

Accountability of pension fund service providers The role of trustees



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Executive Summary

- 1 This paper will discuss the legal relationship between the board of trustees (“the board”) of a pension fund and the service providers that it appoints to render services to the fund.
- 2 Trustees sometimes operate on the basis that they are not required to exercise effective control over service providers to the fund. The reason for this is often because trustees are not properly advised of what their powers and functions are.
- 3 Trustees have legal duties, the source of which is legislation, the common law and the rules of the fund. Essentially trustees have fiduciary duties towards the fund.
- 4 In most cases the rules of a fund will grant discretionary powers to the trustees. The trustees must ensure that the extensive powers granted to them to manage the fund are exercised in accordance with their fiduciary duties. Trustees have a fiduciary duty to exercise their powers with care, diligence and good faith.
- 5 The rules of the pension fund may expressly or tacitly grant trustees the powers to delegate some of their administrative functions to service providers.
- 6 The appointment of competent service providers to a fund is essential, as it is unlikely that trustees will be able to fulfil the needs of a fund to ensure the efficient management of the fund.
- 7 Service providers deal with daily operations of the fund and the carrying out of its core function. Boards must be aware of what service providers functions are and what are important factors that must be considered by the board when electing to appoint them. Appointments of service providers must be made by

the trustees in accordance with their fiduciary duties, this being that appointments made must be in the exclusive interests of the fund.

- 8 Section 13B of the Pension Funds Act was enacted in order to enable the Financial Services Board (“FSB”) to regulate the industry effectively. As from 1 April 1996 it is a criminal offence for any person not approved by the FSB to undertake any administration in respect of a retirement fund. Approval does not depend upon subjective factors such as the institution’s level of skill or competence so trustees cannot rely on the fact that an entity is registered to establish that a high quality service will be provided.
- 9 Two broad categories of administrators are affected by the section and the board notice. These are investment administrators and benefit administrators. The board notice sets out the requirements that must be complied with by an administrator in order to qualify for FSB approval. It is recommended that the guidelines contained in the board notice should be considered by trustees when engaging any service provider.
- 10 Many retirement fund service providers offer a ‘one stop shop’ alternative to clients. It is not necessary for a board to accept the ‘one stop shop’ alternative. It may be in the fund’s interests for the trustees to procure independent service providers for the various services that a retirement fund requires. This will enable the trustees to mitigate against the potential conflict of interest that may arise.
- 11 Essentially the trustees should exercise an independent discretion because the appointment of service providers to the fund is a decision that is solely at the discretion of the board of trustees of the fund and trustees should be loath to abdicate this responsibility.
- 12 The legal relationship between trustees and service providers is contractual in nature and the parties to the contract will only be bound by terms that have been agreed upon as contained in the contract. There must be agreement

(consensus) between the parties that they will be bound by the terms of the contract. Once a contract is validly entered into the board will have a right to enforce a service provider's obligation to perform in terms of the contract.

- 13 The board should seek to insert terms in the contract that ensure that the relationship is to the fund's advantage even if they may be onerous to the service provider. These would be clauses that relate to the monitoring of service provider performance and penalties for poor performance. Examples of the possible content of such clauses are:

13.1 Requiring a benefit administrator to make payment of benefits within a stipulated time period and failure on the part of the administrator to comply with the time period will result in a penalty being attached requiring the administrator to pay a punitive amount to the member.

13.2 Clearly stipulating in the contract that any loss suffered by the fund or any member as a result of an error on the part of the administrator will be payable by the administrator.

13.3 Requiring a valuator to prepare and lodge the fund's valuation report within the time required by the FSB. Failure to do so resulting in a penalty for the valuator in the form of a reduction in fee payable for the service;

13.4 Agreeing on a benchmark of performance with an investment manager. Failure on the part of the investment manager to achieve the benchmark will result in a penalty in respect of the fee payable by the fund to the administrator.

13.5 Stipulating that the risk of poor investment performance will be apportioned between the member, employer and the service provider. This will assist in alleviating the detrimental effects that member's will face where there may be adverse performance by a fund.

- 14 The board should enlist legal assistance in drafting and considering the contract that the board signs with the service provider.
- 15 It is essential that the board, in order to comply with their fiduciary duties, monitor the performance of all service providers appointed to the fund. The means by which trustees may do this is to agree on benchmarks that will assess the service provider's performance. These benchmarks must be set out in the contract entered into with the service provider.
- 16 Service providers will commit a breach of contract where they fail to perform in a manner required by the terms of the contract or perform in a manner that is defective in that the performance is below the standard agreed upon. In such circumstances the board can invoke the legal remedies and enforce penalties that will be available in terms of the contract.
- 17 A trustee in the exercise of any of his/her duties must so far as possible avoid a position where private interest conflicts with his/her duty as a trustee.
- 18 Trustees are under a duty to utilise their powers for the benefit of and in the exclusive interest of the fund and its members. Whenever there is a divergence between the funds' interests and those of the service provider the legal duty of trustees is clear, they are obliged to act in the interests of the fund and its members.
- 19 Where trustees fail in their duties, there are mechanisms that will allow the fund or members to take action against the trustees in their individual capacity or collectively.
- 20 The appointment and management of service providers to a fund is the prerogative and duty of the board. These duties must be exercised in accordance with the trustees' fiduciary duties. Onerous obligations are therefore placed on trustees in this regard and trustees may not absolve

themselves of this responsibility when delegating these functions to external service providers.

- 21 It is suggested that boards develop and implement codes of conduct that comply with best corporate governance practices as this will assist trustees in appointing, managing and monitoring service providers in an effective and transparent manner. Practices set out in the second report of the King committee published on 26 March 2002 that are important for funds to have regard to in the appointment and management of service providers are that trustees should:

21.1 Be aware that they are ultimately responsible and accountable for the affairs of the fund. Delegating authority in any way does not mitigate or dissipate the discharge by the board of their duties and responsibilities.

21.2 Retain full and effective control over the fund and monitor implementation of fund plans and strategies.

21.3 Ensure that the fund and service providers comply with all relevant laws, regulations and codes of conduct.

21.4 Reserve specific powers to the board and delegate matters to service providers with the necessary written authority. These matters must then be monitored by the trustees and evaluated on a regular basis.

