The Governance Of Pension Funds

Paper to be presented by Rosemary Hunter to the annual convention of
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1. INTRODUCTION

1.1. The publication of the *King Report on Corporate Governance for South Africa 2002*¹ (“King II”) on 26 March has come as a timely reminder to pension funds of the importance not only of the corporate governance of the companies in which pension funds invest but also the corporate governance of funds themselves, the entities in which many thousands of employees invest.

1.2. During the last twelve months or so our attention has been so focussed on legislative changes in relation to pension fund surpluses that many of us have paid little regard to the failures of proper governance which can have significant financial and other consequences for funds.

1.3. Some of our funds have become so large that they have become the personal fiefdoms of their chief executives or principal officers. Most of you will have seen the story in the papers a few months ago of the principal officer of the SACCAWU² provident fund who managed to siphon some R14 million out of the fund’s expense account to use in impressing his girlfriend. His union colleagues expressed surprise by his conduct, saying he had been a trusted comrade and for this reason they had not felt it necessary to monitor his activities.

1.4. Union funds are not the only funds with exposure to abuse by staff and officials. This abuse can take the form of the hiring of inappropriately high grade cars when taking trips on behalf the fund and bias in the hiring of staff to the use of fund assets to meet personal expenses. Some large umbrella funds are administered by special purpose administration companies in which their trustees and senior management are shareowners.

1.5. It is highly unlikely that the members of the funds or the contributing employer or even the regulator are aware of these arrangements and thus unlikely that they will question why the funds have been administered by the same organisation for so long. Almost certainly they will not be given the opportunity to question whether the administration expenses of their

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¹ Published by the SA Institute of Directors in March 2002.
² SA Commercial, Catering and Allied Workers Union.
funds are appropriate and whether another service provider could effectively administer the funds for less.

1.6. Good corporate governance, both of companies and of pension funds, is not simply a “nice to have”. It is about the application of principles in order to make organisations worth of trust and is essential to the effective achievement of their goals. In the pension fund context it assists in managing the competing interests of members, the sponsoring employer, unions, employees of the fund and the members of the fund’s board of management. In relation to companies, good corporate governance practices have been demonstrated to increase shareholder value. It is also a good mechanism for encouraging efficiency and preventing corruption. I have no doubt that it could be demonstrated that pension funds with good governance policies and procedures have better, more cost-effective administration and achieve better returns on the investment of pension fund assets than those that do not. Any takers for a good topic for a Masters degree dissertation? What is clear is that, cost effective administration and better investment returns aside, good governance benefits everyone except the corrupt. It benefits members by protecting fund assets and it benefits employers by removing the potential for distrust by staff and provides an incentive for staff to remain loyal to the employer. Finally it reduces the likelihood of litigation against the fund.

2. ARE WE SAYING THAT THE TRUSTEES OF A FUND ARE ACCOUNTABLE TO EVERYONE?

2.1. It is now trite law that, at common law, a board of directors owes it primary fiduciary duty to the company, not the shareowners of it.

"The logic has been that shareowners are entitled to expect directors to run companies in their sole interests – the so-called shareowner dominant theory. This approach has been rejected by courts in various jurisdictions because, on incorporation the company becomes a separate persona in law and no person whether natural or juristic can be owned. Courts have also held that shareowners have no direct interest in the property, business or assets owned by a company, their only rights being a right to vote and a right to dividends. Shareowners also change from time to time while the owner, the company, remains constant. Consequently, directors, in exercising their fiduciary duties, must act in the interests of the company as a separate person."

Pension fund trustees too, owe their common law fiduciary duties to the fund and not directly to its members.

2.2. The problem in this country has been that pension funds have been regarded as mere arms of the employers which established them. We now also have funds which are effectively organs of the unions which established them. Neither of these arrangements is healthy. Whereas the members of a company can recall directors who do not properly perform, members of funds do not have the power to recall trustees. Furthermore, the trustees of such funds almost inevitably face conflicts between the interests of those who appointed or elected them and the interests of the fund itself. A few weeks ago I attended what I had thought was a meeting of a board of trustees to discuss an opinion that I had provided to the fund on whether the fund had any prospect of recovering from the sponsoring employer.


monies in respect of so-called “past improper use of surplus”. I was astounded to find that, not only were half the people at the meeting representatives of the employer but also that each of them had a copy of my opinion. An efficient trustee had simply decided that this was an issue of relevance to the company and had sent around copies of my opinion to various people and had asked them to attend the meeting with me. He clearly failed to appreciate that his role as a trustee required him not to disclose confidential information obtained in the course of his work as such to anyone other than the fund. An employer for which I am now doing some work is experiencing the problem from another angle: A legal advisor employed by it spends his days digging up the dirt on the company to use in litigation on behalf of the fund of which he is a trustee against the company. That is a clear breach of the duty of good faith owed by the employee to his employer and, in my opinion, justifies his dismissal.

