

## “Prudence is process, not performance”<sup>1</sup>

### Legal issues associated with retirement fund investments

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#### Introduction

I have been asked to speak to you today about legal issues in relation to the investment of occupational retirement fund investments.

Let me first make one disclaimer: I am no investments expert. I know very little about asset-liability matching and how different asset classes can be expected to perform in different circumstances. For this reason I have a lot of sympathy for trustees who are, I imagine, in the main, ordinary ignorant people like me. And I think that it is fair to say that courts worldwide<sup>2</sup> and certainly our erstwhile adjudicator<sup>3</sup>, have allowed and will continue to allow trustees a fairly wide margin of error because they recognize that retirement fund trustees are generally doing the best that they can with what little knowledge that they have.

But let's start with the basics because if trustees, in making fund investment decisions, violate the basic rules, very few people, and no courts, will have sympathy with them.

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<sup>1</sup> Gillesse, E. Fiduciary responsibility – a regulator's viewpoint” *The Pensions Commission of Ontario Bulletin*, Summer 1995.

<sup>2</sup> See, for example, the judgment in *Stark v United States Trust Company of New York* 445 F Supp 670 (1978) described in *Jones v AMP Perpetual Trustee Company New Zealand Ltd* [1994] 1 NZLR 690 as follows:

“. . . the Court said (at p678) that it is clear that a trustee is neither an insurer nor guarantor of the value of a trust's assets and that a trustee's performance is not to be judged by success or failure, that is, whether he or she was right or wrong. While negligence may result in liability, a mere error of judgment will not. Neither prophecy or prescience is expected of trustees and there performance must be judged, not by hindsight, by facts which existed at the time of the occurrence.”

<sup>3</sup> See, for example, *Hooley v Haggie Pension Fund & another* [2002] 1 BPLR 2939 (PFA) at which the adjudicator said:

“I am satisfied that the fund was not negligent in relation to the investment of its assets. As pointed out by the fund, it adopted a strategy pursuant to expert advice and which did not deviate to a significant extent from that adopted by numerous other funds which likewise were hit by the market crash of 1998. Furthermore the subsequent recovery of the equity market refutes the Complainant's contention that the trustees' investment strategy was imprudent.”

The authors of the *Mouton Report* in 1992 listed the duties of trustees in relation to fund investments as the duties -

- to invest for the benefit of both current and future beneficiaries;
- to exercise their powers of investment impartially between the different classes of members and beneficiaries, the employer/sponsor and other parties involved in the fund;
- to exercise utmost good faith in the investment and handling of the fund's monies;
- to "take such care as an ordinary prudent [person] would take if he [or she] were required to make an investment for other people for whom he [or she] felt morally bound to provide"<sup>4</sup>;
- to ensure that investments at all times fall within the laws and regulations;
- to ensure that the fund's investments are made within the terms of the fund's rules<sup>5</sup>;
- to ensure that the investments are made in a professional manner, by applying sound investment principles and with the necessary advice and expertise; and
- regularly to review the fund's investments and investment performance to ensure that the investment objectives of the fund are achieved and the interests of the fund's stakeholders are protected<sup>6</sup>.

In the US, the Employee Retirement Income Security Act (ERISA) requires that a fund fiduciary "discharge his duties with respect to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."<sup>7</sup> In relation to the making of an investment, a fiduciary will satisfy the requirement if he or she has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties and has acted accordingly. "Appropriate consideration" includes, but is not limited to, a decision by the fiduciary that a particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that part of the fund's portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. It also includes

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<sup>4</sup> See also Honore's *South African Law of Trusts*, 4<sup>th</sup> ed., *Sackville West v Nourse* 1925 AD 516, and *Durban Meat Security Association Pension Fund & others v Momentum Employee Benefits* [1999] 10 BPLR 127 (PFA).

<sup>5</sup> See Honore's *South African Law of Trusts*, 4<sup>th</sup> ed.

<sup>6</sup> *Mouton Report*. Annexure C3. "Draft Investment Guidelines for Retirement Funds". Paragraph 7(a) at page 446.

<sup>7</sup> Section 404(a)(1)(B).

consideration of the composition of the portfolio with regards to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the fund and the projected return of the portfolio relative to the funding objectives of the fund.<sup>8</sup>

This is an interesting elaboration of the standard of care that Paul Myners of the *Myners Review* (UK) recommends be legally required. Myners recommended that it be required by statute that, when trustees make a decision, they should be able to do it with the skill and prudence of someone familiar with the issues concerned.<sup>9</sup> This is higher standard than that identified in the *Goode Report*<sup>10</sup> and, as I say, is the standard required of trustees in the US in terms of the Employment Retirement Income Security Act<sup>11</sup>.

