

# **Retirement Funds and their investment consultants and asset managers: risks, risk management tools and remedies**

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## Outline:

- Legal framework within which funds' relationships with their investment consultants and asset managers operate;
- Extent to which framework protects funds from the exploitation of conflicts between interests and duties;
- What boards of funds can do now to minimise their risks.

## Legal framework:

- Funds are not-for-profit organisations;
- The objective of retirement fund investments is to secure for each member a retirement income which is reasonable when regard is had to –
  - His or her pre-retirement income;
  - The period of his or her membership;
  - Contributions made in respect of him or her during that period.
- Members of boards are not expected to be investment experts, so –
  - They should take expert advice; and
  - They are entitled to delegate investment management work to experts subject to appropriate limitations.

## Problems facing boards:

- Information asymmetry / information inequity; and
- Small market with many disclosed or undisclosed relationships between product and service providers, allowing opportunities for the exploitation of conflicts between duties and interests.

‘It is almost impossible to identify a group of professional fee-charging advisers because the sources of revenue to investment advisers have become so diversified that it is difficult to describe coherently the services that they provide to their customers. More importantly, perhaps is the question of the independence of the advice that they give.

Rusconi, 2008.

## The role of the investment adviser:

- Broker / adviser is obliged to act in the best interests of the client alone;
- Broker / adviser must ascertain the needs of the client and seek to find the best products or services to meet those needs;
- Must be able to explain the basis for the recommendation.

It is 'generally, if not always, humanly impossible for a person to act fairly in two capacities and on behalf of two interests in the same transaction . . . If one of the interests involved is that of the trustee personally, selfishness is apt to lead him to give himself an advantage.'

Bogert & Bogert said in their book *The Law of Trusts and Trustees*

'A man must not put himself in a position where duty and [personal] interest conflict or where his duty to one conflicts with his duty to another unless expressly authorised'.

*Re Thompson's Settlement* [1986] (UK)

‘It is sadly the high commissions which often leads to poor judgment on the part of those offering members of public advice, the consequences of which are, regrettably, for the consumer to bear. The level of skill which members of the public are entitled to expect of a licensed financial advisor is consistent with that of any professional who provides due care, skill and diligence to his work. This is in line with the twin objectives of the FAIS Act and that is the protection of the consumer and the upholding of the integrity of the financial services industry.’

*CJ du Plessis & another v Wilma Willemse & another*, a determination of the FAIS Ombud dated 18 August 2006

‘The broader the activity-range of financial firms in the presence of imperfect information,

- (1) the greater the likelihood that the firm will encounter potential conflicts of interest; and
- (2) the higher will be the potential agency costs facing clients; and
- (3) the more difficult and costly will be the internal and external safeguards necessary to prevent the exploitation of the clients in the interests of the financial firm.’

Walter Ingo ‘*Conflicts of Interest and Market Discipline Among Financial Services Firms*’  
October 2003

Proposal that the law be amended to –

- Require intermediaries to declare themselves to prospective policyholders as either –
  - Agents of insurers (whether ‘tied’ or ‘independent’) who will be remunerated by the insurer if the policies are purchased; or
  - Independent financial advisers that will be remunerated by policyholders for the advice either by direct payment or authorised deductions from the proceeds of their investment in the policies,
- Require intermediaries to choose which of these they are in relation to all their clients;
- Allow only independent financial advisers of the latter kind to call themselves ‘advisers’;
- Improve the standard of investment advice given to members of the public through higher standards of intermediary education and implementing a system of accreditation.

*‘Contractual Savings in the Life Insurance Industry’*, a discussion paper issued by the National Treasury in 2006.

## The Role of the Asset Manager

‘The **principal** bargains for the disinterested skill, diligence and zeal of the **agent** for his own exclusive benefit, confident that he will act with a sole regard for the interests of the principal . . . . He must, while holding the position of trust and confident, prefer the interests of his principal even to his own in a case of conflict and to his skill, diligence and zeal must be added the utmost good faith.’

Mason J in *Transvaal Cold Storage v Palmer* 1904 TS 3 at 33

**‘A director, member, partner, official, employee or agent of a financial institution or of a nominee company who invests, holds, keeps in safe custody, controls, administers or alienates any funds of a financial institution [including a retirement fund] or any trust property [including retirement fund assets] –**

- must, with regard to such funds, observe the utmost good faith and exercise proper care and diligence;**
- must, with regard to the trust property and the terms of the . . . agreement by which the . . . 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 duties;**
- may not . . . make use of the funds . . . 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.’**

Section 2, Financial Institutions (Protection of Funds) Act, 2001.

**Ways in which ‘information inequity’ and excess of power can be exploited to the prejudice of client funds**

- ‘Front-running’;
- ‘Ramping’;
- ‘Market timing’;
- ‘Late trading’; and
- ?

## Conclusion: What should be done ?

- Law should be amended to require improved disclosure in a manner that will allow proper comparisons;
- Funds should amalgamate to improve their bargaining power;
- When selecting advisers and asset managers, funds should –
  - Engage in ‘due diligence’ exercises;
  - Conclude more comprehensive agreements with advisers and asset managers including appropriate warranties and other safeguards including provisions for regular disclosure and assessment;
  - Appoint stock-brokers and custodians themselves;
  - Determine their own investment policies and strategies including proxy voting policies.