21.5 Develop a code of conduct that addresses the management of conflicts of interest and should be regularly monitored and updated as and when necessary.

21.6 Have a procedure whereby they may, if necessary, take independent professional advice at the fund's expense.

- 21.7 Develop a charter setting out their responsibilities that should be disclosed in the fund's annual report, alternatively, forwarded to members with communication material.
- 21.8 Arrange for incoming trustees to undergo a formal orientation programme to ensure that they are familiarised with their fiduciary duties, responsibilities and liabilities. Trustees should continuously receive continuing education on developments in the industry.
- 22 Trustees must ensure that their conduct in appointing and monitoring of service providers is in accordance with the standard of care expected in terms of their fiduciary duty. In doing so, it is likely that trustees will place themselves in a position where they are accountable to members with regard to the appointment and monitoring of service providers.

Introduction

- 1 This paper will discuss the legal relationship between the board of trustees (“the board”) of a pension fund and the service providers that it appoints to render services to the fund.
- 2 Trustees sometimes operate on the basis that they are not required to or are unable to exercise effective control over service providers to the fund. The reason for this is often because trustees are not properly advised of what their powers and functions are.
- 3 The legal relationship between service providers and the fund will be considered and proposals will be made on recommended best practice to be adopted when funds contract with a service provider.
- 4 There is no doubt that to appoint, monitor and hold service providers accountable is an onerous task which the board is obliged to fulfil in order that the fund’s and members’ interests are protected.
- 5 The discussion of these issues in this paper is aimed at assisting trustees to understand their duties and roles with regard to service providers and managing their relationship in the best interests of the fund.

Trustees powers and duties

- 6 Trustees powers and duties are governed by legislation, the common law and the rules of a fund. These important sources are discussed below.

Legislation

Pension Funds Act 24 of 1956

- 7 The establishment and operation of pension funds is regulated by the Pension Funds Act 24 of 1956 (“the Pensions Act”).

- 8 The object of the board of trustees is defined in section 7C(1) of the Pensions Act as being to “direct, control and oversee the operations of the fund in accordance with the applicable laws and rules of the fund.”
- 9 Every fund is required in terms of section 7A of the Pensions Act to have a board of management consisting of at least four board members, half of which must be elected by the members of the fund, unless the Registrar of Pension funds (“the Registrar”) has exempted the fund from this requirement.
- 10 The relationship between the board and the fund is a fiduciary one.¹ There are various fiduciary duties that trustees owe to the fund. Fiduciary duties are duties of loyalty or care² that arise whenever a person acquires a power. The power is granted on the condition that the person undertakes to utilise it in the exclusive interests and favour of another.³ The bearer of this duty must not exercise the power either in his or her own interests, or in the interests of a third party.
- 11 Certain fiduciary duties are set out in Section 7C(2) of the Pensions Act. Section 7C(2) provides that, in pursuing the object of the fund, the trustees must:
- 11.1 Take all reasonable steps to ensure that the interests of members in terms of the rules of the fund and the provisions of the Act are protected at all times.
- 11.2 Act with due care, diligence and good faith.
- 11.3 Avoid conflicts of interest.
- 11.4 Act with impartiality in respect of all members and beneficiaries.⁴

¹ *Tek Corporation Provident Fund and Others v Lorentz* 1999 (4) SA 884 (SCA)

² JC Sherdard *The Law of Fiduciaries* (1981) at 4-9

³ Gerard M. D Bean *Fiduciary Obligations and Joint Ventures* (1995) at 23

⁴ Section 7C(2)

12 In addition to the fiduciary duties, Section 7D of the Pensions Act places certain non-fiduciary duties upon trustees in relation to their administration of the pension fund. These duties are quite distinct from the fiduciary duties listed above, but must nevertheless be exercised in such a manner so as not to detract from the fiduciary duties. These non-fiduciary duties are:

12.1 Ensure that proper registers, books and records of the operations of the fund are kept, inclusive of proper minutes of all resolutions passed by the board.

12.2 Ensure that proper control systems are employed by or on behalf of the board.

12.3 Ensure that adequate and appropriate information is communicated to the members of the fund informing them of their rights, benefits and duties in terms of the rules of the fund.

12.4 Take all reasonable steps to ensure that contributions are paid timeously to the fund in accordance with the Act.

12.5 Obtain expert advice on matters where board members may lack sufficient expertise.

12.6 Ensure that the rules and the operation and administration of the fund comply with the Act, the Financial Institutions (Investment of Funds) Act 39 of 1984 and all other laws.⁵

Financial Institutions (Protection of Funds) Act 28 of 2001

13 The Financial Institutions (Protection of Funds) Act 28 of 2001 (“the FI Act”) governs financial institutions.

⁵The legislature’s reference to “all other laws” is a reference to all laws that may be applicable generally and specifically to the rules, operation and administration of a fund.

- 14 Section 1 of the FI Act adopts the definition given to a “financial institution” in section 1 of the Financial Services Board Act 97 of 1990. This section defines a “financial institution” as:

“...any pension fund organisation registered in terms of the Pension Funds Act, 1956 (Act 24 of 1956), or any person referred to in Section 13B of that Act administering the investment of such pension or the disposition of benefits provided for in the rules of such a pension fund;
...”

- 15 Section 2 of the FI Act states that:

“A director, member, partner, official, employee or agent of a financial institution...who invests, holds, keeps in safe custody, controls, administers or alienates any funds of the financial institution or any trust property:

- 15.1 must, with regard to such funds, observe the utmost good faith and exercise proper care and diligence;
- 15.2 must, with regard to the trust property and the terms of the instrument or agreement by which the trust or agency in question has been created, observe the utmost good faith and exercise the care and diligence required of a trustee in the exercise or discharge of his or her powers; and
- 15.3 may not alienate, invest, pledge, hypothecate or otherwise encumber or make use of the funds or trust property in a manner calculated to gain directly or indirectly any improper advantage for himself or herself or for any other person to the prejudice of the financial institution or principal concerned.”⁶

