocent party to lose the benefit of the contract at the option of the other. It would also be wrong to impute the manager's knowledge on either client if neither has actual knowledge: imputing knowledge on the defendant would justify rescission against him, but equally imputing knowledge to the party claiming rescission would deprive that party of the right to claim rescission on the grounds of consent and affirmation.

An exception to the general rule, described as a 'reservation' by Millett J in *Logicrose,* provides for a party to be entitled to rescission where, unknown to the party,

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[96] Ibid 262.

[97] *Logicrose Ltd v Southend United FC (No. 2)* (1988) 1 WLR 1256, 1260-1.

[98] *UBS AG (London Branch) v Kommunale Wasserwerke Leipzig GmbH* [2014] EWHC 3615.

[99] Ibid 701; *Logicrose* (n 97) 1260-1.

the counterparty paid a third company advising the party a bribe or secret commission even though not linked to the transaction to be rescinded. Even if a counterparty believes that the recipient of the payment will disclose a conflict or profit to the party seeking rescission it cannot deny that party rescission unless it has disclosed its own payments to the party or its advisers.

The scope of the 'reservation' is controversial. It was reviewed in the Court of Appeal in a case brought by the municipal water company of Leipzig.[100] The company had incurred substantial losses on financial transactions. There was, however, a corrupt agreement between the financial advisers to the company and a senior director. There was also an arrangement whereby the counterparty to the financial transactions paid commission to the same financial advisers on business introduced to the counterparty, albeit business introduced to a separate team to the team involved with the company. The company sought rescission of the financial transactions on the grounds that the contract arose through fiduciary breach and the counterparty was aware of this, albeit the separate breach involving the commission. The claim succeeded notwithstanding that the financing company had no knowledge of the bribe: it was enough that it had failed to notify the company of its payment of commission to the advisers. Gloster LJ in a dissenting judgment considered that this was 'to impose on counterparties the moral standards of the vicarage':[101] there were two self-standing and separate schemes and she considered that, in the absence of knowledge of the bribe, the resort to the separate fiduciary breach should not be permitted.

The issues raised bear close resemblance, as Millett L J pointed out in *Logicrose*, to the requirements for establishing liability for 'knowing assistance to a breach of trust'. In this light the reservation should probably reflect developments in the latter, in particular the return to an objective standard by the Privy Council and the Supreme Court.[102] On this basis the Court of Appeal in *Kommunale* simply decided what was

[100] *Kommunale* (n 98).

[101] Ibid 347; Lord Briggs agreed, 'Equity in Business' 2018 Denning Society Annual Lecture, (2019) 135 LQR 567.

[102] *Barlow Clowes International Ltd v Eurotrust* [2005] UKPC 37, (2006) 1 WLR 1476; *Ivey v Genting Casinos* [2017] UKSC 67, [2018] AC 391, both quoted in Prashant Kelshiker, 'Rescission and attribution of knowledge in multi-party cases of dishonest assistance' (2018) 134 LQR 363.

required of UBS to act reasonably and that, in the particular circumstances, by failing to alert the water company to the other wrongful payment, UBS had failed to do this. UBS had knowledge of what appeared to be, prima facie, a fiduciary breach and was obliged to notify the water company before entering the financing contracts with the company if it was to be able to refuse a subsequent rescission claim.

The *Kommunale* case also provided affirmation that the knowledge of the senior director of his receipt of a bribe could not be attributed to the water company. To do so would attribute knowledge of a scheme intent on defrauding the company to the potential victim. The principles were subsequently affirmed by the Supreme Court[103] which held that the rule is based on public policy and, in the *Kommunale* case, the need to ensure the principal receives disinterested advice from the fiduciary. The position where the third party's knowledge of fiduciary breach arises after a contract with the Client has been agreed does, however, remains open.[104]

The issue remains as to whether rescission could benefit the Client more than damages for breach of contract. This would require that contractual damages be less than the benefits to the Client of rescission: for example, if securities are acquired for the Client at a price higher than that available from a third party, contractual damages would equal, in the absence of manager wilful misconduct or fraud, the difference in price, while rescission would allow the Client to escape any reduction in value of the security after the acquisition.

This would require either the vendor to be an associate of the manager not operating behind an effective information barrier (and thus deemed to have knowledge of the breach): or the counterparty to be an independent third party with actual knowledge of the manager's (potential, if Client consent is not given) breach which is not shared with the Client. Either is, in practice, highly unlikely, if not strictly impossible – and would in any event subject the manager to enforcement action by the FCA for regulatory breach. That said, the absence of the need to overcome the significant

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[103] *Bilta v Nazir* [2015] UKSC 23, [2016] AC 1.

[104] Goff L.J. in *Armagas Ltd v Mundogas (the Ocean Frost)* [1986] AC 717.

evidential hurdle necessary to establish fraud or wilful misconduct to obtain the same damages award can be seen as a potential benefit, albeit principally procedural.

- *IMA*

Turning to the IMA , rescission would in theory be available to the Client following a fiduciary breach by the manager. There would, however, be a question whether the provision of services by the manager would operate as a bar to rescission as these would prevent a restoration to the pre-IMA position. In practice the need for a smooth transfer of portfolio management to a successor means that the interests of the Client would be better served by the Client terminating the manager's discretion in accordance with the IMA terms and either itself directing how the portfolio should be altered or, more likely, appointing a successor portfolio manager and triggering the transfer procedure. Rescission would not affect the portfolio transactions already undertaken with third parties, although raises there is the possibility of forfeiture of the fees for services provided prior to the breach.

A claim for forfeiture of an agent's commission following the latter's default can be made under both common law and equity. At common law the claim may be subject to a counter claim for the fee due in respect of the services actually performed by the agent. The fees due to a manager for the period prior to a breach of the IMA would remain payable with only any fee directly linked to the breach repayable. This would typically leave a manager entitled to the management fee for services provided in compliance with the IMA but not any fee in respect of any transaction involving a breach of contract.

Where the breach of the IMA is a fiduciary breach the position is less certain. In *Kelly v Cooper,* Lord Browne-Wilkinson said that a fiduciary only forfeits its fee if it has acted dishonestly [105] though the narrowness of this proposition was subsequently doubted.[106] In more recent cases forfeiture has been held appropriate where the services

[105] *Kelly* (n 47), 216.

[106] *The Peppy* (1997) 2 Lloyd's Rep 722 (QBD), 728-9.

had been provided alongside a continuous serious breach of fiduciary duty, for example failure to disclose ongoing conflicts of interest and denying the past receipt of bribes from the principal's competitors.[107] While remuneration would be inappropriate in a case where there had been a total failure of consideration under common law principles, where the agent is a fiduciary a total failure of consideration is not a prerequisite. If the breach is sufficiently serious, there is no reason why forfeiture should be considered inappropriate, with the decision whether to be fact based.[108]

A final word on contracts entered by the manager as agent for the Client with an associate which are not the purchase or sale of a security. Examples include borrowing to provide gearing to the portfolio, investment advice in connection with a takeover or transaction and the provision of securities lending, custodian and administrative services. The same limitations as apply to rescission of the IMA make it highly unlikely, if not impossible, that rescission could provide a greater damages award than available for breach of contract by the associate. The *Kommunale* decision does, however, raise the possibility that, in exceptional circumstances, losses on contracts with, or following advice from, an associate might be recoverable, but such transactions fall outside the normal scope of an IMA for based on securities and related financial services rather than investment in highly complex financial instruments.

- *Pecuniary rescission*

'Pecuniary rescission' is a term used to describe a remedy available for breach of fiduciary duty as an alternative to rescission when the latter is unavailable, for example because rescission has been barred.[109] The basis for the award is the right of a beneficiary of a trust to have property wrongfully removed from the trust fund by a trustee to have that property restored. The claim is best analysed as a form of equitable compensation, which is considered below.

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[107] *HPOR Servicios de Concultoria v Dryships Inc* [2018] EWHC 3451 (Comm).

[108] *Imageview Management Ltd v Jack* [2009] EWCA Civ 63, [2009] Bus LR 1034; *Keppel v Wheeler* (1927) 1 KB 577; *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244, [2005] ICR 450.

[109] An early, if not the first, use of the expression was by Peter Birks: P Birks, 'Unjust Factors and Wrongs: Pecuniary Rescission for Undue Influence' (1997) 5 RLR 72.

