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# PENSIONS MIS-SELLING—THE LESSONS FOR REGULATING PRIVATISED SOCIAL SECURITY\*

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## INTRODUCTION<sup>1</sup>

The introduction of regulation to the retail financial services sector of the United Kingdom coincided with the government's decision to allow banks, insurance companies and building societies to offer private alternatives to state pensions ("personal pensions") direct to the general public. The resulting situation, generally reported in the media as the "Personal Pension mis-selling scandal," is a case study on both the hazards of privatising Social Security and the conditions of effective regulation. Retail regulation and the marketing of personal pensions as alternatives to state and occupational pensions both commenced in 1988. By 1992 it became apparent that 91 percent<sup>2</sup> of personal pensions sold to former members of occupational pension schemes failed to comply with regula-

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<sup>1</sup> This Article draws on a study conducted by the authors into the causes of the U.K. pension mis-selling scandal. As well as drawing on written sources, the study included interviews with regulatory staff (past and present) of the three key regulators—the Securities and Investment Board ("SIB"), Financial Intermediaries, Managers and Brokers Regulatory Association ("FIMBRA"), and Life Assurance and Unit Trusts Regulatory Organization ("LAUTRO")—as well as sales and marketing directors and compliance officers from twelve major product providers, actuaries and trade union officials. Many of those interviewed provided statements anonymously. The study is to be published in the *MODERN LAW REVIEW*.

<sup>2</sup> See SIB, REPORT BY KPMG PEAT MARWICK (Jan. 1994).

tions. This has led to an enforced review of 2.4 million personal pension sales with a view to identifying loss and offering compensation.<sup>3</sup> It is estimated that the costs of this review and compensation will amount to anywhere between £2 and £11 billion.<sup>4</sup>

With many countries reviewing the affordability of their Social Security arrangements (particularly, given demographic considerations, the cost of state pensions), the U.K. pension mis-selling scandal offers a case study to those seeking to construct a regulatory system which can reduce, or re-distribute, the losses to consumers which may otherwise follow from an increased reliance on privatised forms of Social Security. In particular, there are two debates on the effectiveness of regulation that may be informed by the U.K. experience. First, the choice between self-regulation and regulation by government agency or department. Second, the relative advantages of general rules and principles over more detailed and prescriptive forms of regulation. These are, as we shall see, overlapping choices and concerns.

#### I. STYLES OF INVESTOR PROTECTION: SELF-REGULATION VS. REGULATION BY GOVERNMENT DEPARTMENT

The introduction of regulation to the retail sector of the financial services industry in 1988 was part of a general reform of financial regulation carried out in response to a number of financial scandals in the early 80's. The proper balance between government regulation and self-regulation formed a major part of the debate that preceded these reforms. In the White Paper which preceded the introduction of the Financial

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<sup>3</sup> See HM TREASURY, PENSION MIS-SELLING, H.C. 1997/8 712-iii ¶¶ 13, 27 (Memorandum submitted House of Commons Treasury Select Comm.).

<sup>4</sup> The government's estimate for the cost of investigating and compensating 600,000 "priority" cases is £2 billion. There are another 1.8 million "non-priority" cases. See *id.* The financial press have estimated the total cost of investigating and compensating all mis-sold personal pensions at £11 billion. See *Payment Row Grows: The Pension Scandal*, FIN. TIMES (London), July 4, 1998, available in LEXIS, WORLD Library, FINTIME File.

Services bill,<sup>5</sup> the advantages of self-regulation were said to be:

1. Best possibility of combining regulation with market innovation.
2. More likely to be effective if there was significant practitioner involvement in devising the rules and enforcing rules.
3. Greater flexibility as rule changes did not require Parliament.
4. Practitioners best equipped to spot breaches and take swift and effective enforcement action.
5. Easier to prepare private regulation ahead of introduction.
6. Day to day regulatory action would be distanced from government.

Although they often accompany arguments on self-regulation, reasons three and five have little merit in a country whose legislative processes are capable of exhibiting some foresight and flexibility. However, the other considerations assume that industry participants can be expected to show greater expertise than civil servants in drafting and enforcing investor protection measures. They are also expected to have a greater ability to assess the trade-off between the benefits of such protection and market innovation, a function of their greater knowledge, and their insulation from political pressures.<sup>6</sup>

Considerations of institutional design were associated with styles of regulatory intervention. Government regulation was associated with a detailed, prescriptive and interventionist style.<sup>7</sup> By contrast, self-regulation, whereby organisations participated in rule creation and took an active role in rule enforcement, was expected to lead to a less detailed, more flexible and informal form of investor protection.

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<sup>5</sup> FINANCIAL SERVICES IN THE UNITED KINGDOM: A NEW FRAMEWORK FOR INVESTOR PROTECTION, 1985, Cmnd. 9423, ¶ 5.14.

<sup>6</sup> See Alan C. Page, *Financial Services: The Self-Regulatory Alternative?*, in REGULATION AND PUBLIC LAW 298 (Robert Baldwin & Christopher McCrudden eds., 1987).

<sup>7</sup> The Council for the Securities Industry argued that government regulations would "inevitably tend towards over-detailed regulation and rigid interpretation of rules." *Id.* at 306.