The UK government has indicated that it intends to legislate to enact the proposed new standard<sup>12</sup>. If trustees do not feel that they possess the required standard of expertise, they should, Myners says, delegate their decision-making power on the issue to someone whom they believe does<sup>13</sup> or take steps to acquire the expertise<sup>14</sup>. It will be interesting to see whether our new Retirement Funds Act contains similar provisions.

### **The Pension Funds Act and regulations**

Our governing statute, the Pension Funds Act, says very little about the duties of trustees in relation to investments. In essence, it says that a board of trustees must direct, control and oversee the operations of the fund and take all reasonable steps to ensure that the interests of the members in terms of the rules of the fund are protected at all times<sup>15</sup>. The Financial Institutions (Protection of Funds) Act puts things a little more strongly in that it requires all persons who invest, keep in safe custody, control or administer fund assets to observe the utmost

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<sup>8</sup> Section 404(a)(1)(B).

<sup>9</sup> *Myners Review*, paragraph 77 at page 14.

<sup>10</sup> The *Goode Report* (UK) says that the trustees of a fund must “exercise, in relation to all matters affecting the fund, the same degree of care and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide and to use such additional knowledge and skill as the trustee possesses or ought to possess by reason of the trustees’ profession, business or calling.” See paragraph 4.9.7 of the *Goode Report*.

<sup>11</sup> In the US, fund fiduciaries are required to discharge their duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims”. US Department of Labor, 44 *FR* 37225 26 Jun 1979.

<sup>12</sup> *Myners Review: Institutional Investment in the UK. The Government’s Response* HM Treasury and the Department for Work and Pensions.

<sup>13</sup> *Myners Review*, paragraph 77 at page 14.

<sup>14</sup> *Myners Review* “Recommendations” at page 21.

<sup>15</sup> Section 7C.

good faith and exercise proper care and diligence in doing so. It also prohibits these people from making use of the assets in a manner calculated to gain directly or indirectly any improper advantage for himself or any other person at the expense of the fund.<sup>16</sup> This, I venture to say, effectively prohibits trustees from procuring, for themselves or anyone else, commissions for the placement of fund insurance or investment business.

The Pension Funds Act then empowers the Minister of Finance to prescribe limits on the exposure of the fund to various asset classes. These regulations are currently quantitative: the regulations define the asset classes in which a fund may invest, prescribe *maxima* for each such asset class (and for certain combinations of asset classes such as “equities and property combined”), and prescribe a maximum on any single investment, a maximum on investment in the sponsoring employer, and a maximum on foreign investment<sup>17</sup>.

These limits are designed to achieve some diversification and dispersion, but they fail to guide the board of a fund which may make investments which are inappropriate in terms of the liabilities and objectives of the fund. The quantitative limits also exclude policies of insurance where these policies provide any form of guarantee.

This deficiency became apparent in the case of *van der Bergh v Anbeeco Pension Fund*<sup>18</sup>. In that case some R3m, or the whole of the assets of the fund were invested in an off-shore investment policy with a fixed period of five years which was due to expire in 2004. The employer company ceased to trade on 1 September 2001 and all of its staff were retrenched. Mr. van der Bergh was eligible for early retirement but the fund was unable to pay him the full amount of his commuted portion of his pension or any pension instalments because it did not have the liquid assets available for the purpose. The adjudicator found that the trustees appeared to have breached their duties in terms of section 7C of the Act by making the investment in the policy and

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<sup>16</sup> Section 2.

<sup>17</sup> The *maxima* are broadly the following:

- no more than 75% of a fund's assets may be invested in equities;
- no more than 25% in property;
- no more than 90% in a combination of equities and property;
- no more than 5% in the sponsoring employer, no more than 15% in a single “large capitalisation” listed equity;
- no more than 10% in any other single equity;
- no more than 20% with a single bank;
- no more than 15% off-shore; and
- no more than 2,5% in “other assets” including derivatives.

The Registrar has the power to exempt funds from some or all of these *maxima*.

<sup>18</sup> [2002] 3 BPLR 4111 (PFA). The interim ruling of the adjudicator may be found at <ftp://ftp.fsb.co.za/public/pfa/vdBergh.pdf> and the final ruling at <ftp://ftp.fsb.co.za/public/pfa/Bergh.pdf>. There is also an interim ruling in the related matter of *HC Orsmond & 20 others v Anbeeco Pension Fund* at <ftp://fsb.co.za/public/pfa/Orsmond.pdf>. In that interim ruling of September 2002 a host of parties, including the fund's actuaries and consultants, administrators, provisional liquidator and insurer were joined. It appears that the matter was not finalised before John Murphy left office in May 2003.

thereby making it impossible for the fund to discharge its obligations towards members in terms of its rules.