- *Equitable compensation*

Equitable compensation is concerned with the compensation to be awarded to a principal who has suffered fiduciary disloyalty. The award does, however, not rely on property having changed ownership and the award is designed to compensate the principal for financial loss caused by the disloyalty. The origin is generally considered to be *Nocton v Lord Ashburton* where the claim was for loss resulting from the release of security on the advice of a solicitor who had an undisclosed conflict (and had benefitted as a result).[110] Viscount Haldane evoked the 'pecuniary rescission' doctrine (without referring to it by name) to justify an award against the solicitor based on what would have happened if disclosure had been made (and no release granted).[111]

The doctrine provides that if property has been sold following its wrongful removal from a trust the beneficiary is entitled to the sale proceeds; in other circumstances the claim is for money that represents the value that has been lost. Where the wrongful disposal is by a fiduciary, the fiduciary is ordered to pay the money as a form of substitute for the obligation to return the property that would be returned if rescission was possible.[112] Although there are some authorities that the value should be assessed when the wrongful transfer took place,[113] the better argument is that the value should be the current value as this enables restoration.[114]

An award of damages for breach of contract is monetary compensation to be awarded to a party to a contract that has been breached by the counterparty: equitable compensation seeks to compensate the principal for losses resulting from the fiduciary breach. The objectives are the same and the issue is whether there are circumstances in which an award of equitable compensation could provide the Client with additional benefit, in terms of an increased monetary award, to that available for breach of the IMA.

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[110] [1914] AC 932 (HL).

[111] Ibid 956, 957.

[112] Charles Mitchell, 'Equitable Compensation for Breach of Fiduciary Duty' (2013) 66(1) Current Legal Problems 316.

[113] E.g. *Mahoney v Purnell* (1996) 3 All E r611.

[114] D O'Sullivan, S Elliott and R Zakrzewski, The Law of Rescission (OUP 2008), 15.25.

The manager has discretion to alter the content of the Client's portfolio and is in a similar position, in terms of investment powers, to a trustee. The basic principle is that a trustee with control over the property of its principal is obliged to keep that property safe. If it fails to do so the trustee is obliged to restore the property.[115] This principle is applied to cases where a fiduciary wrongfully disposes of property that is under its control and the contractual rules as to remoteness and causation do not apply. The aim becomes restoration of the portfolio to the state in which it would have been 'but for' the breach.[116] The situation where the fiduciary does not have control of the principal's property is less clear[117] but is not relevant to a manager.

The requirement for a link between breach and loss represents a restrictive interpretation of the 1930s case of *Brickenden v London Loan & Savings Co,* in which the Privy Council ruled that once fiduciary breach failure was established no further enquiry of what action the principal would have taken if the fiduciary breach had not occurred disclosure had been made is appropriate and the fiduciary is required, as if a trustee, to restore the position to what it would have been 'but for' the breach.[118] Subsequent cases have moved away from this with the current position described by Lord Reed ' the loss must be caused by the breach, in the sense that it must flow directly from it'.[119] The losses to be made good must be losses caused by the breach rather than for extraneous reasons. If the loss is the result of negligence or wilful misconduct by third parties the loss will be recoverable from the fiduciary only where there is a link between the fiduciary breach and the loss: if there is no link the loss is recoverable, but only from the third party.[120]

[115] Lord Browne-Wilkinson in *Target Holdings Ltd v Redferns* [1996] AC 421.

[116] Sarah Worthington, 'More disquiet with equitable compensation', C L J 2020, 79(2), 220.

[117] *Sim Poh Ping v Winsta Holding Pte Ltd and another and other appeals* [2020] SGCA 35 is a decision of the Court of Appeal of Singapore which describes the issues and settles the law in Singapore but is not binding in England.

[118] *Brickenden v London Loan & Savings Co* [1934] UKPC 25, (1934) 3 DLR 465.

[119] *Target* (n 115).

[120] *Target* (n 115).

Applying this analysis to portfolio management, if the manager acquires securities for several portfolios and a clerical error means one portfolio is charged too much for the securities acquired repayment the excess charge is the compensation for the IMA breach. Any subsequent fall in the value of the security is not caused by the error but by market forces. The exception would be if the error was deliberate, with the manager responsible for wilful misconduct and satisfying the inhibition principle so also making the breach a fiduciary breach. The manager would be responsible for the subsequent loss in value with no difference in the damages award under either claim.

If the manager sells securities and a similar error occurs the reduction in consideration received by the portfolio is compensation for the IMA breach. Any subsequent fall in value is not a loss to the portfolio, while the loss of the gain that would have accrued but for the sale is not damages caused by the error and could be claimed only if the error was deliberate, which would constitute wilful misconduct by the manager and a fiduciary breach. There is again no difference in the damages available under either claim.

The examples above assume a transaction following an investment decision that was not a breach of the IMA. If the transaction is linked to another, for example a reverse trade to cure an existing breach of the mandate, the manager will incur a loss to the extent the price of the security has fallen since the initial transaction, but any subsequent fall in price will not affect the damages award. The award will once more be the same under either claim.

Even if it is possible to imagine circumstances where the two approaches might produce different results there are two relatively recent cases[121] in which the Supreme Court ruled decisively against any different approach to calculating compensatory damages and equitable compensation. The judgments received considerable criticism for apparently abandoning, or at least misapplying, the legal precedents.[122] Others argued that this represented a policy decision, in a modern commercial context, as the

[121] *Target (n 115); AIB Group (UK) Plc v Mark Redler & Co Solicitors* [2014] UKSC 58, [2015] AC 1503.

[122] E.g. J E Penner, 'Distinguishing Fiduciary, Trust and Accounting Relationships' (2014) 8(3) Journal of Equity 202, 205.

purpose of both damages and equitable compensation is the same (to place the claimant in the position it should have been but for the breach) and it is only right that the damages awarded should be the same whichever is chosen.[123]

The Court of Appeal has also clarified that any damages award must take into account the scope of the duty breached by the fiduciary – discretionary investment in the case of the manager: the 'SAAMCO principle'.[124] This was developed further in *LIV Bridging Finance Ltd v EAD Solicitors LLP (In Administration)* where the Court held that equitable compensation should be restricted to the loss caused by the breach.[125] This suggests that a failure to take reasonable steps to ensure fair treatment for a Client should allow the Client to claim only the results of the failure, not any additional losses associated with the underlying transaction provided the transaction was not itself in breach of the investment mandate. This would appear to rule out an award of equitable compensation exceeding that available as damages for breach of the IMA, reflecting the Supreme Court judgements in *Target* and *AIB* . Any calculation based on assessing what the portfolio would have been had a breach involving an investment decision not occurred, whether for equitable compensation or contractual damages, should produce the same result.

- *Account of profits, constructive trust and proprietary remedies*

An account of profits is based on establishing the profits made in breach of the manager's duty of loyalty rather than the damage sustained by the principal as a result of such a breach.[126] It follows that the claim is of benefit to the principal when the profits

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[123] Sarah Worthington, 'Four questions on fiduciaries' (2018) 32 Trusts Law International 22, 37 et seq; see also Alex Chan, 'In Defence of AIB v Mark Redler' (2021) (27) (7) Trust & Trustees 725 et seq.

[124] *South Australia Asset Management Corp* (n 21).

[125] *LIV Bridging Finance Ltd v EAD Solicitors LLP (In Administration)* [2020] EWHC 1590 (Ch).

[126] *Barnsley v Noble* [2014] EWHC 2657 (Ch), Nugee J at [300].; *Target* (n 115) 440 per Lord Browne-Wilkinson.

gleaned by the fiduciary exceed the damage the principal has suffered.[127] One example is a claim for forfeiture of fees as already discussed.[128]

Although there is no specific waiver of the 'no profit' rule included in the IMA the issue is covered, as a practical matter, by the provisions for the management of conflicts of interest, combined with the FCA guidance that for a conflict there must be risk that the Client could suffer loss (including a reduction in gain) as a result of the conflict. Thus, for example, the practice whereby the manager or an associate undertakes to indemnify the portfolio against any losses resulting from securities in the portfolio being used for securities lending means that no conflict of interest arises as long as the fee charged for the indemnity is no more than available from an independent third party and any fee paid to the manager or any associate for assistance in arranging the 'loan' transactions is similarly 'fair'.

It is accordingly difficult to envisage what other profits might be gleaned from a manager's appointment. While the firm might be vicariously liable for the actions of a rogue employee, for example who revealed confidential data to a third party in exchange for money, this would not place the firm at risk of fiduciary breach. There might be a question as to the efficiency and adequacy of internal procedures designed to prevent such action which could lead to FCA enforcement action, but the liability of the firm for the breach would be vicarious and there would be no secret profit for the manager.