Self-regulation can extend to internal regulation by the firm of itself. Such forms of regulation are said to allow inspection to cover operations which could not expect to be monitored, or at least not frequently, by government inspectors. This aspect of self-regulation also gains when combined with general rules. The general rules allow the firm's own regulatory staff to calculate the implications of such rules in the specific circumstances facing the firm. Such staff may be better qualified and will, in any case, have better knowledge of the firm's environment. Self-regulation in this form allows inspection by government inspectors to take the form of checks on the procedures adopted by the firm's compliance staff. Where such self-regulation is required and undermined by statutory provisions, it has been styled by Ayes & Braithwaite as "enforced self-regulation."<sup>8</sup>

## II. RETAIL INVESTOR PROTECTION UNDER THE FINANCIAL SERVICES ACT 1986

It is not our intention to become embroiled in a discussion of whether the system of regulation introduced in 1988 was truly "self" as opposed to "government" regulation. Rather, we wish to consider whether those features of the system that approximated to each of these models provided the benefits claimed for the respective model. In particular, whether the self-regulatory features of the system provided greater protections against pension mis-selling than could have been expected from a system which relied more on regulation by government agency.

The Financial Services Act 1986 allowed the Secretary of State to delegate the regulation of financial services to the Securities and Investment Board ("SIB"). This body, a corporation rather than a government department, was expected to be staffed by experts from within the industry. Alongside SIB, the various sectors of the industry were allowed to set up their own self-regulatory organisations ("SROs"). To be authorised to carry out investment business, an individual or firm had to be a member of an SRO or licensed and regulated directly by SIB.

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<sup>8</sup> I. AYRES & J. BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992).

SROs could legislate and enforce their own rules. However, as their rules had to offer investor protection that was at least as good as that provided by SIB's rules, they tended to mirror SIB's own.<sup>9</sup> The independence of the SROs was, therefore, focused at the level of enforcement. The most important of these SROs for the control of retail financial services was LAUTRO which regulated the insurance companies and FIMBRA which regulated independent financial intermediaries.

SIB's expertise was less informed by industry experience than one might have hoped. The initial rule draftsman, for example, was an ex-Parliamentary counsel used to drafting statutes. However, its board included experienced city practitioners, and, thus, to the extent that the expertise which needed to be supplied through self-regulation was that of senior management, SIB should have provided the benefits of self-regulation. The SROs followed this pattern. For example, whilst the board of LAUTRO was made up from the senior executives of insurance companies, its senior enforcement officer came from the Department of Trade and Industry. Given the previously unregulated existence of the retail financial sector, this pattern of recruitment was unsurprising. Until self-regulation by firms led to the introduction of compliance officers, there could be no "poachers turned game-keepers" who could provide regulatory agencies with enforcement expertise.

Nevertheless, the rules of SIB, LAUTRO and FIMBRA that are relevant to the pension mis-selling scandal exhibit many of the features associated with self-regulation. They were general rather than specific. What they required in practice was left to the firms to decide for themselves. The details of these rules changed over the period in question,<sup>10</sup> but, in essence, required any person advising on or recommending an investment product to obtain sufficient information from the customer as to his/her financial circumstances (the "know your customer" rule),<sup>11</sup> to advise only on those products which were suitable for the customer,<sup>12</sup> to recommend only that product

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<sup>9</sup> The SROs were required to have rules which were "equivalent" to SIB's rules under the FINANCIAL SERVICES ACT 1986 ("FSA"), sched. 2, ¶ 3.

<sup>10</sup> See J. BLACK, *RULES AND REGULATORS* (1997).

<sup>11</sup> SIB RULES 3.01 (1987); SIB PRINCIPLE 4.

<sup>12</sup> See SIB RULES 5.01 (1987); SIB CORE RULE 16. LAUTRO and FIMBRA had equivalent rules. The meaning of the suitability rule was the subject of a number

on the product range which would best meet the customer's needs ("best advice"),<sup>13</sup> and a requirement for adequate records to be kept.<sup>14</sup>

These duties, in particular that of suitability, have been repeatedly emphasised by SIB to be key elements of the investor protection regime,<sup>15</sup> but exactly what they require in any particular circumstance has been a matter of considerable debate. SIB has always maintained that the duty has a comparative aspect, and that inherent within the duty are two principles: that the investment recommended "must not be one which on any reasonable view the customer would be better off without" and that an advisor should not recommend a product when another type "would plainly be more appropriate."<sup>16</sup> However, during the period in which most of the mis-selling occurred, 1988-1992, there was no guidance from the regulators as to exactly what the duties of know your customer and suitability required in any particular case.

In a similar vein, the regulators gave no guidance on what constituted "adequate records." Whilst the most common method of recording knowledge of customers was a standard "fact find" which each salesman would be required to complete, the length of such a document, or the information it was to record, were not proscribed. Indeed, LAUTRO confirmed that there was no requirement to use a fact find, merely noting that it was a "popular solution for the know your customer and record keeping requirements."<sup>17</sup>

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of discussion documents: COMMITTEE TO REVIEW THE MKTG. REGIME FOR RETAIL PRODS. AND SERVS., REGULATION OF THE MARKETING OF INVESTMENT PRODUCTS AND SERVICES (1990); SIB, REGULATION OF THE MARKETING OF INVESTMENT PRODUCTS AND SERVICES: A POLICY STATEMENT ¶ 18 (Mar. 1991) (SIB stated that it agreed with the view that suitability has a comparative aspect, "so that investment recommendations should not be given without any regard to the merits (relative to the customer's needs) of alternative types of saving and investment vehicles. SIB attaches great weight to the suitability requirement as a key component of the investor protection regime.").