If the off-shore policy included some form of guarantee, the trustees of the fund may not have breached the investment regulations but, as John Murphy indicated, they may nonetheless have been in breach of their duties in terms of section 7C.

This case, then, neatly illustrates how little protection the current investment regulations provide. Another may be the case of the Joint Municipal Pension Fund which has lost one third of the value of its assets in speculation in maize futures when, according to the regulations, not more than 2,5% of the assets of the fund could have been exposed to this sort of activity. I understand that the FSB believes that the fund gave WJ Morgan an open mandate whereas the fund says that it did not and WJ Morgan simply breached the mandate that it had been given. The facts, when they are finally established, should prove instructive to trustees in the future.

What is evident is that the regulations themselves do not provide funds with adequate protection and in any event may be honoured in the breach.

In these circumstances it may be reasonable to expect our regulator to call for stricter limits on fund investments. Instead the FSB has drafted new regulations which are intended to replace the current prescribed maxima with a prescribed methodology for determining an investment strategy which should provide a better guide to trustees. The FSB's thinking appears to be this:

Over the past few years the investment opportunities that have become available to retirement funds have become more complicated in the context of the introduction of derivatives, structured products and foreign investments. The exclusion of insurance policies incorporating a (perhaps meaningless) guarantee defeats the purpose of the regulation which is to guard funds against imprudent investment decision-making. The current regulation does not, itself, provide much guidance to trustees as to how to go about deciding what they should do, in the circumstances facing the fund, to achieve the fund's investment objectives. It also does not require any independent verification of the soundness of the investment strategy adopted. The regulation allows up to 100% of a fund's assets to be invested in fixed-interest stock, which may be entirely inappropriate. On the other hand, it allows what could be an excessive exposure or an under-exposure to equities, depending upon the fund's circumstances. The "one size fits all" approach reflected by the regulation encourages a uniformity of approach amongst fund investment managers despite the fact that funds have differences that should be reflected in different

investment strategies. Derivatives and structured products which may be assist funds in proper asset-liability matching are unduly restricted<sup>19</sup>.

The *Mouton Report* simply recommended that funds continue to invest their assets with due regard for their security, expected returns and marketability<sup>20</sup>. It also recommended the development of Investment Guidelines to be made available to all trustees<sup>21</sup>. This is consistent with the view expressed in the *Myners Review* that regulation can be a blunt instrument when used to compel funds to behave in a desired way. *Myners* recommends instead a good practice model, backed up with minimum disclosure requirements. In particular, pension fund trustees should be required annually to set out in writing what they are doing to comply with each of the principles proposed in the good practice model<sup>22</sup> and, if they chose not to comply with a principle, why they do<sup>23</sup>. This should promote a culture of justification to stakeholders<sup>24</sup>.

In 1999 the Pension Funds Advisory Committee established a sub-committee led by the Financial Services Boards' chief actuary and, after consulting major stakeholders and retirement practitioners, including the Actuarial Society of South Africa, Business South Africa, COSATU, FEDUSA, the Institute of Pensions Consultants and Administrators, the Institute of Retirement Funds, the Pensions Lawyers Association and the SA Institute of Chartered Accountants, it submitted a draft new regulation 28 for consideration by the Minister of Finance.

The new prudential regulations propose a combination<sup>25</sup> of a "prudent expert" measure and quantitative measures: boards must establish an investment strategy with expert assistance

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<sup>19</sup> These views are drawn from various sources and are captured in a draft research report prepared by Jeremy Andrew.

<sup>20</sup> *Mouton Report*. Executive Summary, paragraph 3.7(c) at page 16.

<sup>21</sup> *Mouton Report*. Paragraph 29.4 at page 225, paragraph 32 at page 240 and Annexure C3.

<sup>22</sup> The proposed principles for defined benefit funds can be found at page 148 and 150 respectively of the *Myners Review*.

<sup>23</sup> *Myners Review* paragraphs 84 and 85 on pages 15 and 16.

<sup>24</sup> *Myners Review*, paragraphs 85 and 86.

<sup>25</sup> The proposed new regulation 28, if promulgated, would require the trustees of each fund other than a retirement annuity fund or a preservation fund to invest the fund's assets in accordance with an investment strategy. In determining the strategy the trustees, if they did not have sufficient expertise themselves, would be required to consult experts. They would also be required to take into account the objectives of stakeholders, the nature and term of the fund's liabilities, the funding methods used by the fund and the risks to which the assets and liabilities of the fund will be exposed. The strategy would have to be documented and make explicit what percentages of the fair value of the assets of the fund may be invested in various classes and categories of asset and what discretion the fund's investment manager or managers will have to deviate from these percentages with or without the consent of the board. The strategy would be required to include the criteria by which investment managers would be selected and the manner in which and the frequency with which their performance would be assessed. The trustees and their advisors would be required to disclose any actual or potential conflict between their duties to the fund and their interests in the appointment of the investment managers and any benefit that they or their employers may derive from the appointment.

