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

A paper presented by Rosemary Hunter of Hunter Employee Benefits Law (Pty) Ltd
at the annual conference of the Pension Lawyers Association,
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Introduction

Rob Rusconi's paper,[1] which he presented at this conference yesterday, is a timely and helpful one. In it he alerts all of us to the numerous risks and hazards involved in the investment of retirement fund assets and makes some recommendations as to how they may be minimized.

What I want to do this morning is to describe in more detail than he sought to do the legal framework for the relationships that are at the heart of some of the problems that he has described; the relationships between funds and their investment consultants and asset managers. I also propose to discuss the extent to which this legal framework provides an effective basis for the regulation of those relationships and what retirement fund boards can do now without resort to the law to minimize the risks.

I am not going to address the position of trustees and whether they may lawfully delegate their investment decision-making powers to members of their funds. That that is a topic that has been addressed by Advocate Andre Oosthuizen.

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[1] Rusconi, R '*South African Institutional Investments: Whose money is it anyway ?*', unpublished paper released in January 2008.

The legal framework within which the investment of retirement fund assets takes place

Retirement funds are 'not for profit' organizations, the purpose of which is to provide members with the benefits provided for in terms of their rules. They are not 'products', as some of the service and product providers who have created these funds often describe them. Thus, while the funds may have been established at least partly in order to provide asset managers with assets to manage, the funds themselves are like children who must be allowed to grow up and make their own decisions, including decisions as to who will administer the fund and manage its assets on the bases of quality and price.

It is often said, quite glibly, that the point of retirement fund investments is to maximize the return earned on those investments. However, the various discussion papers issued in the last few years by Government departments on the reform of retirement funding in South Africa have reminded us that the objective of the investment of fund assets is to seek to achieve a reasonable income for a member after his or her retirement taking into account his or her income before retirement, the period during which he or she contributed to one or more retirement funds and the rate at which he or she and/or his or her employer contributed to that fund or those funds. This means that the risks associated with investments in various asset classes or products, including the risks of excessive and hidden costs, must be weighed against the potential returns they could deliver and an appropriate balance between them sought. This approach applies whether or not the fund is a defined benefit, balance of cost, fund or a defined contribution fund. As the registrar has usefully reminded us in PF 130, boards of funds are not entitled to use an employer's guarantee as a license to engage in high risk investment strategies.[2]

Members of boards of management are not expected to be experts on all aspects of retirement fund management and may take expert advice and rely on it unless it is patently wrong.[3] A board may also delegate to appropriately qualified persons and

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[2] See paragraph 54 under principle 9.

[3] In the famous British case of *Cowan v Scargill* [1984] *IRLR* 260 (ChD), Megarry VC said that –

> "….., the standard required of a trustee in exercising his powers of investment is that he must -

organizations its powers and duties in relation to benefit administration and fund investments[4] provided that their rules permit it, the powers are not powers that the board can reasonably be expected to exercise itself, the amount of discretion conferred on the delegatee is not inappropriate and the board supervises and checks the performance by the delegatee in the exercise of its delegated powers. [5]

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The problems that are the subject of this paper lie in the apparent inability of most of our boards of trustees dispassionately and properly and assess investment advice given to them by their investment consultants and to monitor and supervise the performance of those to whom investment powers are delegated. They do not have the knowledge and

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> > 'take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.'
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> . . That duty includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments, and on receiving that advice to act with the same degree of prudence. This requirement is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness. Some of the most sincere people are the most unreasonable . . . Accordingly, although a trustee who takes advice on investments is not bound to accept and act on that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act."

[4] *Kaplan & another NNO v Professional and Executive Retirement Fund & others* 1998 4 *SA* 1234 (W) at 1239 C-D and F-G at which the court said that the power to delegate certain functions had to be implied in the rules of the fund in the circumstances.