Common Law

⁶Section 2

- 16 Common law is the law that is developed over time through the decisions of the courts.
- 17 Pension fund trustees are obliged to conduct the affairs of a pension fund in accordance with the common law regarding the fiduciary duties of those who occupy positions of trust in the wide sense.⁷ On appeal,⁸ Marais JA reiterated that the trustees of the fund owed fiduciary duties to the fund, its members and other beneficiaries.
- 18 The common law duty of a trustee in respect of trust property requires that a trustee must observe greater care in dealing with trust property than he or she does when dealing with his own property. The Court further held that a trustee may be removed from office for breaching his fiduciary duties even if his conduct complained of was *bona fide* ('in good faith') since *mala fides* ('bad faith') or even misconduct are not necessary requirements for his removal.⁹
- 19 One of the important cases to pronounce on trustees' duties was *Sackville – West v Nourse*¹⁰ in which the Appellate Division held that a trustee must consider that he is not dealing with his own money but that of the trust and therefore greater care and caution is required than when he deals with his own property. The court found that the standard of care to be observed was not that which an ordinary man generally observes in the management of his own affairs but that of the prudent and careful man, the 'reasonable man'. The court also held that a trustee is not free from liability for breach of trust merely because imprudent action was taken in good faith.

⁷Honoré op cit p.3 states that in a wide sense a trust exists whenever someone is bound to hold or administer property on behalf of another or for some impersonal object and not for his or her own benefit. At the minimum such a person has a duty to keep the property administered separate from personal property and to avoid a conflict of interest with the beneficiary or the trust object. In this wide sense a 'trustee' is any person so holding or administering property.

Euijen v Nedcor Pension Fund [2000] 5 BPLR 465 (PFA)

Meyer v Iscor Pension Fund 2003 (2) SA 715 (SCA)

⁸Tek's case supra at note 1.

⁹*Tijmstra NO v Blunt-Mackenzie NO and others* [2002] (1) SA 459 (T)

¹⁰1925 AD 516

The Fund's Rules

- 20 Section 7A(2) of the Pensions Act provides that the constitution of the board, the election procedures of the members, appointment and term of office of the members, procedures at meetings, voting rights of members, quorum for a meeting, breaking of deadlocks and the powers of the board must be set out in the fund's rules.
- 21 The rules of a registered fund are, in terms of section 13 of the Pensions Act, binding on the fund, its members, shareholders and officers and on any person who brings a claim under the rules or a person whose claim is derived from the person claiming under the rules.
- 22 Trustees are obliged to act in accordance with the fund's rules and not beyond it. Where trustees act in excess of the powers conferred by the rules they will have acted *ultra vires* ('beyond the scope of their powers') of the rules of the fund and such acts will be unenforceable.¹¹
- 23 The common theme that runs through the duties imposed on trustees, as set out in statute, the common law and commonly, the rules of the fund, is that the trustees of a fund owe a fiduciary duty to the fund, its members and other beneficiaries.¹²

Trustees Powers

- 24 Trustees have the right and duty to exercise the powers of their office. These powers will be as provided for in legislation, the common law and the fund's rules. In terms of the Pensions Act, the trustee's objects are to direct, control and oversee the operations of the fund in accordance with applicable laws and the rules.

¹¹ *Mgulwa and Another v First National Bank Group Pension Fund and Others* (1999) 12 BPLR 379 (PFA).

¹² *Tek*, supra at note 1.

- 25 The objects of a pension fund are generally to provide benefits at retirement or death to persons that qualify in terms of the fund's rules. Trustees are generally required to do whatever is possible and necessary to attain the objects of the fund. The powers conferred on pension fund trustees commonly include the following:
- 25.1 Management of the moneys received by the fund, including investing and realising moneys in a manner that the trustees determine.
 - 25.2 To open and operate a bank account in the name of the fund.
 - 25.3 If necessary, to borrow money in favour of the fund.
 - 25.4 Institute or defend legal proceedings in the name of the fund.
 - 25.5 Delegate powers where necessary.
 - 25.6 To determine the allocation of death benefits on the death of a member.
 - 25.7 To amend the fund's rules.
- 26 In most cases the rules of a fund will also grant discretionary powers to the trustees. While trustees are conferred extensive powers in managing the affairs of the fund, a correlative to these powers is the duty to exercise the powers in accordance with the fiduciary duties imposed upon them.
- 27 The term fiduciary duty encompasses various independent duties. It is not possible to prepare an exhaustive list of all the obligations that could constitute a fiduciary relationship. Fiduciary duties are essentially aimed at the prevention of abuse of trust in the relationship between the trustees and the fund.

Appointment of Service Providers

- 28 Trustees have a fiduciary duty to exercise their powers with care, diligence and good faith.¹³ Trustees have an obligation to manage the fund's assets and to administer the payment of benefits.
- 29 Many trustees do not have all the necessary skills and knowledge to perform the required functions and independently ensure that there is proper administration and good investment returns for the fund. As a consequence it is an accepted practice in the industry for trustees to employ the skills of service providers to assist them in performing their functions. Good governance requires that trustees seek external assistance in fulfilling their duties when required.
- 30 Trustees may either enlist on a full time basis all the necessary expertise that they require to administer the functions of the fund, or they may make use of external service providers on an occasional or permanent basis to perform some or all of these functions. Most funds make use of external service providers.
- 31 The rules of a pension fund may expressly or tacitly grant trustees the powers to delegate some of their administrative functions to service providers.
- 32 Scott¹⁴ states that trustees cannot delegate the performance of functions that they can reasonably be required to personally perform. The standard to determine whether a particular function is such that the trustees can be reasonably required to personally perform it, is an objective standard according to which must be assessed what the reasonable and prudent trustee would do.
- 33 The delegation of discretion is not always improper. However, where the function involves a high degree of discretion, this will strongly imply that since

¹³ Section 7C(2)(b)

¹⁴ *Scott on Trusts: Volume II* (1956) 2ed by Austin Wakeman Scott at 442

the trustee is the person who was ultimately appointed to exercise this discretion, he should not delegate it to another.¹⁵

34 In all other cases trustees will be able to delegate their powers to another person provided that they:

34.1 Do not thereby free themselves from liability for the conduct of the services provider appointed to perform their functions for them.