2.3. What the regulator has done to try to promote good governance of pension funds is to procure the enactment of section 7A of the Pension Funds Act. Every fund is now required to have a board of management which can be expected to

- determine the fund’s purposes, values and strategies;
- monitor implementation of those strategies;
- exercise leadership, enterprise, integrity and judgment;
- ensure proper risk assessment and management;
- assess the performance of the board itself and of the fund; and
- ensure that it has or obtains the skills, expertise and facilities that it and the fund need properly to perform their functions.

2.4. The other important element of section 7A is that it gives members the right to elect at least 50% of the members of a fund’s board of management. While, as a result of this change, many people have incorrectly regarded employer-appointed and member-elected trustees as “representatives” of their “constituencies” and meetings of boards of management as fora for collective bargaining, it has meant that bias on the part of trustees one way or another has had some check placed on it. A single trustee of courage and integrity sometimes can prevent a board from abusing its powers simply by disclosing such abuses to members, to the regulator or even the pension funds adjudicator.

2.5. Compliance with section 7A is not, however, enough. A simple 50:50 split does not take proper account of the different interests within member groups and does not give access to board decision-making to stakeholders who are not members. For this reason effective boards of management will allow themselves to be called by all stakeholders to account for their actions.
2.6. As King II puts it:

‘One is liable to render an account when one is accountable and one is liable to be called to account when one is responsible. In governance terms, one is accountable at common law and by statute to the company if one is a director, and one is responsible to the stakeholders identified as relevant to the business of the company. The stakeholder concept of being accountable to all legitimate stakeholders must be rejected for the simple reason that to ask boards to be accountable to everyone would result in their being accountable to no one. The modern approach is for a board to identify the company’s stakeholders, including its shareowners, and to agree policies as to how the relationship with those stakeholders should be advanced and managed in the interests of the company.’

2.7. Companies that embrace the principles of good corporate governance recommended by King II are expected to report on the “triple bottom line” namely –

2.7.1. the economic aspect of a company’s business which includes the financial aspects;

2.7.2. the environmental aspects including the effect on the environment of the company’s products or services; and

2.7.3. the social aspect which deals with the company’s values, ethics and relationships with stakeholders other than shareowners.

These three reporting themes reflect the concerns of the various stakeholders in a company including its shareowners, its employees, its service and product providers, its customers and the community that is affected by its activities.

2.8. There are now standards being developed for the reporting on these aspects of a company’s business.

2.9. In South Africa we have not quite yet got to the point of requiring our funds to report on their social responsibility but I have no doubt that this is not far off. There are already demands from certain unions that funds be obliged to invest more in, for example, local government infrastructure. Pension funds, after all, are by their very nature, organisations whose primary objective is the care of the vulnerable, not the pursuit of profit. Of course, without good investment returns a fund cannot take care of the vulnerable, but there are ways of achieving good investment returns while contributing to upliftment of the community, while promoting sustainable development.

2.10. Some funds already have in place procurement policies that take account of the need to promote black empowerment. Others invest in socially desirable investment portfolios. The legality of using what is effectively trust money for purposes other than the direct financial benefit of its intended beneficiaries is uncertain, to say the least, but I have no doubt that in

5 At page 7.

6 See Cowan v Scargill [1984] IRLR 260 (ChD), a British case concerning a decision by trustees of a union-dominated fund not to invest in South Africa and to invest only in Britain in order to protect British jobs. Megarry J said in his judgment in the matter that “when the purpose of the trust is to provide financial benefits for the beneficiaries, the best interests of the beneficiaries are normally their best financial interests.”
this country, a carefully formulated, properly managed, socially desirable investment programme can achieve significant financial benefits and so the issue need not arise. But that is a topic which deserves a conference of its own and I hope that one will be organised before too long. What is immediately pertinent is the duty of the board of a fund to exercise the voting powers of the fund as an investor and to account for the way in which that voting power has been exercised. This responsibility may be delegated to the fund’s investment manager provided that the investment manager is given a specific mandate which is consistent with the fund’s investment strategy.