The remedies for breach of the duty of loyalty that have been described create a personal claim for the Client against the manager. As an alternative the Client may be able to claim that any property or money that is removed from the portfolio in breach of the duty of loyalty or property that is acquired with the sale proceeds are, if traceable, subject to a constructive trust and held by the legal owner as trustee for the Client. This will not, however, be the case if a transfer to the legal owner (or to any prior holder since the transfer from the portfolio in breach of fiduciary duty) was to a bona fide purchaser for value without notice of the Client's equitable interest.

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[127] *Tang Man Sit v Capacious Investments Ltd* [1996] AC 514, (Lord Nicholls).

[128] Page 210.

There was until recently doubt whether a constructive trust could apply to bribes received by a fiduciary as the principal at no time would have not had an interest in the bribe, with the remedy accordingly restricted to a personal action against the fiduciary. This was resolved by the Supreme Court decision in *FHR European Ventures v Cedar Capital Partners LLC* that bribes received by a fiduciary are held on constructive trust for the principal.[129]

A constructive trust could provide a Client with an additional benefit to that available for breach of contract as, in an insolvency of the manager, the Client would have priority over unsecured creditors that would not apply to a claim for damages for breach of contract. This could also apply to any other insolvent party who had acquired assets wrongfully disposed of by the manager and was not a bona fide purchaser for value without notice (unless a bona fide purchaser had acquired the assets before the acquisition). However, the benefit would only be the case if the bribe or any property otherwise subject to constructive trust was traceable and not, for example, used to pay the ongoing costs or other debts of the defendant or any intermediary legal owner. In such a case the Client would also have a claim for damages against the manager, recoverable unless it also was insolvent.

The problems of a constructive trust solution would become acute in a case involving the insolvency of a manager who has been guilty of a breach of fiduciary duty as the law must choose how to share losses between two 'innocents': the investors who have suffered from the fiduciary breach; and the unsecured creditors of the insolvent manager. One argument is that the breach of 'trust and confidence' by the fiduciary should 'trump' the credit risk that an unsecured creditor undertakes voluntarily and aware of the potential consequences. A counter is that the credit risk assumed by the creditor could not take into account the liabilities represented by the then undisclosed

[129] [2014] UKSC 45 [2015] AC 250.

liabilities for the fiduciary breach and so the creditor should not be penalised by the undisclosed principal taking priority.[130]

Although the insolvency of a manager is always a possibility, the regulatory system operates on the basis of an investment firm at all times holding reserves sufficient to fund its operations for three months during which time steps would be taken to secure the continuing provision of investment services, including the transfer of the business to a third party, potentially for consideration. The circumstances might nevertheless arise where the assets retained by the firm were insufficient to meet all claims by creditors and the bribe was both identifiable and traceable. While the detailed requirements for traceability are outside the scope of this thesis, the possibility remains that the remedy of constructive trust could provide a Client with an additional benefit to that available for breach of contract. If, however, the contents of a managed portfolio are securities and financial products the likelihood of assets wrongfully removed from the portfolio not being either acquired by a bona fide purchaser for value without notice or used to meet expenses or other debts are exceedingly small.

Interestingly the judgment in *FHR* did not need to extend to the question whether all benefits received by a fiduciary in breach of fiduciary duty are held on constructive trust. As Matthew Conaglen has pointed out, this leaves open a number of questions, in particular in relation to profits obtained only indirectly as a result of a breach of fiduciary duty. The argument is based on the 'disability' model of fiduciary law that sees the fiduciary as acting at all times in that capacity if there is any breach of the no conflict rule. This contrasts with the 'duty' model on which only compensatory damages are available for breach of the IMA.[131] This issue is, however, of little relevance to portfolio management given the restricted scope for a manager to earn unauthorised profits directly, let alone indirectly, from a breach of fiduciary duty.

This section has concentrated on the availability of equitable remedies for breach of the modification of the common law prohibitions, that is proscriptive fiduciary duties. There remains uncertainty as to the existence of prescriptive duties, as discussed in

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130 *Re D&D Wines International Ltd (In Liquidation)* [2016] UKSC 47, (2016) 1 WLR 3170; *Neste Oy v Lloyds Bank Plc* (1983) 2 Lloyd's Rep 658.

131 M Conaglen, 'Proprietary Remedies for Breach of Fiduciary Duty' (2014) 73 CLJ 490, 492.

Chapter 2 section II . It is also fair comment that the 'bad faith' feature of fiduciary breach included in the *Mothew* judgment could be characterised as a breach of a duty of good faith - and thus not only prescriptive but also not restricted to fiduciaries. This suggests that, if only because the law develops over time, prescriptive duties may be fiduciary duties and that these duties may bear a close resemblance to duties that could be owed by non-fiduciaries, for example if included in the terms of a contract between non-fiduciaries.

It would nevertheless appear that fiduciary breach would require particularly poor behaviour by the manager, with this almost certainly qualifying for a damages award based on wilful misconduct and thus without reduction for causation or remoteness. This would bring the damages fairly into line with those available for fiduciary breach and eliminate the possibility of any additional benefit given the restricted meaning of unauthorised profits as a consequence of the COBS. This is not, however, to remove the potential procedural advantage that the claimant Client would not need to clear the high evidential hurdle needed to establish wilful misconduct or fraud, even if establishing particularly bad conduct may still represent a high hurdle..

VII- The roles of the FCA and the Financial Ombudsman Service (the 'FOS').

Although there is little litigation between manager and Client, this does not provide the complete picture as industry sources talk of complaints against managers that have been settled without recourse to the Courts, whether by negotiation, mediation, arbitration, or some combination.[132] Given the Unilever precedent it will normally be in the interest of both parties that these matters remain confidential. This means that there is no reliable data available concerning complaints by professional investors against portfolio managers settled, whether by negotiation, mediation or arbitration or any combination. There are two other major reasons for the lack of litigation: the enforcement role of the FCA and the system for settling complaints by retail investors operated by the FOS.

[132] This is a general assumption within the industry based on many conversations with the author and the widely advertised availability of advice to settle complaints.

- the FCA

The background to and role of the FCA was described in the first chapter. The concentration on conduct and prevention of, rather than penalising, breach has not, however, meant that the FCA has ceased to use its powers of enforcement to pursue firms and individuals who have breached the FCA Handbook, either by way of the FCA's extensive civil enforcement powers or by way of prosecuting individuals involved in serious misconduct and pressing for significant penalties, as well as taking related ancillary proceedings, such as confiscation applications. The most important aspect of these powers and their use is in the context of deterrence and in marked contrast with the limited role of fiduciary obligations and the availability of equitable remedies.

The FCA has an extensive range of disciplinary, criminal and civil powers under FSMA.[133] These include powers: to withdraw or suspend a firm's authorisation; to prohibit an individual from operating in financial services; to prevent an individual from undertaking specific regulated activities; to suspend a firm for up to 12 months from undertaking specific regulated activities; to suspend an individual for up to two years from undertaking specific regulated activities; to censure firms and individuals through public statements; to impose financial penalties; to seek injunctions; to apply to court to freeze assets; to seek restitution orders; and to prosecute firms and individuals who undertake regulated activities without authorisation.

The FCA may apply to the High Court for injunctive relief and restitution orders under sections 380–381 and 382–384 of FSMA.[134] Injunctions forbid a person from continuing or repeating certain types of misconduct and are designed to protect against a risk that a person may commit a breach at some point in the future. They can be sought, for example, to prevent a manager or person committing market abuse. Private warnings are also used by the FCA to put a person on notice that a breach may have occurred but, for whatever reason, formal action will not be taken on the particular occasion. Firms and individuals can be subject to disciplinary action which may involve public censure; a fine; or suspension of permission to carry on regulated

[133] Financial Services and Markets Act 2000, Part XIV.

[134] Financial Services and Markets Act 2000, s.380-384.

activities.[135] A public censure is intended not only to change the behaviour of the recipient but also to send a message to similar firms engaged in comparable activities (and to achieve 'credible deterrence', part of the FCA's enforcement strategy). The FCA also aims to remove any financial gain or benefit that the non-compliant firm or individual has received as a result of breach.