34.2 They can at any time freely revoke the appointment of the service provider.¹⁶

35 From these two requirements it becomes apparent that delegation is the appointment of another to act on one's behalf while still retaining the responsibility for such person's actions. Abdication is the opposite of this, since it involves the situation where another is appointed to act instead of one, so as to relieve one of his or her own responsibilities.¹⁷

36 Abdication of power by a trustee is not permitted since it will be a contravention of the duties imposed upon trustees under the Pensions Act. Thus, trustees cannot transfer their own responsibilities to the fund onto another person. They are only permitted to seek assistance from service providers, because in all cases the trustees will ultimately be responsible for the affairs of the fund.

37 Bismilla and le Grellier¹⁸ note that in order for trustees to properly delegate their powers, they must exercise prudence with regard to the service providers to whom their powers have been delegated to. This may include the utilisation of monitoring and evaluation mechanisms and procedures by which trustees can judge the performance of service providers. Possible mechanisms that may be utilised by trustees will be considered later in this paper.

¹⁵ *ibid*

¹⁶ *Hoosen and Others NNO v Deedat and Others* 1999 (4) SA 425 (SCA)

¹⁷ Shahnaaz Bismilla and Gail le Grellier "Delegation v Abdication" *Pensions World* March 2002/May 2002 (note 11) at 46

¹⁸ Bismilla and le Grellier (note 4) at 46

The Functions of Service Providers

38 Service providers deal with daily operations of the fund and the carrying out of its core function, these would typically include day to day administration, financial management, data management, benefit payments, member information, reporting, legal, regulatory and compliance services, secretarial, rule drafting, consulting, audit, actuarial, investment and asset management. Important considerations relating to investment management and benefit administration are discussed below.

Investment Management

39 The board has the duty to manage the fund's assets and develop an investment policy and strategy for the fund.

40 In investing the assets of the fund, the basic principles of investment¹⁹ that trustees should consider are:

40.1 Maximise after-tax investment returns without taking undue risks.

40.2 To take cognisance of the cash flow needs for liabilities.

40.3 Flexibility to change investments or investment managers.²⁰

40.4 The extent to which trustees wish to be involved in investment decisions, and if so, what expertise they have for this purpose.

41 Trustees may enlist expert assistance by delegating their functions to investment managers. The appointed investment managers must always act

¹⁹Discussed in Bismilla and le Grellier at 258

²⁰The terms of a contract that trustees would have entered into may impact on the level of flexibility that trustees may have to change an investment manager for example clauses which provide for lengthy notice periods to terminate a contract or penalty clauses which financially prejudice the fund if investments change or the contract is terminated early. It is therefore important for trustees to ensure that they do not enter into contracts that have restrictive clauses that will not allow them to 'escape' from a contract or to change the fund's investments on reasonable notice and without financial penalties.

on instruction of the trustees in carrying out their functions. The functions of investment managers are typically the following:

41.1 Receipt of money for investment purposes.

41.2 Investing these monies in an appropriate vehicle to achieve maximum returns with the recognition of the associated risks.

41.3 Safe custody of assets.

41.4 In consultation with trustees, formulating an investment strategy for the pension fund.²¹

41.5 Reporting on all transactions made.

42 Persons that may be considered for such appointments include life insurers, unit trust managers, merchant banks, stock brokers and investment managers who conduct this type of business.

43 It is suggested that trustees take into account the following factors when appointing investment managers.²²

43.1 *Past Performance*: Although the history of a investment manager can never be a guarantee as to what the future will provide, it may nevertheless be a strong indicator as to whether the services of the investment manager may be expected to be reliable. It is suggested that the performance over at least the last five years should be considered, since shorter performance periods may be unreliable.

43.2 *Qualifications and experience*: It is suggested that the board consider the qualities of the person's who will actually invest the fund's money, and compare these to the qualities of similar person's in other candidates for

²¹Trustees must not allow investment managers to unilaterally determine the investment strategy of the fund.

²²These factors are discussed in Bismilla and le Grellier at 258.

the function. Relevant qualities may include academic qualifications, work experience, etc.

- 43.3 *Strength of research team*: Although most stockbroking firms will allow client's to view their research, it is advisable that investment managers themselves have their own team of researchers.
- 43.4 *Back-up*: The board is advised to enlist the services of an investment manager that does not depend too extensively upon the services of a single individual for the good results it achieves. Rather, boards are advised to enlist the services of investment managers that have good back-up staff that will cater for any deficiency that would result should a valuable employee leave the employ of the investment manager.
- 43.5 *Communication*: Investment managers should regularly (at least every six months) communicate the progress or developments in the investment strategy to the board. This will enable the trustees to continually assess the quality and performance of the investment managers.
- 43.6 *Investment charges*: The board should weigh up the cost of an investment manager with the level of competency that the board may expect from the candidate.
- 44 It is necessary that trustees play a well informed, active role in determining and altering investment policy. Trustees must be actively involved in determining the fund's investment strategy by being aware of and expressing an opinion on the approach suggested by an investment manager. Trustees should determine the extent to which they agree with the investment policy that the investment administrators recommend and the extent to which the trustees will influence future investment strategy.
- 45 A description of the investment strategy agreed upon by the board on the suggestion of the investment managers should be recorded in writing and

contained as part of the written service agreement entered into between the fund and the investment manager.²³

- 46 Differences in investment policy philosophy may arise in the context of socially responsible investments (“SRI”). SRI refers to investment strategies that incorporate social and environmental factors and financial factors.²⁴ There are different manifestations of SRI ranging from investing away from entities that are seen as having poor social and environmental performance, to investments in entities that have strong social and environmental qualities.
- 47 If the board decides to invest the fund’s assets in SRI, it is recommended that the board formulate an investment policy statement that outlines their reasons for doing so. This policy must state why, in the opinion of the trustees, there will be no conflict between adopting various social objectives and their responsibility to achieve satisfactory investment returns. They should also highlight the social and environmental objectives that they wish to invest in.²⁵
- 48 If the trustees elect to adopt a SRI scheme, they should inform their investment manager of all relevant details in order to ensure that the selection criteria and performance measurement process complies with the fund’s SRI policy.²⁶

Benefit Administration

- 49 Benefit administrators include both persons who are actually involved in the payment of benefits as well as those who undertake only the general administration of the fund, and which directly or indirectly facilitate the payment of benefits. Both of these classes of persons are required to register under section 13B of the Pensions Act. Examples of benefit administrators include:

²³The investment strategy could set out amongst others the types of investments, the maximum amounts to be invested in any particular investment, the levels of risk, the time periods for which investments will be made and whether socially responsible investing will be implemented.