<sup>13</sup> SIB RULE 5.07, 5.08 (1987); SIB CORE RULE 17. LAUTRO and FIMBRA had equivalent rules.

<sup>14</sup> See SIB PRINCIPLE 9.

<sup>15</sup> See, e.g., SIB, REGULATION OF THE MARKETING OF INVESTMENT PRODUCTS AND SERVICES, A POLICY STATEMENT (Mar. 1991); SIB, RETAIL REGULATION REVIEW (Discussion Paper No. 2, 1991) [hereinafter DP2]; REGULATION OF THE MARKETING OF INVESTMENT SERVICES AND PRODUCTS: REPORT OF A REVIEW COMMITTEE (1990).

<sup>16</sup> DP 2, *supra* note 15, ¶ 26.

<sup>17</sup> LAUTRO, ENFORCEMENT BULL. 1, ¶ 3.02 (July 1988).

### III. THE MIS-SELLING SCANDAL

The "scandal" started with a statistical fact. In 1992, when SIB looked at a sample of SRO members' pension sale files, only 9 percent had records which demonstrated substantial compliance with the know your customer and best advice rules.<sup>18</sup> SIB required the SROs to require their members to conduct a review of their pension sales to see whether, in fact, there had been a breach of these rules. In light of the difficulties of recreating the circumstances of these sales, and the circumstantial evidence that large numbers of such sales were carried out in breach of these rules, most firms have simply conceded non-compliance, and are seeking to establish loss with a view to paying compensation.

The circumstantial evidence which makes non-compliance likely also forms part of the scandal. There was a general failure on the part of salesmen, compliance officers, senior management and regulators to appreciate the complexities and risks involved in selling personal pensions to members, or persons eligible to be members, of their employer's occupational pension scheme. Although this scandal has implications for privatising Social Security, it should be pointed out that this is not an example of individuals receiving less than their state pension as a result of mis-selling. There is no suggestion that the standards of advice and recordkeeping provided to those who exchanged state pensions for personal pensions was any better than for those who gave up occupational pensions. Statistical surveys carried out by SIB established that the level of government subsidy provided to personal pensions had been so generous that few of those who would otherwise have relied solely on the state pension were made worse off by changing to a personal pension.<sup>19</sup> However, for those who were, or were eligible to be, members of occupational pensions, the position was very different.

Comparing the benefits of occupational and personal pension schemes is made complex by the fact that they offer very different forms of benefit. Personal pensions are defined contribution schemes. The scheme is simply a tax efficient savings

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<sup>18</sup> See *supra* note 2.

<sup>19</sup> See SIB, PRESS RELEASE (Mar. 1996).



vehicle whereby the accumulated savings of the individual are used to purchase an annuity at retirement. By contrast, the bulk of occupational pension members belong to defined benefit schemes. The benefits, which are secured by a fund, are calculated by reference to the member's salary at the date of leaving the scheme. The risk that the fund will not prove sufficient to pay the benefits is born by the employer, who must make additional payments if the scheme becomes insolvent. A typical scheme pays 1/60th of a member's final salary for each year of membership. Occupational schemes also typically offer death in service benefits (a form of life insurance) and ill health benefits (a form of disability insurance). Moreover, occupational schemes typically provide benefits to spouses and dependents on a non-negotiable basis, whilst in personal pensions these are often optional extras.

These differences make it difficult for any salesman to give "best advice" to an occupational scheme member intending to take out a personal pension instead of continuing to belong to their employer's scheme. However, alongside these complexities, there is a stark and, on the part of the industry and regulators, overlooked fact. For any person who is currently eligible to belong to an occupational pension scheme, and who expects to stay in that scheme for more than two years, a personal pension is unlikely to provide better value. Employers contribute to their occupational pension schemes, and their contributions are, in the long term, typically at least as much as those made by the employees. The employers' contributions are necessary because the value of occupational scheme benefits is greater than could be afforded by the members' contributions alone. Employers are not required to make any equivalent contribution to the personal pensions of employees who leave the occupational scheme in order to take out a personal pension (opt-outs) or fail to join the occupational scheme having taken out a personal pension (non-joiners). Thus, scheme members who decide to pay their contributions to a personal pension scheme instead of their employer's scheme simply forego the extra value represented by their employer's contributions. To put this in colloquial terms, this is simply not a level playing field. Except for those members who leave an occupational scheme within two years (who only get a return of their own contributions plus interest), the lack of a contribution from the

employer means that there is little likelihood of a personal pension proving to be a better investment than an occupational scheme. Following their report on poor record keeping, SIB commissioned further research to find out what proportion of personal pensions had been sold to persons who were, or were eligible to be, members of an occupational pension scheme. This research revealed that 22 percent of all sales had been to such persons.<sup>20</sup> With the evidence provided by these two surveys, it was generally accepted, especially within the media, that there had been a widespread breach of the "best advice" and "know your customer rules." The focus of attention became: what had firms, and regulators, done to prevent the mis-selling of personal pensions? The answer to this question represents a major regulatory failure, by both firms and regulators.