The fund's valuator would be required to state whether or not he or she is satisfied that the fund's investment strategy is consistent with the fund's objectives and will result in an appropriate relationship between the fund's assets and its liabilities. An appropriately qualified person would have to be appointed as compliance officer to report to the Registrar at

(taking account of the characteristics of the particular fund), implement the strategy, monitor performance and periodically review the strategy, with quantitative limits confined to:

- investment in the sponsoring employer;
- any single investment; and
- the total amount invested outside South Africa (a limit which is periodically reviewed by the National Treasury in consultation with the South African Reserve Bank).

The actuary must confirm the suitability of the strategy to the fund, taking account of issues such as asset / liability matching. The board must inform members of the strategy and any changes to it.

You may ask why I am spending so much time on draft regulations that have been awaiting the Minister's approval for some three years.

Well, work has begun on the drafting of a new Retirement Funds Act and it is likely that the new draft regulation will be incorporated in it. In any event, it is arguable that the standards sought to be imposed by the draft regulation are already the standards by which the trustees of a fund will be

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least once a year on the fund's compliance with the regulation. A summary of the compliance officer's report would have to be communicated to the fund's members in an appropriate form.

If a fund invests in a collective investment scheme or a policy of insurance, the proposed new regulation would require that the trustees of the fund select the scheme or investment portfolio offered by the insurer that will best satisfy the demands of the fund's strategy.

At least once per year and whenever there was or was likely to be a material change to the fund – such as a significant change in the fund's membership, benefit structure, asset or liability values, or transfer from or to the fund – the trustees would be required to review their investment strategy.

The Registrar of Pension Funds would be empowered to exempt funds from any of the provisions of the regulation on such conditions as he or she may impose.

Not all investment limitations would be eliminated by the regulation. Funds would still be prohibited from investing more than 5% of the fair value of the funds' assets in the quoted share of a listed company with a market capitalisation of R2 billion or more than 5% in the shares of or a loan to the funds' sponsoring employers or more than 2,5% in any other single investment. Off-shore investments would still be subject to foreign exchange limitations imposed by the SA Reserve Bank. Investments which would be excluded from the limitations would be bills, bonds or securities issued or guaranteed by, or loans to or guaranteed by, the Government of the Republic, insurance policies issued by insurers registered in terms of the Long-term Insurance Act, 1998, provided that the underlying assets backing such insurance policies were subject to limits at least as strict as the limits in the regulation and investments in collective investment schemes regulated in terms of the Collective Investments Scheme Act if the assets held by the collective investment schemes were subject to limits at least as strict as the limits in the regulation. If an insurance policy were not exempt from the limits in the regulation, the long-term insurer which issued it would be required to provide the board of the fund with the split between classes of asset in which all the policies within the same class, or sub-class of business, are invested, and a schedule of any assets which exceed the limits in the regulation as if the policy owned a share of such assets in the proportion that the value of the policy bore to the value of all policies within the same class, or sub-class, of business. Where a collective investment scheme was not subject to limits at least as strict as the limits in the regulation, the collective investment scheme would be required to provide the board of the fund with the split between classes of asset in which the scheme has invested, and a schedule of any assets which exceed the limits in the regulation, as if the fund owned a share of such assets in the proportion that the fair value of the share of the scheme belonging to the fund bears to the total fair value of the scheme.

judged in terms of common law.

An ex-South African judge of the English High Court, Hoffmann J (as he then was) said in his 1993 judgment in *Nestle v National Westminster Bank plc*<sup>26</sup> that -

“Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasizes the risk level of the entire portfolio rather than the risk attaching to each investment decision taken in isolation.”

In that case the beneficiary of a trust sought compensation from a bank which had been responsible for the investments of the trust. Wrongly believing that it was not empowered in terms of the trust deed to dispose of the trust’s banking and insurance shares, the bank did not diversify the trust’s investments in equities as the beneficiary thought that it should have done. The plaintiff pointed out that the index of leading equity shares had increased by 659% between 1922 and 1960 whereas the trust’s equities had increased only by 419%. The court held that, although the bank had failed in its duties properly to appreciate its powers under the trust deed and had not regularly reviewed its investments, the plaintiff had failed to prove any loss.<sup>27</sup> A comparison with the equities index was inapposite because it was calculated by reference to the performance of leading equity shares and the composition of the list changed with the companies’ fortunes. This could not be a measure against which the performance of the ordinary prudent trustee could be assessed. Although a trustee is required to act prudently, he or she will not incur liability for a decision made on the wrong grounds or for an untenable reason if it subsequently appears that there were good grounds for the decision<sup>28</sup>. In the Nestle case, although the bank was wrong in failing to appreciate that it had the power to invest a greater proportion of the trust’s assets in equities, in hindsight it would have been prudent to desist from investing more in equities because the trust was sufficiently exposed to them through the banking and insurance shares.