²⁴Harry Belyveld “Why Trustees Should Have a Documented Policy on Socially Responsible Investment.” *Pensions World* June 2003 10 at 11

²⁵These are the arguments provided by Belyveld (note 1) at 12

²⁶ibid

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- 49.1 Retirement fund administrators.
- 49.2 Insurers that act as administrators.
- 49.3 An employer who employs his staff to administer the pension fund, subject to limitations.
- 49.4 Any company that is appointed to administer the fund;
- 50 The following are typically functions of benefit administrators:
- 50.1 Managing a bank account in the name of the fund.
- 50.2 Receiving contributions.
- 50.3 Calculating and paying benefits.
- 50.4 Paying re-insurance premiums for risk benefits.
- 50.5 Paying of available cash to an investment manager.
- 50.6 Record keeping of members' transactions.
- 50.7 Performing accounting functions.
- 51 In appointing benefit administrators, the board should identify persons or entities that are reputable in respect of being committed to provide accurate, regular and punctual service. Such commitment may be ascertained by way of references that are provided from persons who had previously made use of the benefit administrator.
- 52 Only institutions approved by the Financial Services Board ("FSB") as a benefit administrator are eligible to be appointed by the board. Approval will be obtained if certain minimum requirements are met. These will include prescribed minimum asset requirement, compulsory audits and fidelity cover. Approval does not depend upon subjective factors such as the institution's

levels of skill or competence so trustees cannot rely on the fact that an entity is registered to establish that a high quality service will be provided.

Section 13B of the Pension Funds Act and Regulation 24 of 2002

53 Section 13B of the Pensions Act was enacted in order to enable the FSB to regulate the industry effectively. As from 1 April 1996 it is a criminal offence for any person not approved by the FSB to undertake any administration in respect of a retirement fund.²⁷

54 The registrar of pension funds determined conditions in respect of administrators acting on behalf of pension funds and these are contained in Board Notice 24 of 2002 (“the board notice”). The board notice consists of a schedule that contains the conditions for approval.

55 The FSB circulated an in house guide to the industry in July 1996. This guide contains the FSB’s interpretation and internal practice notes and clarifies the following:

55.1 Two broad categories of administrators are affected by the section and the board notice. These are investment administrators and benefit administrators.

55.2 The audit and valuation function in respect of retirement funds constitute control functions and can therefore not be included under the term “administration”. Auditors and actuaries will therefore not be required to apply for approval.

56 In terms of the board notice, amongst others, the following requirements must be complied with in order for investment and benefit administrators to qualify for approval:

²⁷Hanekom K and Marx G L, The Manual on South African Retirement Funds and other Employee Benefits Vol 1 2003 edition.

Written Agreement

57 A written agreement must be entered into between the administrator and the fund before any administrative function can be undertaken for the fund. The board notice also stipulates that the administration agreement must comply with the following requirements:

57.1 The powers of the administrator to administer the investments of a fund or the disposition of benefits in terms of the rules of a fund must be stated.

57.2 The powers of the trustees which are delegated to the administrator must be particularised.

57.3 The administrator must ensure that all investments of the fund are made subject to and in accordance with the provisions of the Pensions Act.

57.4 The basis for remuneration of the administrator must be set out.

57.5 Each party to the agreement must be entitled to terminate the agreement in writing by notice of not more than 90 days.

57.6 Any amendment to an agreement must be effected by a written addendum or new agreement.

Indemnity and fidelity guarantee insurance

58 Administrators must effect and maintain professional indemnity insurance (cover for the administrator's negligence) and fidelity guarantee insurance (for theft and fraud).

Approval of management by the FSB

59 Administrators must furnish the registrar with such information concerning its shareholders, directors, members, partners or senior employees as may be

required. Any change in the factual control of the administrator may only take place with the prior approval of the registrar.

- 60 While section 13B may not apply to service providers who do not provide administrative or investment services, we suggest that the guidelines contained in the board notice should be considered when a board engages any service providers. We therefore recommend that all contracts with service providers be in writing and contain the provisions as set out in clause 60 above with whatever changes are appropriate to the particular service provider.

Factors trustees should consider when appointing service providers

- 61 In order to comply with their fiduciary duties, the trustees decision to appoint service providers to the fund must be made in the exclusive interests of the fund.
- 62 Many retirement fund service providers offer a ‘one stop shop’ alternative to clients. This entails that in addition to the day to day administration of the retirement fund, the same company will provide consulting, investment, actuarial, trust and even insurance services to the fund. While the different services will be housed in different divisions within the company, in effect, all the services are provided by one company. The problem with this approach is the conflict of interest that will arise due to a lack of independence between the different service providers.
- 63 It is not necessary for a board to accept the ‘one stop shop’ alternative. It may be in the fund’s interests for the trustees to procure independent service providers for the various services that a retirement fund requires. This will enable the trustees to mitigate against the potential conflict of interest that may arise.
- 64 It is also common in the industry for the board to appoint a company to render consultancy services to the fund and this consultant will then be responsible for

choosing and appointing all the other service providers to the fund. Where the consultant is employed by an entity that renders the 'one stop shop' alternative he/she will often proceed to appoint different divisions of the 'one stop shop' company as the service providers to the fund. For example of this being that XYZ Consultants will proceed to appoint XYZ actuaries, XYZ administrators and XYZ investment managers to the fund.

- 65 These appointments are often made without the board's sanction and approval and trustees are often of the mistaken view that these appointments are the prerogative of the consultant and that there is no requirement or room for input from the board.
- 66 The board should be aware that these appointments are not only the prerogative of the trustees but it is part of the trustees' fiduciary duties to ensure that these appointments are made in the best interests of the fund. The board should therefore be wary of allowing an appointed service provider to appoint further service providers without input and approval from the board.
- 67 A service provider may assist the trustees in terms of obtaining tenders from various contenders and managing the appointment process but it is for the board of trustees to apply their minds to the various contenders and make a decision on which service provider to appoint.
- 68 Essentially the trustees should exercise an independent discretion because the appointment of service providers to the fund is a decision that is solely at the discretion of the board of trustees of the fund and trustees should be loath to abdicate this responsibility.