### *A. Regulatory Failure Within Firms*

#### *1. Management Supervision and Training*

The complexities of selling personal pensions were not something that the industry took on board from 1988 until 1992. The main focus of firms was in securing their future against a background of significant restructuring as banks, building societies and life companies competed for the same markets. Competition took the form of a battle for distribution outlets. Life companies moved to set up or expand direct sales forces and to ensure that as many brokers as possible sold the company's products. In such a battle, both the management supervision and the training of advisors suffered. Both the direct sales forces and appointed representatives (formally independent individuals or firms who sold only the products of the product provider) were frequently recruited without adequate checks.<sup>21</sup> As one senior sales director admitted: "we

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<sup>20</sup> See SIB, *PENSIONS OPT OUTS* (Oct. 1994)

<sup>21</sup> At the end of its first full cycle of enforcement visits in 1993, LAUTRO's monitoring committee reported that 22% of firms and 35% of life offices had exhibited "serious compliance shortcomings." The principal failures which were found were in recruitment processes for sale agents, both direct sales forces and appointed representatives, including failure to check references or indebtedness to previous firms; poor recordkeeping including non-completion of fact finds; failure to

were looking for people capable of producing a reasonable level of business, and quality came second." The lack of controls over appointed representatives ("ARs") in particular became a matter of increasing regulatory concern.<sup>22</sup> Although the principal firm was meant to take responsibility for ensuring the competence of its ARs and their compliance with the regulatory requirements,<sup>23</sup> frequently that supervision did not occur.<sup>24</sup>

## 2. Management Supervision Over the Direct Sales Force was Often Also Weak

Monitoring systems, for example, giving area sales managers responsibility to check fact finds, were designed on the assumption that the sales managers would then use these finds as part of the ongoing training or improvement of standards; any failings in these were then not examined in depth and explanations often easily accepted. As another senior sales director explained: "a lot of things we did not investigate because we trusted the salesmen and the sales managers and the

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supervise and adequately control the direct and/or appointed representative sales force; and failings in the training and competence systems. *See* LAUTRO, ENFORCEMENT BULL. 25, ¶¶ 2.05, 3.03 (Oct. 1993).

<sup>22</sup> *See* LAUTRO, LAUTRO, ENFORCEMENT BULL. 25, ¶ 3.03 (Oct. 1993); LAUTRO, ENFORCEMENT BULL. 14, ¶¶ 2.06-07 (Feb. 1992); ENFORCEMENT BULL. 5, § 1 (Oct. 1989); *see also* KIT JEBENS, LAUTRO: A PIONEER REGULATOR 55, 77-99 (Institute of Chartered Accountants of England and Wales ("ICAEW"), 1996). For this reason, those with extensive AR networks were seen as priorities for early periodic inspection visits, *see* LAUTRO, ENFORCEMENT BULL. 14, ¶¶ 2.01-02 (Feb. 1992), and LAUTRO introduced rule changes concerning the member firm's responsibility for ARs and a separate register of ARs to parallel that for company representatives. *See* LAUTRO, ENFORCEMENT BULL. 31 (Mar. 1990).

<sup>23</sup> Under section 44 of the FSA, a person could be the AR of an authorised firm, without themselves having to be authorised. Initially introduced as a mechanism to cover self-employed salesmen who sold only the products of one firm (e.g., the sales forces of Allied Dunbar, Abbey Life) and avoid the need for each one of them to seek authorisation, it became a vehicle by which firms of any size could tie themselves to a product provider, and so avoid the costs of authorisation and compliance. The principal firm was under an obligation to ensure that the firm complied with the rules. The regulator had no direct relationship with the AR; it could only act against the AR through the member.

<sup>24</sup> "[R]ules concerning the member's responsibilities towards its ARs" were being "misread, ignored and even flouted." JEBENS, *supra* note 22, at 55. Kit Jebens was chief executive of LAUTRO from 1989-1996.

last thing that you wanted to do was to put that trust at risk . . . . After 1993 we were much more forceful and distrustful than before."<sup>25</sup>

The generally low levels of training and competence of sales agents of all types compounded the lack of management control and supervision. LAUTRO's rules in 1988 required a member not to appoint a person as a company representative unless they had the "requisite aptitude and competence,"<sup>26</sup> but did not elaborate. In practice, the provision addressing training for direct sales forces and ARs varied considerably, ranging from a two week initial training course, plus private study and three to six months of ongoing training, to two hours for an appointed representative.<sup>27</sup> The average amount of training time an agent of a direct sales force had before meeting a customer in a supervised interview was seven and a half days; the average time before going out alone was thirteen days, and some did not have supervised visits at all.<sup>28</sup>

Pension's training took the same form as training on the firm's other products: advisors were meant to know the technical aspects of the firm's in-house pension products. Lack of training on occupational pension schemes meant that salesmen had neither an awareness of the need to make detailed comparisons nor an understanding that would enable them to do so.