<sup>26</sup> The plaintiff’s appeal was dismissed by the court of appeal. See *Nestle v National Westminster Bank plc* [1994] 1 *All ER* 118 (CA).

<sup>27</sup> The same problem faced the plaintiffs in *Bierworth v Donovan* (US) F 2<sup>nd</sup> 263 (2d Cir) cert denied; 459 US 1069 (1982). The US Department of Labor sued the trustees of the Grumman aircraft pension fund for buying shares in the parent company in order to help fend off the acquisition of the company by Lockheed. By the time the matter came to trial, the value of the shares had increased to such an extent that no loss by the fund could be demonstrated. See also *Twerefo v Liberty Life Association of SA Ltd & others* [2000] 12 *BPLR* 1437 (PFA).

<sup>28</sup> In this regard judges Dillon, Staughton and Leggat LJJ relied upon the statement by Megarry V-C in *Cowan v Scargill* [1984] 2 *All ER* 750 at 766, [1985] *Ch* 270 at 294:

“If trustees make a decision on wholly wrong grounds, and yet it subsequently appears, from matters which they did not express or refer to, that there are in fact good and sufficient reasons for supporting their decision, then I do not think that they would incur any liability for having decided the matter on erroneous grounds; for the decision itself was right.”

These views of the “prudent trustee” and “portfolio theory” are views that inform the new draft regulation.

What the new draft regulation does not reflect, and what it perhaps should reflect, is the modern demand that funds “actively” invest their assets.

### **Activist investing**

In its 2002 report the Taylor Committee<sup>29</sup> recommended that trustees, or their agents, be required to be active investors on behalf of their funds. This means that they should monitor the corporate governance of the companies in which they invest and exercise the votes attaching to their shares. If the funds are sufficiently large, they may enjoy representation on the boards of those companies<sup>30</sup>. The *Myners Review* (UK) says that it is concerned by the value lost to institutional investors through the reluctance of fund managers actively to engage with companies in which they have holdings, even when they have reservations about potential causes of under-performance. It recommends that the active investing mandates are included in fund management mandates and are required by law<sup>31</sup>. Specifically it recommends that all retirement fund trustees incorporate the principle in the US Department of Labor Interpretative Bulletin into fund management mandates and ultimately that it be incorporated into UK law. The Bulletin says the following:

“The fiduciary act of managing plan assets that are share of corporate stocks includes the voting of proxies appurtenant to those shares of stock.

The fiduciary duties of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan’s investment.

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary’s obligations under ERISA when the responsible fiduciary concludes that there is a reasonable expectation that activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan’s investment, after taking into account the costs involved. Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are

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<sup>29</sup> The Committee of Enquiry into Comprehensive Social Security, chaired by Vivien Taylor, which reported in 2002.

<sup>30</sup> *Taylor Report*, paragraph 9.2.3 at page 96.

<sup>31</sup> *Myners Review* paragraph 79 at page 14. In particular the *Myners Review* recommends that the US Department of Labor’s interpretative bulletin on the Employment Retirement Income Security Act (USA) 1974 be included.

held as long-term investments or where a plan may not be able easily to dispose of such an investment.

Active monitoring and communication activities would generally concern such issues as the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, the corporation's investment in training to develop its workforce, other workplace practices and financial and non-financial measures of corporate performance. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder."

The UK government has indicated that it intends to legislate to enact the proposed requirement for both trustees and fund managers<sup>32</sup>. Wise trustees will not wait for similar legislation here but will engage with their asset managers on the ways in which the latter can ensure that the funds are kept informed on issues on which shareholders may wish to exercise a vote and the terms on which shares owned by the funds should be voted. In the English case of *Bartlett v Barclays Bank Trust Co*<sup>33</sup>, Brighton J indicated that trustees have a duty to take positive steps to safeguard the investments of their trusts:

"The prudent man of business [the standard of care applied to trustees] will act in such a manner as is necessary to safeguard his investment. He will do this in two ways. If facts come to his knowledge which tell him that the company's affairs are not being conducted as they should be, or which put him on enquiry, he will take appropriate action. Appropriate action will no doubt consist in the first instance of enquiry and consultation . . . and in the last but more unlikely resort, . . . to replace one or more of the directors. What the prudent man of business will not do is content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at an annual general meeting."<sup>34</sup>

The US Bulletin also says, in relation to the exercise by fund managers of their discretionary powers, that "fiduciary duties . . . require that, in voting proxies, the responsible fiduciary consider

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<sup>32</sup> *Myners Review: Institutional Investment in the UK. The Government's Response* HM Treasury and the Department for Work and Pensions.