How do trustees legally regulate the fund's relationship with a service provider

- 69 The legal relationship between trustees and service providers is contractual in nature.

- 70 A contract is an agreement entered into between two or more parties whereby they voluntarily agree to bind themselves to various terms that they have included in the contract. Usually these terms would contain a duty on one party to perform tasks, with a correlative right to another party who may enforce this duty.
- 71 These contracts require that in return for remuneration, service providers are under a duty to perform the tasks that they are required to in terms of the contract. The contract should be specific about the standard of service that is required from the service provider. Attached as annexure “**A**” to this paper is an example of two clauses setting out the duties of a service provider to render services to the fund. We are of the view that option 1 is an inappropriate clause as it will not sufficiently protect the fund’s interests whereas option 2 is a clause that protects the fund’s interests to a greater degree.
- 72 The parties to the contract will only be bound by terms that have been agreed upon as contained in the contract. There must be agreement (consensus) between the parties that they will be bound by the terms of the contract. Once a contract is validly entered into the board will have a right to enforce a service provider’s obligation to perform in terms of the contract.
- 73 The board should seek to include terms in the contract that ensure that the relationship is to the fund’s advantage even if they may be onerous to the service provider. These would be clauses that relate to the monitoring of service provider performance and penalties for poor performance. Examples of the possible content of such clauses are:
- 73.1 Requiring a benefit administrator to make payment of benefits within a stipulated time period and failure on the part of the administrator to comply with the time period will result in a penalty being attached requiring the administrator to pay a punitive amount to the member.

- 73.2 Clearly stipulating in the contract that any loss suffered by the fund or any member as a result of an error on the part of the administrator will be payable by the administrator.
- 73.3 Requiring a valuator to prepare and lodge the fund's valuation report within the time required by the Financial Services Board ("FSB"). Failure to do so will result in a penalty for the valuator in the form of a reduction in fee payable for the service;
- 73.4 Agreeing on a benchmark of performance with an investment manager. Failure on the part of the investment manager to achieve the benchmark will result in a penalty in respect of the fee payable by the fund to the administrator.
- 73.5 Stipulating that the risk of poor investment performance will be apportioned between the member, employer and the service provider. This will assist in alleviating the detrimental effects that member's will face where there may be adverse performance by a fund.
- 74 The board should be wary of entering into contracts with service providers that do not make provision for onerous clauses that seek to protect the fund's interests.
- 75 Parties will only be bound by terms in a contract if the terms are certain or ascertainable. Where a contract contains terms that provide mechanisms to monitor service provider performance and where penalties for poor performance are provided, trustees should be careful to ensure that the clauses are unambiguous, since uncertainty may lead to that clause being unenforceable or being enforced in a manner that the parties did not contemplate.
- 76 The board should enlist legal assistance in drafting and considering the contract that the board signs with the service provider. Often service providers

will provide the board with a standard contract that will govern the relationship between the fund and the service provider. It is common for such contracts to be drafted in a manner that is advantageous to the service provider and trustees in order to act in the best interests of the fund should always seek independent legal advice on the terms of the standard contract. This will enable the trustees to identify onerous clauses that may not be to the advantage of the fund and that attach too little liability on the part of the service provider. This will also provide trustees with an opportunity to tailor make the contract so as to incorporate tight monitoring and performance requirements into the contract.

Monitoring of service providers and ensuring compliance

- 77 It is essential that the board in order to comply with their fiduciary duties monitor the performance of all service providers appointed to the fund. The means by which trustees may do this is to agree on benchmarks that will assess the service provider's performance. These benchmarks must be set out in the contract entered into with the service provider.
- 78 Mechanisms must be put in place to monitor whether service providers are compliant with applicable regulations and rules, these may be contained within the fund's rules, legislation, FSB rules and guidelines and taxation requirements.
- 79 Monitoring mechanisms must be consistently utilised to ensure that the board complies with its fiduciary duties. The form that monitoring mechanisms could take is:
- 79.1 Requiring service providers to provide the board with regular written reports on tasks performed during pre-determined periods.
- 79.2 Requiring extensive communication exercises with trustees in respect of decisions and course of action adopted in respect of the investment strategy of the fund. In cases where the board may be unsure of which

route to adopt trustees should be entitled to obtain independent third party verification of advice received from a service provider.

79.3 Clauses that expressly provide that the board will have recourse where there has been non-compliance by service providers or defective performance of tasks by service providers. Examples of these being where an administrator fails to process and pay claims to members within the stipulated period or where an investment manager has failed to grow the fund's assets or has lost a significant portion of the fund's assets.²⁸

80 A difficulty faced by many funds is that often the board does not interact with all the service providers that have been appointed. This is often the result of a 'one stop shop' scenario where one service provider has appointed all the others. The board then does not have direct contact with all the service providers and is often unaware of whether the service provider is performing as the board depends on the one service provider to manage the others and monitor their performance. Where the service providers are all part of one entity there may exist significant conflicts of interest and it is unlikely that one division of the same company will provide the board with a critical and objective report of the other division's performance

81 It is not advisable for boards of funds to condone such a scenario because it is the trustees' fiduciary duty to ensure that service providers are acting in a manner that is in the best interests of the fund, a board cannot leave the monitoring of service providers to a third party.

82 It is acknowledged that often the board will not be in a position to assess a service provider's performance due to lack of skill or resources. It is suggested that in such circumstances the board compel service providers to produce

²⁸The difficulty with monitoring investment managers is that a distinction will have to be drawn between poor performance that is as a result of the investment manager's performance or as a result of the poor performance of the market generally.

progress reports and employ the assistance of a third party to periodically audit the performance of these service providers.

- 83 Where trustees are successful in monitoring a service provider's performance it is essential that trustees are able to act when a service provider acts in a manner contrary to its obligations. Often trustees are unaware and do not enforce the terms of the contract and the penalties provided for in the contract against a service provider when necessary. Trustees should endeavour to understand the provisions of the contract and be in a position to enforce the contracts when necessary.
- 84 Service providers may commit a breach of contract where they fail to perform in a manner required by the terms of the contract or perform in a manner that is defective in that the performance is below the standard agreed upon.
- 85 In such circumstances the board must implement the remedies available to the board as contained in the contract. These remedies may be cancelling the contract requiring the service provider to perform the task as contractually required to and recovering damages (compensation) for the loss that the fund suffered as a result of the service provider's breach and enforcing penalties that are contractually provided for.