The role of the FCA in deterrence arises first through the expanding range of prescriptive and proscriptive regulations, one element of which is to make it more difficult to avoid disclosure of a breach and, especially when discovered by the FCA rather than notified by the firm (when the regulations require),[136] more likely to be followed by regulatory enforcement action. A particular concern for many regulated firms is the power of the FCA to obtain a view from a third party (a 'skilled person') about aspects of a firm's activities if the FCA is concerned or wants further analysis.[137]

Not only will such a report inevitably involve considerable management time but also the legislation provides for the firm under investigation to meet the costs of the skilled person's work, which is typically significant. The costs incurred on all reports in the year to April 2019 was £51.2 million, with this reducing to a still substantial £39.4 million in the following year.[138] Not all skilled person reports lead to further enforcement action, but the costs are not recoverable. Where enforcement action does follow and breach is identified the principle is that any and all financial gains made as a result of misconduct should be forfeit, with no restriction to misconduct that represents fiduciary breach.[139]

The issue of penalties and the factors that might increase or reduce the size of any fine are only considered after the disgorging of profits and while regulatory remedies concentrate on compensatory damages there is no reason why, in an appropriate case,

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[135] Financial Services and Markets Act s.205, s.206 and s.206A respectively.

[136] Notification is required of any 'significant breach, which is widely defined FCA Handbook: Supervision Manual ('SUP') Ch 15.

[137] Financial Services and Markets Act 2000, s.166 FSMA (as amended).

[138] FCA Annual Report and Accounts 2019/20 and 2020/21>.

[139] FCA Handbook: Disciplinary Procedures and Penalties Manual ('DEPP') ch 6.

the manager would not, as part of a settlement with the regulator, undertake to pay disgorgement damages, with these being taken into account in the FCA's calculation both of the profits to be forfeited and the penalty for breach of regulation to be imposed. Only in calculating the latter will the motive of the manager be taken into account, with other factors including the level of cooperation of the firm, with cooperation and early admission of breach potentially leading to significant reduction.

That the FCA has the power to consider imposing disgorgement damages without the need to prove fiduciary breach, the requirement being simply that the FCA considers this appropriate to take into account when deciding on penalties, is perhaps the clearest indication that fiduciary law plays little role in the protection of investors against manager misconduct, although the fiduciary principle may be a factor in a decision whether the firm under investigation is in breach of the regulatory duty to act honestly professionally and in the interests of the client whenever conducting investment business.[140]

The activities of the FCA range from calls for greater concentration on the spirit as well as the language of the FCA rules, typically following thematic reviews of particular aspects go investment manager and adviser practice, through the amendment of existing rules and the introduction of new rules and guidance to regulatory investigation and enforcement. The last has included a number of cases where managers have made payments to investors, including without any formal admission of liability.

Examples of payments to investors for issues that included alleged misconduct by portfolio managers include the £194 million compensation scheme for investors in split capital investment trusts announced by the Financial Services Authority on Christmas Eve 2004.[141] A more recent example is the FCA action in respect of so-called 'closet tracking'. This, also called 'closet indexing' or 'index hugging', is the practice of portfolio managers claiming to be actively managing a portfolio when the portfolio is in fact closely tracking a benchmark, in effect being passively managed while the higher fees typical for active management are being charged for returns not materially different to an index

[140] Ibid 6.3a.1 G.

[141] Philip Augur, *Reckless: The Rise and Fall of the City*, (Vintage 2010), ch 10.

fund. The higher fees are justified by the higher level of management and thus cost required to seek higher returns, while passive funds charge materially less as the manager simply tracks stock market returns incurring materially less cost required. The manager often fails to disclose that passive management, is available for a much-reduced fee. The FCA announced an investigation in 2017 and of the 84 investment funds it analysed, 64 were ordered to make changes to the way they were marketed, with the higher charges to be reimbursed as an alternative to regulatory enforcement action. In March 2018, the FCA announced that £34 million in compensation had been paid to the relevant investors.[142]

The general principle that investors who suffer damage because of manager misconduct should receive compensation is also evidenced through the publication of regulatory enforcement being accompanied by confirmation that the firm involved has or will pay compensation to investors who have suffered damage as a result. Notable examples include the FSA action in 1996 that led to Morgan Grenfell paying an estimated £400 million compensation to 180,000 investors after a fund manager was found to have committed multiple breaches of investment mandates. Moving forward, in 2015 the FCA fined Aviva Investors £17.6m for failing to manage conflicts of interests fairly, with the firm also paying £132m in compensation to investors.[143]

Portfolios being managed by the same team paid differing levels of performance fees so creating a conflict of interests as there was an incentive to favour funds paying the higher fees. Weaknesses in the firm's risk management allowed employees to delay allocating trades so they could assess a trade's performance and allocate trades that were doing well to funds which paid better performance fees, with less successful trades allocated to other funds: the practice known as 'cherry picking' . Even though the FCA publicly acknowledged that after the firm discovered the misconduct it had engaged with the regulator in 'an exceptionally open and cooperative manner' and had made a number of changes to its 'control environment',

142 https://www.fca.org.uk/firms/authorised-and-recognised-funds/closet-trackers accessed 17 August 2020.

143 https://www.fca.org.uk/publication/final-notices/aviva-pension-trustees-uk-limited-aviva-wrap-uk-limited.pdfaccessed 17 August 2020.

as well as working to drive a healthier culture across the business under a new management team, the size of the fine demonstrates how serious the FCA considers the effective management and mitigation of conflicts of interests.

Shortly before the implementation of the Market Abuse Regulation, which contained enhanced provisions to counter insider dealing, failure to disclose market sensitive information and market manipulation, in 2016 the FCA fined WH Ireland £1.2 million and banned the firm from taking on new clients for regulatory breaches for a period that included failure to manage conflicts of interest due to inadequate systems and controls and took the opportunity to set out, in the final notice of the decision, the steps that the FCA expected firms to maintain or improve for compliance with the new regime.[144]

In 2018, the FCA publicly censured Capita Financial Managers Limited (CFM) for its role in a failed investment fund and ordered that it pay up to £66 million to investors who suffered loss as a result of investing in the find on the basis of false representations, with payment being made via the FCA. The FCA subsequently announced, in November 2019, that it had fined Henderson Investment Funds Limited ('HIFL') £1.87 million for failing to treat fairly more than 4,500 retail investors in two of its funds. The role of active management in the two funds had been reduced, indeed all but eliminated, in November 2011. Nearly all of the institutional investors who were affected were informed and offered a complete rebate of all future management fees if they remained invested. In contrast, HGIL did not notify the change in investment strategy to any of the retail investors. The result was that for the nearly five years HGIL charged these investors the same level of fees without providing the same level of active management. The fees were accordingly reimbursed to these investors as part of the FCA settlement.[145]

[144] FCA, Final Notice to WH Ireland Ltd, February 22, 2016.

[145] FCA press release, FCA fines Henderson £1.9m, November 20,2019.

More recently, the FCA fined asset manager GAM International Management Limited ('GIML') £9,103,523 for failing to conduct its business with due care and attention and inadequate management of conflicts of interest.[146]

- the FOS

The FOS has to a large extent reduced the role of the Courts in the resolution of disputes between (i) retail and other Small and Medium Enterprise ('SME') investors and other consumers and (ii) discretionary portfolio managers and other providers of financial services falling with the scope of FSMA. This is the result of the FOS operating a scheme under which it can settle any claim against such a provider without recourse to the Courts and with the costs being borne by the services provider and not the complainant. The role of the Courts is instead restricted to restraining the decisions of the FOS as to what is 'fair and reasonable'[147] only where a decision is irrational.[148]

The FOS also publishes an explanation of the basis of its awards to retail investors against portfolio managers and investment advisers which enables retail investors to estimate with some accuracy the size of award the FOS might make in the event of a successful claim. This seems likely to have contributed to the settlement of claims for relatively small amounts by the manager in order to avoid the costs of a FOS claim being incurred by the manager if the claim is upheld. The basis for FOS awards as precedent for the amounts that a Court might award must, however, be reviewed with a degree of caution as FOS awards are not based on the law but on the adjudicator's assessment of what was fair and reasonable in the circumstances, with the adjudicator is required to take the law into account while not being bound by it.[149] The reason for this is to prevent relatively small claims being 'hijacked' by legal arguments as to, for example, technical

146 FCA: press release, FCA fines GAM International, 30 March 2022.

147 FSMA 2000,s.228; FCA Handbook: Dispute resolution: complaints ('DISP') 3.6.4R.

148 *R (on the application of Aviva Life & Pensions (UK) Ltd) v Financial Ombudsman Service & Ors* [2107] EWHC 1153 (Admin).