<sup>33</sup> [1980] 1 All ER (HL).

<sup>34</sup> Quoted with approval by the pension funds adjudicator in *Twerefoo v Liberty Life Association of SA Ltd & others* [2000] 12 BPLR 1437 (PFA).

those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in the retirement income to unrelated objectives."<sup>35</sup>

This brings me to one of the more contentious issues in trustee investment law, the issue of socially responsible investments.

### Socially responsible investments

The demand for socially responsible investing stems from the understanding that all investments have social and environmental consequences.

There are three main pillars to "socially responsible investing"<sup>36</sup>:

1. The first is **screening**. A fund may choose to adopt an "ethical" investment strategy and decline to invest in companies that promote the use of tobacco products, that produce armaments or that treat their workers badly. Such funds are seldom at risk of criticism because there are usually lots of other companies with comparable performance in which to invest.
2. The second is **shareholder activism**. As has been discussed, funds may wish to take a more proactive approach and use their powers of investment to support only those companies that display sound corporate governance, have good labour relations and that protect the environment. They may adopt such policies - not because they want to change the world - but because such companies in the long term are likely to produce healthier returns than their less conscientious competitors.
3. The third pillar is **community social and economic development**. The funds that wish to engage in this do wish to use their investment powers to change the world. These are funds that dedicate a portion of their assets to investments in "black economic empowerment" companies or in start-up enterprises that are likely to create employment. Adherents of this approach say that it is futile to ignore the interests of pension fund members as employees and members of a community. Interestingly, one of the first UK

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<sup>35</sup> See *Myners Review* on page 92.

<sup>36</sup> See Canadian Council for International Cooperation *Investing in Change: Mission based investing for foundations, endowments and NGOs* for a more elaborate description of the various pillars to what it describes as mission-based investing.

cases on trustee investment decision-making using non-financial criteria tacitly acknowledged the members of the fund as employees and not just future beneficiaries.<sup>37</sup>

Such strategies are particularly contentious because, whereas there is evidence to back the claim that companies with good corporate governance and sound labour relations and so on are likely to be profitable in the long term, there is little, if any, evidence that investing in employment and black economic empowerment will have direct financial benefits for a fund.

The call for socially responsible investing by retirement funds is not a new one. The *Mouton Report* noted that “[g]eneral social development is important for future stability and progress in South Africa, which in turn is in the interests of retirement fund members”<sup>38</sup>. In the context that New Zealand had abandoned the compulsion on retirement funds to invest a portion of their assets in socially desirable investments because it did not have the institutional framework to ensure that the investments were effective<sup>39</sup>, the authors of the *Mouton Report* cautiously recommended that “efforts be made to create investment instruments that are appropriate for funds and that can be used to raise funds for development agencies in their field”<sup>40</sup>. These could be securitised, mortgage-backed debentures or other financial packages<sup>41</sup>. On the other hand, they said, “it is vital that retirement funds not be singled out to bear the implicit costs in having to invest in non-market related assets”<sup>42</sup>. On the contrary, investments that may be described as socially responsible should not be supported by funds unless they entail market-related, or close to market-related, investment return and security<sup>43</sup>. The authors of the *Smith Report* were equally cautious, saying only that

“ . . . we believe that high quality retirement fund trustees are sensitive to social issues. Even so, no matter how attractive the leverage provided by retirement fund assets and investments might be

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<sup>37</sup> *Evans v London Cooperative Society Ltd* 1976 CLY2059 (ChD). See also , a US decision in which the court held that a decision by a fund to lend monies at below market interest rates does not, in itself, constitute a breach of the trustees’ fiduciary duties even if they did not have the explicit consent of the members provided that the loan was in the interests of the members, albeit in their capacities as employees.

<sup>38</sup> *Mouton Report*. Paragraph 33 at page 241.

<sup>39</sup> See annexure H6 to the *Mouton Report* and Leeman, MG, *Socially Desirable Investments: Channelling Contractual Savings Institutions’ Funds into Low Income Housing* research report University of Cape Town September 1991.

<sup>40</sup> *Mouton Report*. Executive Summary paragraph 3.7(c) at page 17.

<sup>41</sup> *Mouton Report*. Annexure C4: “Draft guidelines for the appropriate use of funds to finance development and social projects.”