3. THE SEVEN CHARACTERISTICS OF GOOD CORPORATE GOVERNANCE

3.1. *King II* refers to seven characteristics of good corporate governance identified by CLSA Emerging Markets\(^7\): Corporate discipline, transparency, independence, accountability, responsibility, fairness and social responsibility.

3.2. I propose now to discuss each one of these with reference to occupational retirement funds

3.3. **Corporate discipline.** This refers to the commitment by the company’s (or in our case, the fund’s) board and senior management to correct and proper behaviour with particular emphasis on behaviour that is consistent with the principles of good corporate governance. We have remarkable extremes in this country. On the one hand we have funds whose management offices could compete with the wealthiest of our companies for opulence. On the other hand we have bargaining council funds whose trustees will not allow management to purchase decent telephone equipment, and who, by their parsimony, fail to attract and retain the kind of skills that they need. Their argument is that pension fund money is for paying pensions, not for making the lives of fund employees’ comfortable. Neither of these approaches is sound. We need funds to be business-like in their approach to employees. Employees should be appropriately remunerated and should be given the facilities and equipment that they need to do an effective job. Members of the board of management, too, should be remunerated because this is, I have been persuaded, in important way of encouraging them to spend sufficient time on their trustee duties\(^8\). On the other hand they should not be allowed to feather their nests with fund monies. The board of management of the fund should set the standards and keep them themselves. Then they should ensure that the standards are kept by fund employees. Someone on behalf of the board of management should be scrutinising fund expenses and should be reporting on them to the board. But such reports will be meaningless if the board itself has not determined a policy in relation to fund expenses. Such a policy could be incorporated into a code of conduct for the fund’s board and possibly a separate one for fund staff. If the management of a fund is outsourced, the code would be incorporated in the management agreement. Finally it is important that the standards adopted by the trustees be communicated to the stakeholders. Likewise it

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\(^7\) October 2000.

\(^8\) See paragraph 2.30 of the report of Paul Myners (“the *Myners Report*”) on *Institutional Investment in the United Kingdom: A Review* in which he states that “it is a good practice to pay trustees, unless there is a specific reason why this may be unnecessary (for instance where they are senior executives of the sponsor company). In its response to the Myners Report, the British Government said at paragraph 50 that “to the extent that trustees are retaining responsibility for investment issues, they are fulfilling a complex, important and responsible role. At the very least serious consideration should be given to paying them for fulfilling such a role and to providing them with sufficient time to carry out their responsibilities.” See the press release of the British Department for Work and Pensions of 4 February 2002 at [http://www.dwp.gov.uk/mediacentre/pressreleases/2002/feb/myners0402.htm](http://www.dwp.gov.uk/mediacentre/pressreleases/2002/feb/myners0402.htm).
would be appropriate for each of the trustees, participating employers and service providers publicly to declare that they do not derive any financial benefit from their involvement in the fund other than that specifically authorised in the rules or incorporated in an agreement with the fund which is available for scrutiny.

3.4. **Transparency.** This is “the ease with which an outsider is able to make meaningful analysis of a company’s actions, its economic fundamentals and the non-financial aspects pertinent to that business”. It requires that necessary information be made available in an honest, accurate and timely manner. Our pension funds adjudicator has made a number of determinations in relation to the duty of trustees to provide accurate and timely information but the cases before him have been limited to circumstances in which members have been given a choice to exercise, such as a choice of benefits or the choice to transfer to another fund. An effective fund will provide appropriate and timely information to all of its stakeholders on all major policy decisions by it. The timing of the provision of that information is critical to its usefulness. Information regarding policy decisions should be given at a time which permits those receiving the information the opportunity to provide new information or comment on it before the decision is implemented. This is not simply to promote the position of the stakeholders. Its more important purpose is to ensure that the board acts on the best possible information and it cannot do so if it does not invite affected people to submit to it information and thoughts which may be relevant. It also minimises opportunities for corruption. If a decision is to be subject to scrutiny, it is likely to be taken more carefully and with less regard for ulterior motives than might otherwise be the case.