149 FSMA 2000, s.228 et seq.

issues involving interest or limitation periods, which are unlikely to have any material affect given the limit of £350,000 on awards (before interest and costs).[150]

The practice whereby a private investor with a claim in excess of the maximum available under a FOS award sought to claim the excess through legal proceedings after accepting an award was ruled invalid by the Court of Appeal in 2014.[151] In these circumstances the investor has a choice either to accept the award and take no further action or to decline the award and claim through the Courts, but with no guarantee that the Court would reach the same decision as the FOS.

VIII - Summary

This Chapter has identified the principal causes of action and potential remedies available to a Client dissatisfied with the performance of the manager under an IMA. Individual transactions that are incompatible with the investment mandate under any circumstances and a failure to satisfy the duty of care give rise to a breach of the IMA for which compensatory damages are available to the Client. The first category will measure damages by reference to the consequence of the transaction itself, the second by reference to what the Client could reasonably expected from the application of the level of knowledge and skills of a manager acting reasonably, to be measured by reference to the average performance of similar managers or a combination of similar managers before an allowance for the management fees specified in the IMA . If it can be established that the breach of the IMA was the result of fraud or wilful misconduct the damages available for breach of the IMA will not be reduced for remoteness or foreseeability.

If the manager breaches the IMA and the breach is a fiduciary breach, the Client has potential access to equitable remedies in addition to the right to compensatory damages for breach. Whether this provides any additional benefit to compensatory damages available for breach of the IMA is the second question for this thesis: the answer is in the final Chapter.

[150] The maximum award was increased to £375,000 with effect from 1 April 2022.

[151] *Clark v In Focus Asset Management & Tax Solutions* [2014] EWCA Civ 118, (2014) 1 WLR 2502.

In practice, however, the FCA's role as regulator removes, absent exceptional circumstances, the need for a Client or investor to pursue litigation, with the risk of high costs and an uncertain result, to recover compensation for manager misconduct. FCA regulatory enforcement action typically requires payment for losses incurred by investors through manager misconduct as part of a settlement, with any fine reduced to reflect manager co-operation. At the same time the FOS provides a system for settlement of disputes involving retail and certain other investors that is designed and intended to remove the need to resort to the Courts save only where the amounts involved for the individual investor are sufficiently high to be exceptional, but even then FCA enforcement action may well obviate the need to resort to litigation. The role of the Courts and the availability of equitable remedies for fiduciary breach thus plays little, if any, direct role in the protection of the investor against manager misconduct.

Chapter Five: Conclusions

I - Introduction

This thesis has described the history, growth and operations of the discretionary investment management business in the UK, including the development of the legal regime in which the business operates, with attention drawn to the influence of international developments in a highly competitive global industry. The focus has been on the role of fiduciary law reflecting that the discretionary portfolio manager, as an agent with authority to alter the content of the portfolio owned by one or more third parties, has a status traditionally associated with owing fiduciary duties.

The purpose of this Chapter is to answer the two questions set out in the Preface and draw a conclusion. Before turning to the questions the next section reviews the consequences, in the context of discretionary portfolio management and fiduciary duty, of the significant recent changes to market practice as a result of digitalisation and the increasing use of algorithmic tools and remote delivery of services through internet integrated platforms. The move to working from home during the Covid pandemic was greatly facilitated by the continuing and accelerated advances in internet communication, not least by establishing that daily office attendance when not travelling on business is unnecessary and much business travel can be replaced by virtual meetings.

The primary cause is technological advance, in particular in electronic communication and computer capability, with the most recent development being artificial intelligence ('AI'). The impact of AI on portfolio management is as yet primarily to augment, to an increasing extent, the information and analysis on which an investment decision can be made. There is, however, an expectation that this role could, in time, expand to reduce substantially, or perhaps even to replace, the role of human decision making.

The third section answers the two questions and the fourth concludes that, despite the manager being a fiduciary as a matter of law, fiduciary law plays little role in discretionary portfolio management in practice, with this likely to continue to decline.

II - Digitalisation and Artificial Intelligence.

This section considers whether recent developments in the discretionary portfolio industry have altered the role of fiduciary law. As fiduciary law ultimately seeks to prevent manager misconduct the issue is whether the developments have affected the day-to-day exercise of discretion by portfolio management. The FCA rules substitute conflict management for prohibition, with this incorporated into the terms of Investment Management Agreements ('IMAs') [1] between portfolio owners ('Clients') and their discretionary portfolio managers ('managers').

In practice modification of the common law fiduciary prohibitions has been a feature of discretionary management for many years, although the exact scope of the modification provided by market custom and the extent of its validity was not settled until after the introduction of regulation in 1988. Since then market and regulatory developments have further reduced the impact of the manager's fiduciary status as investment mandates have become more detailed and the ability to monitor portfolio content and performance has expanded, with technology now permitting all but instantaneous statistical analysis of portfolios. At the same time increasingly detailed regulation has considerably reduced the flexibility with which the manager can exercise discretion outside the permitted mandate without speedy detection.

Services involved in the portfolio management process are also increasingly provided by intermediaries other than managers. These include not only the traditional custodians and administrators but also investment and financial advisers and consultants and 'fiduciary managers'. Their various roles incorporate advising on or determining an investor's investment objectives; advising on or settling the strategic asset allocation for a portfolio; and advice on or the selection of portfolio managers (but

[1] E.g. Investment Association, 'Model Discretionary Investment Management Agreement' (Investment Association and Norton Rose Fulbright 2018).

not the selection of investments they manage, which remains restricted to managers authorised under FSMA).[2] These tasks were initially performed all but exclusively by managers as an adjunct to portfolio management but are undertaken by, or shared with, others, both associates of the manager and independent third parties.

A further factor is that the discretion permitted to a manager under the IMA is increasingly restrained – with discretion the basis for the manager's fiduciary duty of loyalty. This restraint applies notwithstanding the much greater range of financial assets that have become available following the removal of regulatory and practical barriers in many countries that were, until the last quarter of the twentieth century, effectively closed to minority non-resident third party investment.

This restraint has three main sources: first the increased capacity of professional investors to monitor the contents of the portfolio all but simultaneously and, as a result, to monitor and to impose compliance with far more detailed risk and other constraints in the mandate; second the growth in 'passive' investment management; and third AI not only to assist ('Augmented Intelligence') but also the capacity, as yet limited but actively sought, to replace portfolio management by humans, thereby achieving decision making at considerably reduced cost. Algorithmic trading has, for example, provided a method for providing 'best execution' that is generally considered to avoid, or at least to reduce significantly, the potential bias involved in human decision-making.[3]

The reasons for increased mandate restraint are in part historical. Notwithstanding that the importance of risk measured by reference to the complete portfolio rather than its individual components was recognised in the late nineteenth century, only more recently did risk become a widely shared element in portfolio management. In the USA this followed the return from equity investments, which formed the basis for the content of most managed portfolios and had a very successful run in the quarter century after the second world war,[4] falling below the return on US Treasury

[2] FSMA effectively restricts selection of an investment for acquisition or sale to the investor or its duly appointed (and authorised) discretionary portfolio manager.

[3] McKinsey & Company, 'Advanced analytics in asset management: Beyond the buzz' (McKinsey & Company, March 2019).

bills for 12 of the 24 calendar quarters between 1969 and 1975. A lead article in the first edition of the Journal of Portfolio Management, published in autumn 1974, included a quote from a senior industry professional that: 'the business badly needs to replace its cottage industry operating methods'.[5]

The widespread adoption of risk management and the demand for more, improved and consistent measures of risk followed and continues to this day. One result is portfolio restraints that include increasingly restrictive ranges for increasing statistical measures of portfolio risk. Although evidence is scarce, anecdote suggests that risk management only 'arrived' in the UK when US companies entered the UK wealth management industry following 'Big-Bang'.[6] The continuing technological improvements that enable investors, in particular professional investors, to monitor portfolio composition[7] also allow both greater constraints on portfolio managers and less scope for even temporary divergence going unobserved.

The second factor reducing the role of manager discretion is the growth in 'passive investment'. This has seen not only the development of Exchange Traded Products ('ETPs') that provide close to a 'benchmark' or 'index' return without the involvement of a portfolio manager but also the increasing use of passive asset management techniques as part of strategic asset allocation. The main driver is the reduced costs of providing a relatively risk-free return being perceived as outweighing the loss of the opportunity to generate 'alpha' (investment performance better than the relevant index or benchmark). This popularity has led to increasing competition between passive investment providers that itself leads to reduced costs, with performance judged in terms of proximity to achieving 'beta' (investment performance equal to the relevant index or benchmark). One consequence is that manager discretion

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[4] Some professional managers had 70% or more of portfolios invested in equities in this period, Peter L Bernstein, *Against the Gods: The Remarkable Story of Risk* (Wiley 1996), 301 et seq.