<sup>42</sup> *Mouton Report*. Paragraph 29.4 at page 225.

<sup>43</sup> *Mouton Report*. Annexure C4: “Draft guidelines for the appropriate use of funds to finance development and social projects.” Paragraph 10.

for achieving political, social or ethical objectives, it is important that the basic purpose of a retirement fund not be forgotten.”<sup>44</sup>

The *Jacobs Report* said that –

“[I]n view of South Africa’s great need for capital, it is . . . of utmost importance that insurers and retirement funds should not only help to ensure a stable and increasing flow of funds to the economy, but should also have to apply these funds to investments aimed at optimal productivity. These institutions therefore have to fulfil an important allocative role in the total investment programme.”<sup>45</sup>

Its authors, too, were cautious in their support for socially desirable investments. They said the following:

“As regards the intense debate on the role of insurers and retirement funds in respect of socially desirable investment, it is essential to take cognizance of the fact that these institutions are dealing mainly with trust money. Their first obligation is towards their policy holders and fund members to whose benefit they must ensure that all funds are safely and optimally invested with regard to risk and a market-related rate of return. Furthermore, while these institutions are willing to do their share, it is evident that it is necessary to create not only vehicles for identifying such desired investment projects, but also development agencies with the appropriate expertise, infrastructure and capacity, as well as the appropriate financial instruments.”<sup>46</sup>

In 1997 the “Communication, Education, Management and Control” task team of the Private Sector Retirement Provision theme committee of the NRCF in 1997 suggested that investigations should be conducted into the feasibility of fund investments in ways which would allow members to derive indirect benefits as well as direct financial benefits. Furthermore, it said, regulatory guidelines should be set for development projects which could be supported by retirement funds.<sup>47</sup>

The *Taylor Report* was emphatically in favour of requirements that retirement funds invest a portion of their assets within a socially desirable investment universe. However, it has adopted what seems to be an unduly cautious approach when it says that the initial yield on these

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<sup>44</sup> *Report on the Committee on Strategy and Policy Review of Retirement Provision in South Africa* (“the Smith report”) December 1995 at page 23.

<sup>45</sup> *Jacobs Report* paragraph 5.2.3 at page 11.

<sup>46</sup> *Jacobs Report* paragraph 10 at page 22.

<sup>47</sup> Paragraph 2.4.2 of the *Reports compiled by the National Retirement Consultative Forum Theme Committees*, Department of Finance, 1997, at page 15.

investments should, it says, be in line with returns on marketable investments<sup>48</sup>. The Institute of Retirement Funds does not believe that it would be appropriate to compel funds to make “socially responsible investments” but that funds should be allowed to do so. Decisions as to socially responsible investments should be part of trustee ordinary decision-making, it says, pointing out that wage-linked bonds, social responsibility and off-shore investments are all matters to which the trustees of a fund must apply their minds when determining its investment strategy<sup>49</sup>. Cosatu, on the other hand, supports the proposal by the Taylor Committee<sup>50</sup>. The National Labor College of the US expresses itself more strongly as follows<sup>51</sup>:

“Stewardship . . . implies a relationship of trust. A steward should not do anything with another’s money that will harm that person. For example, a capital steward typically should not invest union pension assets in a union-busting company or in an employer that discriminates against ethnic and minority groups. A capital steward should not support corporations that destroy the environment or ship jobs overseas. These actions work against the principles that the steward represents . . .”

The *Interpretative Bulletin*<sup>52</sup> issued by the US Department of Labor on what it refers to as “economically targeted investments”, however, says that the requirement in sections 403 and 404 of the Employee Retirement Income Security Act that fund fiduciaries act solely in the interests of providing benefits fund’s members and beneficiaries means that those interests may not be subordinated to unrelated objectives. Only if the expected return on an economically targeted investment is commensurate with available alternative investments with commensurate degrees of risk may the first be made.

The initiative needs to come from development agencies to identify and plan suitable socially responsible investment projects, says the *Mouton Report*. This would enable retirement funds to seriously consider providing them with financial support<sup>53</sup>. Investments should be made through special-purpose vehicles with the experience and expertise to manage the projects<sup>54</sup>.

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<sup>48</sup> *Taylor Report*, paragraph 9.2.3 at page 95.

<sup>49</sup> See letter from the Institute of Retirement Funds to the Department of Social Welfare dated 14 June 2002 and entitled “Submission on the Taylor Report”.

<sup>50</sup> Cosatu submissions on the *Taylor Report* to the Parliamentary Committee on Social Development in 2003.

<sup>51</sup> In its course booklet by Jayne Zanglein *Pension Investments and Fiduciary Duties under ERISA* National Labor College 2002 at page 3.