### 3. Commission

Finally, the structure of pay and incentives within firms operated in tension with compliance with the best advice and suitability rules. Compliance with these rules could in some cases mean no sale: the product that the adviser could sell was

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<sup>25</sup> Some of the failings in management supervision did lead to disciplinary action. In 1992, LAUTRO sought the voluntary cessation of sales by the sales forces of three life companies and formally suspended that of another. In one of its more high-profile enforcement actions in March 1994, LAUTRO suspended Norwich Union's 600 strong direct sales force. In June 1994 SIB publicly rebuked Barclays Life, and Nationwide—at the time the appointed representative of GRE—suspended its sales force in agreement with LAUTRO.

<sup>26</sup> LAUTRO RULE 3.5 (1987 as amended).

<sup>27</sup> See O. McDONALD, REPORT ON TRAINING AND COMPETENCE IN THE FINANCIAL SERVICES INDUSTRY ¶¶ 3.4.1-2 (SIB, May 1990).

<sup>28</sup> See *Training for Gain*, MONEY MGMT., Aug. 1991, at 26-32.

simply not suitable for the investor. However, promotion and pay of both advisers and their line managers were sales driven, with most advisers being paid on a commission-only basis. The structure of pay and incentives that existed within firms effectively negated any exhortations that were being made by senior management for compliance.

### B. *Compliance Officers*

The FSA regulatory system envisaged that firms would take responsibility for ensuring their own compliance through employing a particular officer assigned to that particular task.<sup>29</sup> However, it appears that compliance systems within firms at the time were, on the whole, inadequate. The reports of LAUTRO's monitoring committee indicate a significant degree of non-compliance with LAUTRO rules throughout the period. At the end of its first round of periodic inspection visits ("PIVs") the monitoring team reported that 22 percent of all members, and 35 percent of life offices, visited over the full course of the three-year inspection cycle exhibited "serious compliance shortcomings necessitating requests for extensive remedial action."<sup>30</sup> After the first year of the second cycle of visits, 13 to 16 percent were still exhibiting serious compliance shortcomings.<sup>31</sup> Five of the eleven firms disciplined in 1992/3 were found to have "deep rooted and systemic shortcomings in their compliance arrangements",<sup>32</sup> and eight of the thirteen firms disciplined in 1993/4 were disciplined for the same reason.

The compliance officers we interviewed, when asked what the compliance system was like in the early years of regulation, commented variously that it was weak, unsatisfactory, disorganized, chaotic, or under-resourced. Compliance was also a new role, implementing new regulation. As one officer commented: "I'm sure [others] will have spoken to you about compliance officers feeling beleaguered, and it was true. It was a new role, a new domain, so the people put into it had no

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<sup>29</sup> Required by SROs individually, and from 1991, by SIB Principle 9.

<sup>30</sup> LAUTRO, ENFORCEMENT BULL. 25, ¶¶ 2.01, 2.04 (Oct. 1993).

<sup>31</sup> See *id.* ¶ 2.05.

<sup>32</sup> *Id.* ¶ 4.01. The firms were found to have breached SIB Principle 9, which requires companies to have adequate compliance arrangements.

benchmark of how to operate. . . ; they were making things up as they went along.” Moreover, there appears to have been little commitment by firms to compliance as a strategic part of the business as a whole. As LAUTRO noted:

[T]he Compliance department could sometimes be seen as the none-too-demanding last resting-place for long serving staff on the verge of retirement. In other cases, the post of Compliance Officer was given low seniority in the company hierarchy, and/or filled by staff with little natural authority. Consequently, the clout of Compliance was limited in some organizations, a situation not eased by the lack of interest sometimes displayed by senior management who believed they had “done compliance” by setting up the department.<sup>33</sup>

Firms generally sought to comply with the requirement to “know your customer” and keep “adequate records” through fact finds: questionnaire sheets which advisors had to complete. However, the length and depth of fact finds required by compliance officers varied enormously both between firms and within firms over time: the shortest reported was one sheet of A4, the longest thirty-three pages. Fact finds were often either simply filed away or just checked mechanically for completion of data. There was little or no qualitative assessment of how that information was being interpreted or what recommendations had been made. However, even if monitoring of fact finds had been more systematic and vigorous, they would not have prevented pension mis-selling as compliance officers had little understanding of the nature of occupational pension scheme benefits, or the need to compare the benefits of such schemes with the personal pension before selling the latter to a person who was, or was eligible to be, a member of an occupational pension scheme.