Conflict of interest

86 Duty to avoid a conflict of interest

86.1 Trustees in the exercise of any of their duties must so far as possible avoid a position where private interest conflicts with his or her duty as a trustee. Competing interests could be personal or to a third party.²⁹

86.2 The general principle as stated by Innes CJ in *Robinson v Randfontein Estates Gold Mining Co Ltd*³⁰ is that where one man stands to another in

²⁹Honoré, op. Cit. p 315.

³⁰1921 AD 168 at 177.

a position of confidence involving a duty to protect the interest of that other, he is not allowed to place himself in a position where his interests conflict with his duty.

86.3 In *Bellairs v Hodnett and another*³¹ the Appeal Court held that a man in a fiduciary relationship is not allowed to place himself in a position where his own interests and his fiduciary duties come into conflict. The Appeal Court also held that application of the principle does not depend on proof of subjective bad faith or dishonesty and that proof of honest intention is no defence.

86.4 The crux of the fiduciary duty requires trustees to act in the exclusive interest of the fund and its members and not utilise their powers other than for the purpose for which it was conferred. This means that trustees cannot use their powers to further their own interests or the interests of any third party. Within the service provider relationship a possible area where trustees may experience a conflict of interest are:

86.4.1 Independent trustees appointed by service providers to the fund. These trustees may be placed in a conflict as a result of their position as trustee as well as their duties and loyalty owed to the service provider as their employer.

86.4.2 While not documented, it is perceived to be common within the retirement fund industry that trustees are given rewards in cash and kind by service providers to ensure that these trustees have an incentive to persuade the board to continue to use the services of a particular service provider. Such conduct obviously creates a conflict of interest and a violation of a trustee's fiduciary duty.

86.5 Trustees are under a duty to utilise their powers for the benefit of and in the exclusive interest of the fund and its members. Whenever there is a

divergence between the funds' interests and those of the service provider the legal duty of trustees is clear, they are obliged to act in the interests of the fund and its members.

Governance

- 87 The second report of the King committee was published on 26 March 2002. The report contains a code of corporate practices and conduct, which sets out the committee's principal findings and requirements for good corporate governance.
- 88 The code lists the types of entities to which it applies. Banks, financial and insurance entities as defined in various legislation regulating the South African financial services sector are included as entities that the code applies to. We are of the view that the code applies to pension funds.
- 89 The nature and object of pension funds, the significant quantum of assets that funds hold and the catastrophic consequence that the loss or depletion of funds' assets would have are all factors which indicate that corporate governance is important for funds. Good corporate governance also holds a benefit for funds as the implementation of good corporate governance will encourage trustees to appoint and monitor service providers in a manner that is compliant with the board's fiduciary duties.
- 90 Trustees of a pension fund must acquire the basic knowledge and understanding of the business of a pension fund and the risks to which the fund is exposed.
- 91 Practices set out in the code that are important for funds to have regard to in the appointment and management of service providers are that trustees should:

³¹1978 (1) SA 1109 (A).

- 91.1 Be aware that they are ultimately responsible and accountable for the affairs of the fund. Delegating authority in any way does not mitigate or dissipate the discharge by the board of their duties and responsibilities.
- 91.2 Retain full and effective control over the fund and monitor implementation of fund plans and strategies.
- 91.3 Ensure that the fund and service providers comply with all relevant laws, regulations and codes of conduct.
- 91.4 Reserve specific powers to the board and delegate matters to service providers with the necessary written authority. These matters must then be monitored by the trustees and evaluated on a regular basis.
- 91.5 Develop a code of conduct that addresses the management of conflicts of interest and should be regularly monitored and updated as and when necessary.
- 91.6 Have a procedure whereby they may, if necessary, take independent professional advice at the fund's expense.
- 91.7 Develop a charter setting out their responsibilities that should be disclosed in the fund's annual report, alternatively, forwarded to members with communication material.
- 91.8 Arrange for incoming trustees to undergo a formal orientation programme to ensure that they are familiarised with their fiduciary duties, responsibilities and liabilities. Trustees should continuously receive continuing education on developments in the industry.

Remedies available for trustees' breach of duty

- 92 Where trustees fail in their duties, there are mechanisms that will allow the fund or members to take action against the trustees in their individual capacity or collectively. Some of the available remedies are set out below.

Civil litigation

93 Trustees may be sued for failure to carry out their duties properly. A delictual action may be brought against the trustees for the payment of damages for the loss suffered as a result of the trustees' breach. This action will be available either where the trustee's breach is a result of an intentional breach or as a result of negligence.

The Pension Funds Adjudicator

94 The Pensions Act makes provision for the establishment of the office of the Adjudicator. 'Complaints' are defined in the Pensions Act as complaints relating to the administration of a fund, the investment of its funds or the interpretation and application of the fund's rules where the complainant alleges, among other things, that a decision of the fund or any person purportedly taken in terms of the rules was in excess of the powers of that fund or person, or an improper exercise of its powers. Complaints against trustees of a fund can therefore be lodged when it is alleged that the trustees acted in excess of or contrary to their powers. A determination handed down by the Adjudicator has the same status and can be enforced in the same way as a decision of a civil court.

Criminal Remedies

95 Section 37 of the Pensions Act sets out penalties applicable to contraventions and failures to comply with particular sections of the Pensions Act. The relevant provisions of the section are as follows:

"Any person who-

- (a) contravenes or fails to comply with the provisions of section 9, 9A, 13A, 13B or 35³²; or
- (b) fails to make a return or transmit or deposit a scheme, report, account, statement or other document when required to do so in terms of this Act; or
- (c) contravenes the provisions of section nineteen³³ or any condition on which he has been exempted from those provisions; or
- (d) fails or refuses to furnish information, or produce documents or accounts, or render other assistance to the registrar when called upon to do so in terms of this Act; or
- (e) after the expiration of a period of six months from the commencement of this Act, induces or attempts to induce any person to become a member of, or to contribute to a fund not registered under this Act; or
- (f) contravenes or fails to comply with the provisions of section 10, 31, or 32A (2) or (4),³⁴

³²Sections 9 and 9A set out the obligations on a fund relating to the appointment of an auditor and a valuator.