<sup>52</sup> 29 CFR 2509.94-1.

<sup>53</sup> *Mouton Report*. Paragraph 33 at page 241.

<sup>54</sup> *Mouton Report*. Annexure C4: “Draft guidelines for the appropriate use of funds to finance development and social projects.” Paragraph 10.

Unions which made submissions to the Smith Committee in 1995 said that members would like to see evidence that the assets of their funds were being used to improve their living standards by, for example, improving infrastructure in the areas in which they lived. Some would have liked to see fund assets being used to assist the disadvantaged.<sup>55</sup> More recently Cosatu has suggested that funds be required to invest in companies which create jobs or meet other socially desirable goals<sup>56</sup>.

The Retirement Fund Standing Committee of the Life Offices' Association is opposed to any compulsory investment in socially desirable investments, saying that it constitutes an additional tax on retirement funds which will have a negative effect on investment returns and members' benefits<sup>57</sup>. Business South Africa agrees<sup>58</sup>.

The policy question is whether retirement funds should be obliged to invest a portion of their assets in "socially responsible investments"? If yes, should this be –

- subject to the requirement that the SRI be expected to produce a reasonable rate of return on its own;
- subject to the requirement that the overall investment strategy of the fund, including the SRI investment plan, is designed to produce a reasonable overall rate of return; or
- despite the fact that the SRI may be expected to produce a poor rate of return ?

In my opinion funds are intended to be long-term investment vehicles providing for benefits both for current and future beneficiaries. In the light of this, it is foolhardy for any board of trustees to ignore the systemic risk inherent in high levels of unemployment, in poor corporate governance, in the diversion of precious resources towards warfare and tobacco products. Accordingly, an investment which is likely to increase work or business opportunities for the poor, which will make

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<sup>55</sup> *Report on the Committee on Strategy and Policy Review of Retirement Provision in South Africa* ("the Smith report") December 1995 at page 20.

<sup>56</sup> Cosatu *Submission on the Pension Fund Amendment Bill* 27 February 1996 <http://www.cosatu.org.za/docs/pension.html>

<sup>57</sup> Written comment by the Retirement Fund Standing Committee on the *Taylor Report*.

<sup>58</sup> Representations on the *Taylor Report* by Business South Africa to the Portfolio Committee on Social Development in 2003. The LOA and the BSA have support in the dicta of Megarry J in *Cowan v Scargill & others* [1984] 2 *All ER* 750. In that case the National Union of Mineworkers had sought to promote its "invest in Britain" campaign by persuading pension funds over which it had influence to invest in British stock and, in particular, not to invest in South Africa although there were lucrative investments to be made there. The judge said the following:

"in considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any form of investment in South Africa or other countries or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reasons of the views that they hold".

productive and healthy use of resources, which is transparent and which, together with other investments of the fund, is likely to produce for the fund a reasonable overall rate of return is a good investment. The risks associated with investments of this nature could be mitigated if they were made through collective investment schemes or private equity funds no single investment of which would account for more than 10% of the value of the scheme or fund. A decision by a fund to invest, say, up to 10% of its assets in one or more such collective investment schemes or private equity funds should survive legal scrutiny if the portfolio theory of investment is applied by our courts, which I believe will be. As Jonathan Fenton, DLA said at a September 2003 seminar for the UK Association of Pension Lawyers:

“The principle of prudent investment does . . . apply equally to pension fund trustees but the ability to have regard to current portfolio theory would appear to be a benchmark against which the modern pension fund trustee would be judged . . .

In the case of the private equity fund the principle of diversification is satisfied in two principle ways. First, within each private equity fund, the manager will make a series of investments. Each will be made as a result of significant evaluation and due diligence as part of the manager’s investment process. Inevitably, however, some investments will fail to produce the anticipated return and some may fail completely. However, assuming that the manager has a sufficient track record and expertise, and in view of the manager’s continuing involvement with the development of the underlying business of a portfolio company, it is to be expected that a small number of the investments undertaken by a particular fund will do extremely well so producing returns significantly above those which might have been produced through investment in a quoted portfolio. A prudent pension fund will also spread its weighting across a range of private equity funds.”

### **Conclusion**

It may feel like retirement fund trustees are facing potentially big changes in the law governing the investment of pension fund monies. But, in truth, all that is happening is that common law principles which have always governed pension fund investments are being reinterpreted in the context of modern conditions and are, to some extent, being codified. And this is good. Legislation should be there to provide guidance to trustees and should change as conditions change. It is the duty of trustees, however, to make sure that the legislators understand the conditions in which fund trustees work so that the standards imposed on them are appropriate and fairly balance the risks that trustees face in violating the standards with the protection that such standards could provide to the members and beneficiaries.