### *C. Regulatory Failure by the Regulators*

The charge which firms levy at the regulators is that the latter gave them no guidance (at least until 1992) as to what type of information was required to be sought, and what sorts of information had to be obtained, in order to comply with the “know your customer” and “best advice” rules when selling personal pensions. In its first enforcement bulletin, LAUTRO

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<sup>33</sup> LAUTRO, ENFORCEMENT BULL. 33, ¶ xiv (Nov. 1994).

had washed its hands of this responsibility in connection with any investment products: "Members are requested to ensure that their representatives understand that the design of a "fact find" and its manner of use is a company or society matter."<sup>34</sup>

It was not until 1992 that guidance was given as to what the suitability and know your customer duties actually entailed with respect to pensions business. In February 1992 LAUTRO issued an enforcement bulletin<sup>35</sup> which noted the incidence of "large scale advice" to investors to transfer out of occupational pension schemes<sup>36</sup> and a high incidence of complaints about personal pension business.<sup>37</sup> The bulletin warned that sales advisors were failing to make sufficiently detailed, realistic or objective analysis of the relative merits of occupational and personal pensions, failures that were arising for a number of reasons. These included lack of training, a deliberate ignoring of suitability requirements, and inadequate monitoring of fact finds by members. In July 1992 LAUTRO and FIMBRA issued guidance which specifically stated that advising someone to opt out of a defined benefits occupational scheme whilst they were still in the same employment would not, *prima facie*, constitute best advice; the onus would be on the representative to show that opting out was in the investor's interests.<sup>38</sup> With respect to opt outs, information about the occupational scheme and the rights and benefits available under it was required, obtainable from the scheme booklet.

The publication of the guidance marked a significant awakening by LAUTRO to the nature of the issues involved in advising on pensions, demonstrating a far greater knowledge and awareness of the particular nature of pensions business than had been shown hitherto. Its publication prompts two questions: did the 1992 guidance mark a change in standards

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<sup>34</sup> LAUTRO, ENFORCEMENT BULL. 1, ¶ 3.02 (July, 1988).

<sup>35</sup> LAUTRO, ENFORCEMENT BULL. 14, (Feb. 1992).

<sup>36</sup> *See id.* ¶ 3.08.

<sup>37</sup> *See id.* ¶¶ 6.06-10.

<sup>38</sup> *See* FIMBRA, GUIDANCE NOTE NO. 7 (1992); LAUTRO, ENFORCEMENT BULL. 16, ¶ 1.05 (July 1992). SIB issued the same guidance in September 1992 and IMRO in March 1993.

or simply a further specification of them, and what were the regulators doing in their enforcement processes that problems with pensions selling were not picked up on earlier?

### 1. Change in Standards?

With respect to the first question, the regulators, of course, maintain that the guidance, and indeed the criteria being used in the review, did not mark a change in standards: the know your customer and suitability requirements had always been there. The general meaning of the suitability rule (although not its application in the case of pensions) had indeed formed an important part of the review of retail regulation that occurred between 1990 and 1991, and the comparative aspect of the duty had been emphasized.<sup>39</sup> So specification yes, but change, no. Firms, on the other hand, argue that specification equaled change and that regulators had not told them what the general rules required in this particular instance. The regulators' response: you should not need to be told. Thus, the charge that rules were applied retrospectively is complicated to make out, for at its root it assumes a particular distribution of responsibility between regulator and regulatee to determine what conduct is required or barred in particular circumstances. In this particular instance, the issue is essentially not the imposition of a new standard by the regulator but the thinking through of what an existing, but broadly framed, standard could require in particular circumstances. For firms to argue that the imposition of the results of that "thinking through" process is retrospective is effectively for them to argue that it is not their responsibility to go through such a thought process themselves: the regulator should tell them exactly what is required, and, moreover, tell them at the time of doing the business, not after the event. Whether or not it is their responsibility, or should be, is a matter to which we will return below.

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<sup>39</sup> See DP 2, *supra* note 15, ¶ 26.



## 2. Pensions and Enforcement

With respect to the second question of what the regulators were doing in their monitoring activities prior to 1992, the short answer is that no one was looking at pensions, or, indeed, at the sale or marketing of any product in particular. Rather, the monitoring processes of SIB, FIMBRA and LAUTRO looked at the whole of a firm's business across the spectrum of its regulated activities, and further monitoring tended to be firm focused and firm specific. It took a significant period of time to accumulate information about a number of firms, and then the processes for standing back and taking a cross-industry approach to anything but the most blatant activities were limited.

Moreover, the monitoring processes of the regulators differed. FIMBRA had by far the largest membership in terms of numbers but suffered acute financial difficulties.<sup>40</sup> For the first three years, it used three of the major accounting firms to do its monitoring, much of which was based on annual accounts and self-certifications submitted by the firms. Its primary concern, however, was fraud and secondarily churning or other sharp practices: the issue of whether the right product had been chosen in any particular situation was well down the list of priorities.<sup>41</sup> As one ex-FIMBRA official commented:

FIMBRA spent its first five years running out all the crooks and incompetents, [the question was] "where has all the money gone?" It was not about standards of conduct of business. the starting point was, are people fit and proper? It's no good looking now and saying, well why didn't you find this out in your monitoring visits . . . , we were in a different game then.

Thus, even though the Council's attention had been alerted to the potential for mis-selling by a Council member in 1991, it is fairly clear why FIMBRA did not pick up on pensions mis-

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<sup>40</sup> See FIMBRA, ANNUAL REPORTS 1987-1995.

<sup>41</sup> The introduction of a pensions expert onto FIMBRA Council did raise FIMBRA's awareness of the nature and potential problems of pensions business, however, and in FIMBRA Briefing No. 6 in October 1991, it questioned the suitability of advice being given by one IFA to a significant number of members of one particular money purchase occupational scheme to change to a personal pension scheme.

selling in its enforcement activities: questions of suitability and best advice were just too far down their list of enforcement priorities.