Section 13A sets out the obligations relating to payment of contributions to a fund and monitoring the payment of contributions.

Section 13B sets out the restrictions and requirements relating to entities that are authorised to administer pension funds.

Section 35 sets out the documents that members of a fund are entitled to have copies of and sight of.

³³Section 19 sets out the requirements relating to a fund's investments.

³⁴Section 10 sets out the restrictions relating to the business that a fund may carry out. Section 31 sets out the restrictions relating to the carrying on of the business of a pension fund.

shall be guilty of an offence, and liable on conviction-

- (i) in the case of an offence referred to in paragraph (a) to a fine not exceeding R2 000;
- (ii) in the case of an offence referred to in paragraph (b) or (c) to a fine not exceeding R500;
- (iii) in the case of an offence referred to in paragraph (d) or (e) to a fine not exceeding R1 000; and
- (iv) in the case of an offence referred to in paragraph (f) to a fine not exceeding R1 000 or, if the offender is an individual, to imprisonment for a period not exceeding twelve months, or to both such fine and such imprisonment.”

96 Trustees who have acted in contravention of any of the listed sections in the Pensions Act may therefore be convicted and a sanction may be imposed as set out in the Pensions Act.

97 Section 10 of the FI Act provides that a person who contravenes or fails to comply with any provision of the FI Act will be guilty of an offence and on conviction liable to a fine or imprisonment for a period not exceeding 15 years. In addition, a court may order that the convicted person pay the aggrieved party any profit that may have been made and compensate the aggrieved party for any damage suffered as a result of the contravention or failure. Further, a court may also order that the convicted person may not serve as a director, member,

Section 32A (2) provides that pension funds shall not after the expiry of 21 days of notice in the gazette employ any practice or method of conducting business which has been declared to be undesirable or irregular.

Section 32A (4) provides the time period within which a pension fund must rectify what it has been requested to.

partner or manager of any financial institution for such period as the court may deem fit. These provisions are applicable to service providers who fall within the definition of “financial institution” discussed earlier in this paper and trustees of pension funds.

Statutory Remedies

98 Section 5 of the FI Act makes provision for the registrar,³⁵ on good cause shown, to apply to the High Court for the appointment of a curator to take control of, and to manage the whole or any part of the business of an institution.³⁶ This is not a remedy available directly to a member but will be dependent on the registrar bringing an application to court requesting that the fund be placed under curatorship. This remedy is advantageous to members in that the fund’s assets will be protected and removed from the trustees control where necessary. A beneficiary will be able to approach the registrar to take the appropriate action where there are suspicions of a serious breach of fiduciary duties by trustees.

Conclusion and way forward

99 The appointment of competent service providers to a fund is essential, as it is unlikely that trustees will be able to fulfil the needs of a fund to ensure the efficient management of the fund.

³⁵ ‘registrar’ is defined in the FI Act as:

“the registrar as defined in any of the Acts referred to in paragraph (a) of the definition of ‘financial institution’ in section 1 of the Financial Services Board Act, 1990;
the executive officer as defined in section 1 of the FSB Act; or
the registrar of medical schemes referred to in section 1 of the Medical Schemes Act, 1998.”

³⁶ ‘Institution’ is defined in the FI Act as:

“a financial institution;
any person, partnership, company or trust in which, or in the business of which, a financial institution or an unregistered person has or had a direct or indirect interest;
any person, partnership, company or trust which has or had a direct or indirect interest in a financial institution or unregistered person, or in the business of a financial institution or an unregistered person;
a participating employer in a pension fund organisation;
any person, partnership, company or trust that controls, manages or administers the affairs or part of the affairs of a financial institution or an unregistered person; or any unregistered person.”

- 100 The appointment and management of service providers to a fund is the prerogative and duty of the board. These duties must be exercised in accordance with the trustees' fiduciary duties. Onerous obligations are therefore placed on trustees in this regard and trustees may not absolve themselves of this responsibility when delegating these functions to external service providers.
- 101 Boards must ensure that they take responsibility for the management of the fund and are accountable for the manner in which the fund is managed. In so doing boards must be actively involved in the appointment, management and monitoring of service providers.
- 102 It is suggested that boards develop and implement codes of conduct that comply with best corporate governance practices as this will assist trustees in appointing, managing and monitoring service providers in an effective and transparent manner.
- 103 Trustees must ensure that their conduct in appointing and monitoring of service providers is in accordance with the standard of care expected in terms of their fiduciary duty. In doing so, it is likely that trustees will place themselves in a position where they are accountable to members with regard to all aspects of fund management and particularly the management of service providers.

ANNEXURE A

Duties of the service provider

Option 1

[The service provider] undertakes to perform its obligations under this agreement in an acceptable manner.

Option 2

1. [The service provider] acknowledges the statutory functions and duties of the board of trustees and the obligations applicable to the board of trustees in terms of the fund's rules. The service provider undertakes to perform its obligations under this agreement in a manner that will not in any way detract from the statutory functions and duties of the trustees.
2. [The service provider] undertakes to:
 - 2.1 carry out all duties and render such services that are assigned to them from time to time;
 - 2.2 devote their energy, skill and ability to rendering the services to the fund;
 - 2.3 observe the utmost good faith towards the fund and its members and the highest standards of corporate ethics;
 - 2.4 not behave in a manner detrimental to the reputation of the fund and the board of trustees;
3. [The service provider] may not without the prior written approval of the board of trustees of the fund, derive any benefit other than in terms of

this contract from any dealing of the fund or any dealings of any entity in which the fund has an interest.

4. [The service provider] must in rendering the services-
 - 4.1 report to the board of trustees of the fund [insert periodic period in which reports are required] on the [insert applicable area that requires monitoring];
 - 4.2 observe and comply with all resolutions and directives from time to time made or given by the board of trustees of the fund; and
 - 4.3 use their best endeavours to properly conduct, improve, extend, develop, promote, protect and preserve the interests of the fund and its members.

IMPORTANT NOTE: The above clause is drafted simply to illustrate the type of issues that could be included in such a clause. The clause should not be used as a precedent without considering all the specific circumstances of the fund and the particular service provider.