[5] The Dow Jones Index rose from 200 in 1945 to 1000 in 1966; Bernstein (n 4) 301.

[6] Detailed written contracts for wealth management services in the UK were unusual before the 1980s and were based on New York law precedents, with those that did exist consisting of little more than an agency authority and agreement to pay management fees and dealing costs. The author was involved in drafting several early versions.

[7] Individual assets are typically not disclosed, or disclosed only after a time lag, mainly for confidentiality reasons, for example to avoid revealing the manager's short-term trading strategy and target investments.

is reduced as even small divergence from the target beta is clearly and speedily identifiable, with this increasing the chances of multiple redemptions heralding the product being withdrawn.

It remains to be seen if regulation, for example designed to ensure passive managers play an active role in the governance of companies in which portfolios under their management are invested or seeking to minimise the potential for additional market volatility as a result of a reduction of active manager trading, will have an impact on the growth of the sector, whether by increasing costs or providing limits on the assets that are passively rather than actively traded.[8] While most passive management involves an element of discretion, if only to intervene when computer trading is producing error in the search for beta, the ETP sector, with no portfolio management and no manager discretion, is also growing and was recently estimated to account for $9.98 trillion of AUM.[9]

AI is currently used primarily to support investment decisions made by human portfolio managers (often referred to as 'Partial AI' as well as 'Augmented Intelligence') . The manager uses the analysis AI provides from the increasingly rapid review and analysis of the expanding volume of available data to enhance investment decisions, but the ultimate investment decision remains a human responsibility.[10] There is thus, as yet, little direct impact on the contractual obligations under the IMA.

AI is also used in the form of 'robo advice' to widen access to investment advice for retail investors as the reduced costs, in particular as a result of reduced human involvement, allow advice to be accessed at affordable prices. This topic is outside the scope of this thesis but issues raised include whether the information is investment advice, which the investor considers that it is, despite no check on whether the information the investor has provided is accurate. This highlights the contrast between the personalised investment advice the investor is seeking and the information that is

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[8] Kevin R James, Daniel Mittendorf, Andrea Pirrone and Claudia Robles-Garcia, 'Does the growth of passive investing affect equity market performance: A literature review' (FCA Research Note, February 2019).

[9] Statistics from London based consultancy ETFGI, press release November 10, 2021.

[10] Leigh Köhler, 'Can AI be trusted to make investment decisions', Money Marketing, May 9, 2019.

being provided, for a reduced fee, based on categorising the investor with other investors who appear to be in a similar position.[11]

The introduction of algorithmic trading - executing orders using automated pre-programmed dealing instructions that take into account variables such as time, price, and volume to break up orders into small slices ('child orders') over time - has seen a greater AI involvement in securing 'best execution' without the risks involved in decisions potentially affected by human bias or error.[12] Best execution is, however, only relevant after a decision to change portfolio content has been made, with that decision continuing to be human responsibility.

In contrast 'Full AI' uses AI to make, rather to inform, the investment decision, with the investment decision process from start to finish machine driven without human involvement. At present only a very few portfolios have admitted to adopting a Full AI strategy whereby learning algorithms run the entire investment process, with the effect that investment decisions are made only on the basis of analysis of 'structured data'. This is data organised into a formatted repository, typically a database, so that its elements can be more effectively processed and analysed. A major restraint remains that as yet there is a risk that an algorithm interprets literally but incorrectly, with the ensuing investment decision accordingly an error. Until this is solved there will remain a requirement for human oversight, to identify and where necessary correct, e.g. by a reverse trade, the erroneous decision.[13]

At present the industry generally considers that, when using only structured data, full AI engines perform best. In contrast using both structured data and unstructured data (essentially any data that is not structured) and retaining a human element in the research and investment decision process is generally considered to provide the better performance. One consequence of digitalisation is an increase in structured data as

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[11] Iris H-Y Chiu, 'Transforming the Financial Advice market – The Roles of Robo-advice, Financial Regulation and Public Governance in the United Kingdom'(2019) 35(1) Banking & Finance Law Review 9.

[12] McKinsey & Company, 'Advanced analytics in asset management: Beyond the buzz' (McKinsey & Company, March 2019).

[13] International Regulatory Strategy Group, 'Towards an AI-powered UK: UK-based financial and related professional services' (International Regulatory Strategy Group and Accenture, October 2019).

unstructured data becomes structured. The search for computer developments that will enable computer analysis of unstructured data continues. Perhaps the most important issue is that the use of AI in portfolio in financial services generally is in its infancy. The CFA has suggested the industry stands on the 'cusp of arguably its greatest technological transformation'[14]. Only time will tell whether this proves to be the case and the results that will follow, but the pandemic has undoubtedly accelerated the pace of change.

These developments will lead to regulatory challenges, but the impact on the fiduciary duty is less clear - as the duty has become, increasingly, to act 'reasonably', with this involving compliance with increasingly detailed prescriptive regulation to satisfy the IMA. How this alters the relevance or scope of fiduciary duty by affecting the analysis that follows remains an open question.

III - The two questions answered

- *First question*

Does the version of the common law fiduciary duties in the contract (the 'IMA') between a discretionary portfolio manager (the 'manager') and the owner of a portfolio (the 'Client') represent not so much a modification as an exclusion of fiduciary duties?

This apparently simple question goes to the heart of the debate as to the role and purpose of the fiduciary concept. The issue is the extent to which the fiduciary prohibitions, when contractual, are 'little more than a gap-filling device. They are no more than contractual implied terms'.[15] In contrast the FCA conduct of business rules are an example of 'immutable rules [which] cannot be contracted around: they govern even if the parties attempt to contract around them'. [16]

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[14] CFA Institute, 'AI Pioneers in Investment management' (CFA Institute 2019).

[15] AJ Duggan, 'Is Equity Efficient?' (1997) LQR 601, 624.

[16] I Ayres and R Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale Law Journal 87.

There was, when regulation was first introduced in 1988, some uncertainty as to whether the Courts would recognise the regulations as permitting modification of the common law prohibitions or existing contracts. The 1993 judgment of Lord Browne-Wilkinson in *Kelly v Cooper*[17] included an express reference to stockbrokers 'who cannot be contractually bound to disclose to their private clients inside information disclosed to them in confidence by a company for whom they also act'. The implication was that interpretation of contractual duties should consider not only the duty to keep confidential information from other parties to whom services, including agency services, were being provided but also that the services provider was obliged to comply with relevant regulations when interpreting its contractual duties.

The importance of this second conclusion arose in part from the then uncertain status of the regulations, which were imposed by self-regulatory organisations ('SROs') whose status as public law bodies was uncertain. This uncertainty was removed by the changes to the regulatory regime in 2000 and the FCA Rules are now definitely part of public law, with the consequence that a contractual undertaking that requires breach of the FCA regulations would be void as against public policy.

There was also a body of opinion that concluded, doubtless with a sigh of relief, that a further implication was that consent to market practices could be implied provided the practices were permitted by the regulations. In practice this conclusion has not been challenged in the Courts, although a number of practices have since been outlawed, or at least seriously amended, by regulation.[18] As the reasons for regulatory intervention include protection of the investor it is possible that at least some might have not found favour in the Courts, the possible grounds including that the practice was unreasonable and had not received the client's consent[19]. The unlikelihood of any party resorting to litigation rather than awaiting regulatory reform is perhaps best evidenced by the absence of any such case since regulation was introduced in 1988.

[17] *Kelly v Cooper* [1993] AC 205.

[18] For example by MiFID II; Seb Malik, *MIFID II A survival Guide*, Revival Media (2016).

[19] *North and South Trust Co v Berkeley* [1971] 1 WLR 470; *Anglo-African Merchants Ltd v Bayley* [1970]1 QB 311.

There are other views, with the regulatory structure seen as the regulators' response to the uncertainties of fiduciary law.[20] Perhaps the better view is that described by Lord Sales: 'Equity imposes fiduciary obligations for reasons that are normatively independent of contract'. [21] The contractarian analysis that sees the fiduciary prohibitions as mere implied terms has been explained on the basis that the fiduciary duty of loyalty represents what the parties themselves would have preferred if bargaining were cheap and all promises were unforced.[22] It could be argued that the common use of standard form IMAs, typically after little negotiation between manager and Client, supports this analysis, with the greater protection afforded the retail investor under FCA regulations an aspect of consumer protection that overrides freedom of contract. While Clients would welcome the type of protection fiduciary law provides, the ongoing arguments between managers and the regulator as to the content of the regulations suggests that many managers would prefer to be subject to reduced regulatory obligations.