LAUTRO had a far smaller number of members,<sup>42</sup> and its members also tended to be large firms with their own compliance departments. LAUTRO's officers would monitor principally the activities not so much of the firm but of its own internal monitors. After an initial round of advisory visits, it began periodic inspection visits in 1990. These looked principally at recruitment procedures, internal monitoring systems and fact finds. Fact finds were checked principally for completion; there was no suitability assessment, and beyond those instances which were "obvious" (pensions were not in this category), advice given was treated as an area where opinions might reasonably differ. In its monitoring process as a whole, there was no particular focus on the sale or marketing of any particular product.

There were, nevertheless, a number of indications that all was not well in the field of pensions advice to which LAUTRO began to respond. It gave early warnings on the need to give best advice in relation to some pension sales and advertisements.<sup>43</sup> At the end of 1990, action was taken against firms who were targeting three public sector schemes—the police, the miners' and the nurses.<sup>44</sup> However, although there were early indications of some problems, these were seen simply as just another set to add to the list; pensions business was not particularly marked out as being problematic.

Towards the end of 1991 and beginning of 1992, the accumulated findings from inspection visits, the increased levels of complaints from investors relating to personal pensions, and a number of warnings beginning to be sounded by pension fund trustees and specialist actuaries did prompt that some specific attention be paid to pensions, at least at the level of guidance, and in February LAUTRO issued its warning on pensions business, noted above. Further specific guidance on pensions business followed in June,<sup>45</sup> echoed by FIMBRA,<sup>46</sup> and in the

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<sup>42</sup> See LAUTRO, ANNUAL REPORTS 1987-1995.

<sup>43</sup> See LAUTRO, ENFORCEMENT BULL. 7, ¶¶ 2.01-3 (Mar. 1990); LAUTRO, ENFORCEMENT BULL. 5, ¶¶ 2.01-3 (Oct. 1989); LAUTRO, ENFORCEMENT BULL. 1, ¶ 3.09 (July 1988).

<sup>44</sup> Information provided to Authors by Kit Jebens in August 1997.

<sup>45</sup> See LAUTRO, ENFORCEMENT BULL. 16 (June 1992).

request for firms to review all opt out business concluded in the last two years where the investor had terminated the contract. Investors were to be contacted in order to determine whether the sale was made on the basis of inappropriate advice. If it was, the firm was to handle the matter in the same way as complaints.<sup>47</sup>

There appear to be several main reasons why pension mis-selling was not picked up on earlier by LAUTRO. The first relates to the novelty of the regulatory system and the lack of experience that both regulators and firms had with regard to regulation. As an organization, LAUTRO had little experience as to what standards should be required or how they should be imposed. LAUTRO officials did not, on the whole, have an industry background; their initial round of "advisory visits" was intended as much to educate themselves about the industry as they were to introduce the industry to regulation. They also had little specific product knowledge. They simply did not have a detailed awareness of the particular nature of personal pensions or, indeed, the main comparable product, the occupational scheme (which, not being an investment sold by the financial sector, fell outside the regulatory net).

Secondly, the monitoring process adopted was firm based and largely incremental. Information on firm's processes was gathered through the periodic inspection visits, and LAUTRO would then indicate to the firm what standards it expected it to conform to (standards which were themselves evolving). However, inspection visits were a time-consuming process; an inspection of a major life company would take around six weeks, and the first cycle of inspection visits took four years.<sup>48</sup> The follow up or verification visit to ensure implementation of the steps required from the first visit would not usually be for

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<sup>46</sup> See FIMBRA, GUIDANCE NOTE 7 (June 1992).

<sup>47</sup> LAUTRO required firms to report in their January 1993 annual return of any action taken and any on-going action that the results of the survey prompted members to take. See LAUTRO, ENFORCEMENT BULL. 16, ¶¶ 1.16-17 (June 1992).

<sup>48</sup> For reports on the general state of compliance found in those visits, see LAUTRO, ENFORCEMENT BULL. 10 (Sept. 1990) and the annual reports to the Monitoring Committee in LAUTRO, ENFORCEMENT BULL. 14 (Feb. 1992); LAUTRO, ENFORCEMENT BULL. 17 (Jan. 1993); and LAUTRO, ENFORCEMENT BULL. 25 (Oct. 1993).

another few months or even not until the next PIV. Thus, gathering an accumulated body of information from those visits on the state of compliance across firms was a slow process.

Thirdly, the nature of the inspections tended to be very detailed and looked across the whole range of the firm. They were largely file based and tended to focus on particular compliance processes—the monitoring of recruitment processes and fact finds in particular. Monitoring was not focused on particular products or areas of business. Systematic problems, particularly those that were product related, could, therefore, just slip through the net. Fact finds, for example, would be sampled mainly on a random basis. Unless the official specifically asked to see one, he or she simply might not have come across a personal pension fact find, particularly if that was not a significant part of the company's business.