3.5. **Independence.** This refers to the mechanisms that have been put in place to minimise or avoid conflicts of interest that may exist between stakeholders such as dominant shareholders (or, in our case, members). Such mechanisms include those governing -

3.5.1. The composition of the board;

3.5.2. Appointments to committees of the board;

3.5.3. The role of external parties such as auditors.

I know that many employers use their power of appointment of trustees to ensure some sort of control over funds. For this reason you will find numerous company financial directors and human resources directors or managers appointed as trustees. Their appointment often suits no-one, however, as wearing their trustee hats they are required to act in the best interests of the fund even if this is in conflict with their duties as employees of the company. The trustees themselves may find themselves in excruciating positions of conflict and may prefer not to vote on an issue than to adopt a position in favour of one of the parties to which their loyalty is owed. The answer is not for an employer to waive its right to appoint trustees, however, because the fund may then be managed by trustees who are popular with the members but who may not have the skills and experience necessary for the effective management of the fund. Instead in my opinion employers should use their powers of appointment precisely to ensure that the board of management has persons on it with necessary expertise and

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9 See, for example, *Bona v South African Local Authorities Fund and Another (1)* 2001 (10) *BPLR* 2563 (PFA); *Joshua v Dunlop Africa Fund 2001 (4) BPLR* 1852 (PFA)).
experience. An employer should be prepared to hire appropriate professional trustees for the purpose if it does not have people with the time and expertise in its own ranks.

3.6. **Accountability.** This refers to mechanisms which enable stakeholders to query and assess the conduct of the board and its committees. It may include the publication of information, the holding of meetings of members and consultations with all other stakeholders.

3.7. **Responsibility.** This refers to behaviour that allows for corrective action. Boards should establish mechanisms for the swift and effective disciplining of board members and fund officials and employees who abuse their positions. The rules of pension funds should make specific provision for the expulsion after a fair hearing of trustees who misbehave. There should also be mechanisms for the swift and effective resolution of disputes both between the members of the board and between the fund and its various stakeholders. The pension funds adjudicator frequently complains of the lethargy and hostility with which boards approach complaints directed to the fund. This conduct is in the interests of no-one, not even the fund itself. Dispute resolution mechanisms could include the involvement of outside mediators and the provision of advisory awards by external experts but there should also be mechanisms for the internal resolution of disputes to reduce the need to external intervention and minimise the risks of referrals to the pension funds adjudicator.

3.8. **Fairness.** This refers to the respect that must be given to stakeholders with competing interests. The board of a fund should ensure that it recognises, acknowledges and takes proper account of the interests of different stakeholders to the extent that those interests are relevant to decisions to be taken by them. This principle has resonance in one of the important principles of administrative law which have been found to be applicable in the pension fund context: the principle that trustees, when making decisions, should take account only of relevant facts, disregard irrelevant facts and act without bias.

3.9. **Social responsibility.** This refers to the priority that must be given to high ethical standards, non-discriminatory and non-exploitative and environmentally-friendly conduct of corporate activities. *King II* suggests that a company is likely to receive indirect economic benefits such as improved productivity and corporate reputation by doing this. Those of us in the pension fund business know that it can save us the time, expense and reputational risk of tangling with the office of the pension funds adjudicator.

4. **CONCLUSION**

The topic of pension fund governance is one which could provide material for a textbook. We already have very useful written work on the topic by Alexander Forbes and Coopers & Lybrand (as it then was) and no doubt there are materials written by various service providers in the industry. Deloittes last year provided us with some very helpful information after surveying governance practices in the industry. What we need to do now is to work out some best practice guidelines. The Financial Services Board has asked the legal and technical committee of the Institute of Retirement Funds to propose a code of conduct which could be incorporated in a PF circular. As you know, PF Circulars do not have the force of law. Nonetheless they are important documents that not only provide guidance to trustees but may also be used as the measure against which the conduct of a fund may be assessed by the regulator, our courts and the pension funds adjudicator. The IRF legal and technical committee has not yet completed its task but you can be sure that the code that it prepares will be phrased in pretty general
terms so as to accommodate the different circumstances of funds. Certainly it will not attempt to prescribe to trustees what decisions they should take in specific circumstances because that would not be consistent with the purpose of the code. The code will simply propose standards of conduct and behaviour relating to, among other things, the disclosure of personal interests, the avoidance of conflicts of interest, diligence in the execution of board duties, standards of care to be applied and so on. Any suggestions that you would like to feed into the mix will be welcomed.

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