This analysis is also different approach to that the Courts normally adopt in the context of implied terms.[23] Further argument against is that fiduciary duties should not be treated as normal contractual obligations in light of the special remedies available to a principal for breach which are available as of right rather than at the discretion of the Court. This analysis is also supported as, once the fiduciary relationship is established, the mere consent of the principal to an amendment is insufficient, 'fully informed consent' is required.

A variation on the contractarian analysis is that the fiduciary duties are a form of penalty default rules[24]. The prohibitions that would apply to the manager without

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[20] A B Laby, 'The fiduciary structure of investment regulation' in William A Birdthistle and John Morley (eds), Research Handbook of the Regulation of Mutual Funds, Edward Elgar Publishing 2018, 79 (commenting on the USA).

[21] Lord Sales, 'The Interface between Contract and Equity', Lehane Memorial Lecture 28 August 2019.

[22] FH Easterbrook and DR Fischel, 'Contract and Fiduciary Doctrine' (1993) 360 Journal of Law & Economics 425.

[23] *Marks and Spencer plc v BNP Paribas Securities Services Trust Company (Jersey) Limited and another* [2015] UKSC 72.

[24] M J Whincorp, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate law' (1997) 21 Melbourne University Law Review 187.

amendment require the manager to offer a less stringent alternative to the Client who may choose to negotiate or not to proceed, with the alternative provided by the FCA regulations. A professional investor may well seek greater restriction, for example through all conflicts within certain categories requiring prior written consent, to which some managers may well, if reluctantly, agree in order to secure the appointment. The retail investor is protected by consumer law and FCA rules setting the minimum standard, which managers must universally provide. Managers must also take steps to explain what the standard means in practice, as required by consumer law and to avoid allegations of misrepresentation. This analysis and the importance placed on disclosure to the Client as to how conflicts are to be managed is also consistent with the need for 'fully informed consent' when amendment is sought after the relationship has been established. This differentiates the process of amendment of the fiduciary terms from that required under contract.

The purpose of the fiduciary doctrine can also be seen as full disclosure of all material facts by the fiduciary to the principal. This reduces the risk of the manager's discretion being exercised improperly for reasons associated with conflicts of interest or unauthorised profits but is inconsistent with the reasons why the courts introduced fiduciary duties. As Conaglen has suggested, the early judicial decisions indicated an intent to provide a subsidiary and prophylactic form of protection for non-fiduciary duties, with the additional remedies a feature of the discouragement of transactions involving conflicts or profits for the fiduciary without the principal's knowledge and consent.[25]

It is fair comment that fiduciary law has seen many changes and continues to evolve to cater for changes in society and market practice, not least the development of discretionary portfolio management as a separate and international industry. The first decision that a contractual exclusion of a fiduciary relationship was effective, in 2007 in Australia, [26] has been criticised, not least by Professor (now Justice) Finn who argues that the decision that permitted exclusion of fiduciaries was a result of mistaken

[25] M Conaglen, *Fiduciary Loyalty Protecting the Due Performance of Non-Fiduciary Duties* (Hart 2011), Ch 8.1.

[26] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Lt*d [2007] FCA 963.

characterisation.[27] Finn's reasoning was criticised on the basis that a fiduciary relationship that depended on contract must conform to the contract.[28] Furthermore the 'pure' contractarian approach was followed by the Queensland Court of Appeal.[29] The case overturned a first instance decision that did not uphold the exclusion on the basis that superimposing the fiduciary relationship altered the operation the contract was intended to have and would operate to 'defeat, rather than give effect to, the legitimate expectations of commercial people'.

There is also the comment of Deane J that it is conceivable that the consequences of the terms of a partnership agreement would be that any fiduciary relationship between the partners was excluded.[30] Finn analysed this as an agreement which was so precise and detailed that there was no scope for discretion or mutual trust and thus a rarity. The resulting relationship, despite being a partnership, did not create a fiduciary relationship between the partners. The parallel for investment management is perhaps the agent whose role is 'solely mechanical and administrative'[31] and thus is not a fiduciary. This does not describe the discretionary portfolio manager.

There is no direct English precedent, though there is an element of support for Finn in the House of Lords judgment in *Street v Mountford*[32], where a contract that clearly stated it was not a tenancy but included the terms that a tenancy would normally involve was held to be a tenancy and therefore to provide the claimant with security of tenure that the contract, if accepted as a mere contractual licence, would not. There is, however, an element of doubt as to the application of these precedents to a status based fiduciary relationship such as a manager as an agent with discretion to alter portfolio content and thus the property of the Client.

[27] Paul Finn, *Fiduciary Obligations 40th Anniversary Republication with Additional Essays* , The Federation Press 2016, 812.

[28] Eastwood and Hastings, 'A response to Professor Finn's 'fiduciary reflections''(2014) 88 Australian law Journal 314.

[29] *Eaton v Rare Nominees Pty Ltd* [2019] QCA 190.

[30] *Chan v Zacharia* (1984) 154 CLR 178, 196.

[31] *Torre Asset Funding Ltd v Royal Bank of Scotland* [2013] EWHC 2670 (Ch),34.
[32] [1985] UKHL 4.

Amongst these areas of contention and uncertainty there is agreement that fiduciary duties can be modified , with the interesting comment of Gummow J in *Breen v Williams*[33] that ' a contractual term may be so precise in its regulation of what a party may do that there is no scope for the creation of a fiduciary duty'. The comment was, however, in the context of a case concerning doctor's relationship with the patient and thus not a status based fiduciary relationship. Is the contract between agent and principal to be left entirely to the parties to agree or does the relationship provide a basis that may be modified but not excluded? In Finn's view a relationship must be examined and if the result is that a fiduciary relationship has been created then fiduciary duty will be present, though its exact form will depend on the contractual terms. The relationship will have been created notwithstanding the parties may have 'artfully disguised' the fact.[34]. The basic feature of an IMA involves discretion being given to the manager and creates a fiduciary relationship: terms to the contrary are simply erroneous.

I concur with Finn's analysis: a discretionary portfolio manager is a fiduciary and any term to the contrary is invalid. This is not, however, to prevent the consequences of fiduciary status being curtailed if the parties agree - with the principal on notice that in certain circumstances the interests of the portfolio will not be paramount but managed in the manner permitted by regulation and incorporated in the IMA The remedies available for fiduciary breach may also be potentially limited by the IMA or with 'fully informed consent', at least in the case of professional investors. The answer to the first question is accordingly that the fiduciary duties of a discretionary portfolio manager can be modified but not excluded. The manager remains a fiduciary for the purposes of English law, but the scope of the fiduciary role depends on the terms of the IMA.

- *Second question*

Does the availability of equitable remedies in addition to the remedies available for breach of contract provide any additional benefit to a Client whose manager has committed a breach of fiduciary duty?

[33] (1997) 186 CLR 71, 132-3.

[34] *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611; [2000] FCA 1541.

The equitable remedies available to a principal for breach of fiduciary duty rare typically classified under four heads: rescission; equitable compensation; an account of profits; and proprietary remedies based on a constructive trust. Chapter Four reviewed the legal background; the practical implications are examined below.

- rescission

Rescission is available where a contract has been entered into by the manager in breach of the fiduciary duty to the Client. In the context of portfolio management the contracts are the IMA and contracts entered into by the manager as agent for the Client when managing the portfolio. Rescission of the IMA is, however, difficult, not least as, unless the fiduciary relationship was established before the contract was signed, there would be no fiduciary duty prior to the IMA coming into effect at signature. Contracts for services provide by an associate of the manager are also unlikely, absent extraordinary circumstances[35] to offer redress greater than available for breach of contract.

Rescission of a transaction undertaken by the manager as agent could apply to a sale or a purchase of a financial asset agreed in breach of fiduciary duty, with breach including breach of the modified common law prohibitions and the payment of secret commission or a bribe to the manager to procure entry into the contract. Rescission would also be available to a Client if the manager was acting for both parties to the transaction without the Client's consent and the other party knew of the double employment, but as a practical matter the IMA allows such contracts provided the manager takes reasonable steps to procure that both parties receive fair treatment. The normal step to achieve fair treatment for both parties is for a transaction involving a security to be cleared through an exchange or clearing system as an 'agency cross'[36]. This reflects that rescission is not available if the purchaser of a security is a bona fide purchaser for value without notice of the fiduciary breach, which would be the normal case as transactions in securities are typically through a trading system or exchange.