Finally, attention was diverted elsewhere, principally to the problems of monitoring ARs. As LAUTRO's chief executive, Kit Jebens, candidly expressed:

There is little doubt that the large amount of intellectual effort and human resources that LAUTRO devoted to dealing with the AR problem diverted its attention from other bad practices, such as the mis-selling of pensions, which were to have much graver consequences later.<sup>49</sup>

#### IV. LESSONS FOR REGULATION

The failure of self-regulation to prevent pension mis-selling should not be seen as evidence of a need to abandon self-regulation in the context of privatised Social Security. Before abandoning this model, one has to consider whether the alternative, direct government regulation, would have produced greater protection. In the context of this scandal, there is little reason to believe that this would have been the case. The factors that overwhelmed this regulatory system would have produced similar failures in government regulation.

The scandal occurred in the context of an industry that was not used to retail regulation and had little or no experience as to what this would require. It also took place during a

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<sup>49</sup> JEBENS, *supra* note 22, at 79.

period in which major structural changes took place in the distribution of investment products, some of which were the result of regulation itself.<sup>50</sup> With building societies and banks and large numbers of brokers agreeing to be AR's for insurance companies, and a simultaneously large expansion in direct sales, the system of self-regulation by LAUTRO was put under incredible strain. Much of the mis-selling occurred during the period before LAUTRO was able to ensure that its members took proper responsibility for the training and selling practices of its ARs and direct sales forces.

Any claim that government regulation would have provided better protection against pension mis-selling has to show why this would have occurred. There is no reason to believe that government inspectors who undertook retail regulation for the first time would have had greater expertise than the SROs' enforcement officers or the firms' compliance officers. This was a new system of regulation. Like the SROs' enforcement officers, government inspectors would have used their early visits to learn about the industry's practices and identify and prioritise areas for attention. It is unlikely that government inspectors would have identified the particular problem of pension sales earlier, and acted quicker, than LAUTRO, FIMBRA and SIB.

The lack of resources and the sheer number of firms it had to supervise undermined FIMBRA's enforcement practices. This is a problem that remains unsolved. Whilst government regulation might possibly put greater resources into the regulation of small investment intermediaries, one has to see this in the context of burden involved. FIMBRA never got very far beyond the prevention of gross fraud. Ensuring the quality of sales occupies the other end of the spectrum. Unless government is prepared to put enormous resources into providing the number of inspectors necessary to visit regularly enormous numbers of small firms, the best protection against mis-sold private pensions is not government versus self-regulation but restricting the sales of private pensions to large providers or those that tie themselves with, and can be regulated by, larger

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<sup>50</sup> Most critically the requirement that an intermediary be either tied to one product provider or completely independent and able to advise on products of all providers, the so-called "polarisation" rule.

firms. LAUTRO's experience with ARs, and recent evidence of the regulatory failures of large financial intermediaries that seek to provide compliance services to small firms,<sup>51</sup> suggests that a ban on pension sales by small firms would be the preferred option.

The perceived failure of self-regulation is linked to that of general rules. SIB and the SROs failed to spell out what these rules required in practice, making their detailed implication the responsibility of the individual firm. In Ayes & Braithwaites' model of enforced self-regulation, devolving the responsibility for detailed rule making to firms is expected to increase the level of protection. Firms are supposed to develop internal rules, which they impose on their own workforce. For example, a firm that was suspicious of the effects of commission on commitment to best advice, might make follow up telephone calls to customers to check whether details were being properly obtained. They might also develop templates for their salesmen to identify categories of customers for whom particular products are unlikely to prove best advice. Whilst such internal rules have been developed now, they were not in place during the period of mis-selling.

The pension mis-selling scandal is a warning against optimism in claiming such benefits for enforced self-regulation. Whilst private firms may complain about the bureaucratic burden of detailed government rules, they shirk from the responsibility to "think through" the implications of general rules. Although the regulators had no specific requirements for pension sales, the industry felt no need to operate such rules either. Until the regulators specified what was required in the way of training, or record keeping, this too remained inadequate. The logic of enforced self-regulation is that firms are required to be pro-active in spotting the implications of general rules for their own businesses. However, the pension scandal showed the industry to be largely re-active—waiting for the regulators to tell them what to do.

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<sup>51</sup> See *Networks Reel Again: Financial Adviser's Record Fine Further Damages Their Image*, FIN. TIMES (London), July 19, 1997, available in LEXIS, WORLD Library, FINTIME File.

Once again, before concluding that government regulation through detailed rules would have been superior, one has to consider what would have happened. A government department that was responsible for producing regulations for all aspects of retail investment business within a few years would not have developed adequate rules for training, supervision and selling for this whole industry which would have prevented pension mis-selling. Worse still, from the consumer's point of view, if government had failed to spot the potential for mis-selling, it could not have then required the firms to compensate those who suffered thereby. By taking the responsibility for detailed rule making to itself, government also has responsibility for losses arising from the failure to make those rules. However, whereas government may make (and in this scandal has made) firms pick up the compensation bill for their failure to think through the implications of general rules for pension sales, we doubt that government will impose such liabilities on itself. The responsibility to think through the implications of general rules is a potentially retrospective liability: one is a hostage to hindsight. Government may impose large retrospective liabilities on private firms; it is less likely to impose such liabilities on itself.