[35] See p. 207 et seq.

[36] See page 153 et seq.

To come within an exception such a transaction would have to be 'off-exchange', which itself would be so unusual to attract the attention of the manager's compliance department – the independent department of the manager tasked with supervising regulatory compliance required as a condition of FCA authorisation - and thus not be permitted unless the department were persuaded the regulatory compliance was maintained. In addition the transaction by the manager for the Client would have to be a transaction with (i) an associate of the manager that was not operating behind an information barrier, or (ii) a transaction with either an associate operating behind a barrier or an independent third party who, in either case, had notice of the fiduciary breach.

An illustration of how unlikely these exceptions are in practice is that , in the split capital investment trust crisis, when shares in some companies were sold at inflated prices in order to allow the vendors to avoid insolvency in the short term, rescission was not available as not only were the purchasers unaware of the fiduciary breach by the manager (if an agency cross) or managers (of the vendor and the purchaser) involved but also by the time the breaches were discovered the vendors were, almost without exception, in liquidation.

If an exception did arise and the manager sold a security for a portfolio in fiduciary breach the value of which subsequently fell, rescission would mean the Client retaining the loss, while compensatory damages might, for example, result in damages equal to a pricing error in the initial sale on the basis that the fall in value was not caused by the breach: rescission would therefore not be claimed. If the security gained in value after its sale then rescission would allow the Client to assume the gain: however the Client would be able to claim that the gain in value as part of compensatory damages as this loss to the Client would be a foreseeable consequence of the transaction entered in fiduciary breach.

If a transaction entered into in fiduciary breach involved the acquisition of a security permitted by the investment mandate and the value of the security subsequently fell, rescission would allow the Client to avoid the loss. The loss would not be included as compensatory damages where the damage was restricted to, say, pricing error and the loss in value occurred for reasons not linked to the breach. If the security acquired increases in value the Client will already own the gain but may also be entitled to damages if the acquisition price was too high or some other loss was suffered as a result of the fiduciary breach.

Thus rescission could provide additional benefit for the Client in the event of the acquisition of a security from either an associate (not operating behind an information barrier) or a third party (including an associate behind a barrier) with knowledge of the fiduciary breach. The benefit would only become available if the security lost value after the transaction was completed and the loss was not linked to the breach, for example because of a subsequent but unrelated fall in price. This benefit would not accrue, however, if the manager acted with wilful misconduct or fraud as the damages for breach of contract could not be reduced for foreseeability or remoteness.

There is thus a potential benefit to the Client from the availability of rescission, albeit the circumstances in which this would apply can only be described as highly unlikely and the benefit is principally procedural: fiduciary breach avoids the need to clear the high evidential hurdle necessary to establish manager fraud or wilful misconduct.

- *pecuniary rescission*

Where a security has been acquired for a portfolio in fiduciary breach and is subsequently sold through an exchange, rescission is barred as the purchaser would be a bona fide purchaser for value without notice. The Client may, however, claim a money sum representing the current market value of the security. This type of award is known as ‘pecuniary rescission’ and the purpose is to compensate the portfolio by making the manager pay the money value of the security that it would have been required to return to the portfolio if the security had not been sold and was no longer capable of being returned. The money is compensation for the failure to return the security itself. Although early cases calculated the claim based on the value of the security on the date of the acquisition (so ignoring subsequent unrelated price movements) more recent cases have the value calculated based on the market value at the time of the award. There is no difference to the compensatory damages that would be available to the Client for the manager's breach of the IMA.

- *Equitable compensation*

There is a body of case law that sees equitable compensation potentially differing from damages for breach of contract if the relationship between fiduciary and principal is seen as equivalent, for these purposes, to a trustee and beneficiary, with the fiduciary having control over the beneficiary's assets. As the manager has control of the content of the portfolio, albeit without legal ownership, there is an argument that the relationship is akin to that of a trustee and thus that a claim against the manager for a sale of a security in fiduciary breach should be based on the money required to restore the portfolio to the state it would have been had the breach not taken place. Thus, for example, the manager would be obliged to restore the value of the security at the time of the sale even if the value of the security had fallen in the interim. This has, however, been overtaken by Supreme Court decisions which remain controversial, at least in academic circles, while making clear that in both cases compensation should be based on the current value of the security, whether this be above or below the original disposal price[37]. There is accordingly no benefit to the Client from an award of equitable compensation instead of an award of compensatory damages for breach of the IM

- *An account of profits*

An account for profits is unlikely to be relevant in discretionary investment management as this would involve the manager realising profits that could have accrued to the portfolio. This could, in theory, involve a security being acquired without reasonable steps being taken to treat the portfolio fairly, for example a disposal for less than market price, followed by a sale at a price the represents a gain in excess of the invalid price reduction. In practice, however, managers do not deal in securities on their own account. A third-party associate who acquired the asset, or an independent third party who knowingly acquired the asset at below the market price, might be liable to the

[37] See page 214 et seq.

Client, but this would not be by way of a claim for an account of profits and is discussed below. An account of profits might, however, in certain circumstances, including potentially egregious fiduciary breach, allow a Client to recover fees for services provided under the IMA prior to its termination for fiduciary breach.

- Constructive trust and other proprietary remedies

The constructive trust imposed on, for example, bribes, secret commissions and property of the Client transferred in breach of fiduciary duty (e.g. securities sold in fiduciary breach by the manager other than to a bona fide purchaser for value without notice) provides the Client the advantage that the claim ranks ahead of any creditor of the manager in the event of the manager's insolvency. This would, however, require that the manager still retained assets at the time when insolvency proceedings commenced. In practice the FCA seeks to intervene as soon as a manager no longer has its required minimum level of capital so that, as far as possible, the interests of investors are protected.

Insolvency proceedings involving a manager still carrying on investment business are thus highly unlikely. The only exception might be when fraud has been undetected for some time, when detection would most likely follow a failure to pay debts because there are no assets left to meet them, nor to meet a claim of constructive trust. Nevertheless it is possible to envisage a FCA intervention when there are assets, but insufficient assets to meet the manager's debts, in which event the Client would be entitled to a full recovery of the trust assets with the only balance available to the creditors of the manager.

Proprietary remedies could include a claim against a third party who has possession of an asset in a constructive trust, for example a security wrongfully removed from a portfolio in fiduciary breach of the IMA. This is, however, unlikely to occur in practice as securities are typically sold to a bona fide purchaser for value without notice. The answer to the second question is thus that there are circumstances in which the availability of equitable remedies could provide additional benefit to the Client beyond those available by way of compensatory damages for breach of the IMA, though the circumstances are highly unlikely to arise.

V- Conclusion

This thesis has established that a discretionary portfolio manager retains fiduciary status as a result of having control over the content of the portfolio under its management, with obligations that modify but do not eliminate the fiduciary obligations that apply under common law. Breach of these obligations would, as a matter of law, allow the portfolio owner to elect for equitable remedies. The circumstances in which this could benefit the owner are, however, so unlikely that, when combined with the unlikelihood of a dispute ever reaching a Court, leads to the conclusion that the role of fiduciary law in discretionary portfolio management has been all but superseded by the FCA regulations replacing the common law, the enforcement of the regulations by the FCA and the FOS compensatory scheme available to retail investors.

Furthermore the increasing role of technology, in particular artificial intelligence, seems likely to lead to further reduction in human involvement in investment management and thus a move even further away from prohibitions designed to protect against conscious and unconscious bias in human decision-making. The Government has also announced that the future approach of financial services regulators should be to bring about, as much as possible, a single source of requirements for firms - the regulator's rulebook.[38] This, when combined with the FCA's recently announced change of strategy to rely less on compliance with rules than achieving appropriate outcomes for investors,[39] suggests the distinctive role for fiduciary law as a regulator of discretionary portfolio management is set to decline still further. It is not clear that this elimination of a subtle and complex historical doctrine from the relations between managers and investors will improve the certainty and robustness of the protection afforded to investors against manager misconduct.

[38] HMG Treasury, *Financial Services Future Regulatory Review; Proposals for Reform*, CP 548 November 2021, 28.

[39] FCA, *Financial Conduct Authority: Our Strategy 2022-5* , April 2022.

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