[5] *Scott on Trusts* says the following in volume IIA at page 442:

> 'The trustee is under a duty not to delegate the doing of acts he can reasonably be required personally to perform. The question is one of applying the standards of prudence under the circumstances. The trustee must do what a prudent trustee would do under the circumstances ... Undoubtedly one of the most important factors in determining whether a trustee is guilty of an improper delegation in employing an agent is the amount of discretion involved in the matter entrusted to the agent. It is generally true, of course, that such discretion as is involved in the exercise of a power should be exercised by the trustee personally ... The mere fact that the exercise of a power involves a certain amount of discretion does not necessarily make it improper to delegate it, since almost every act involves the exercise of a certain amount of discretion ... the question of the <u>amount</u> of discretion involved is of the greatest importance.' (My emphasis).

Honoré's *South African Act of Trusts* 4th edition says the following at p270:

> 'It is not uncommon for a trustee to delegate the administration of a trust to another. This may be to a co-trustee, to a firm in which the trustee is or is not a partner, to a relative, to a suitably qualified professional person or even to a management committee. Such a course is not improper so long as it amounts only to a delegation (the appointment of another, for whose acts one will be responsible, to act on one's behalf) and not to abdication (the appointment of another to act instead of oneself, so as to relieve oneself of responsibility) ... it does not relieve the trustee from the duty of supervising and checking the work of any non-trustee to whom the delegation may have been made. Indeed, the trustee retains office as trustee with primary responsibility to the beneficiaries under the trust and is accordingly at liberty at any time to revoke the delegation of authority.'

expertise that their investment consultants and asset managers have and this 'information inequity' as Rusconi puts it, gives the service providers advantages over their clients which they can exploit. Members of retirement fund boards try to do their jobs in an environment dominated by product and service providers that are obviously - or not so obviously - related to each other and which have an interest securing advantages for each other from their clients. This is called 'cross-selling' or 'shaking the tree'. We have such a long history of these arrangements that many assume that there must be nothing wrong with them and so do not even ask questions about the extent to which the nature of these arrangements may influence the value of the advice and other services given to them.

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The Role of the Investment Consultant

> **'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 important perhaps is the question of the independence of the advice that they give.'**[6]

Our common law is clear on the role of advisors or brokers. In the judgment of Acting Judge Potgieter in the case of *Lenaerts v JSN Motors (Pty) Ltd*[7], a case involving an insurance broker who persuaded a trucking company to purchase an insurance policy which, as it turned out, did not provide the company with the cover that it needed when its claim arose, the judge said:

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[6] Rusconi, R '*South African Institutional Investments: Whose money is it anyway ?*', unpublished paper released in January 2008.

[7] 2001(4) *SA* 1110.

'On general principles it seems clear enough that the position in South Africa is that the insurance broker performs a mandate on behalf of the insured. Accordingly he owes the insured a duty to exercise reasonable care and skill in the execution of the mandate … this is the fundamental quality of the general duty owed. It stands to reason that, in order to perform the general duty, the broker will have to take reasonable steps depending on the circumstances. The nature of the steps will differ from case to case. They have not been the topic of much discussion in reported South African decisions. Some of the steps that have been identified judicially by English Courts (which recognize the same fundamental duty by the broker to the insured) include the following:

(a) He must ascertain his client's needs by instruction or otherwise;

(b) He must use reasonable skill and care to procure the cover which his client asked for, either expressly or by necessary implication;

(c) If he cannot obtain what is required, he must report in what respects he has failed and seek his client's alternative instructions.'

It is clear from this judgment that an advisor or broker must act in the best interests of his or her client and cannot simultaneously seek to persuade that client to purchase products or services which may not be the products or services best suited to that client.

A complaint heard by the FAIS Ombud illustrates the problem; in the case of *Michael Denman Mackrory v Marius Naude*[8], the Ombud was told that the client had complained to his financial advisor about the performance of his Sage off-shore investment product. The financial advisor immediately recommended that he invest in Leaderguard, the operations of which, as we now all now, have been 'tainted with fraudulent acts' and ultimately collapsed. As we know, a person who has properly investigated and applied

[8] See the determination of the FAIS Ombud dated 31 May 2006 which is published on the FAIS Ombud website under case no. FOC914/05/GP/(1).

his or her mind to relevant facts in coming to a view on an investment will not be held liable if the investment proves bad.[9] It is only if the advisor was negligent that he or she can be found liable to compensate the person who relied to his or her prejudice on the advice negligently or culpably given. So in this case the Ombud said that the financial advisor would have to demonstrate to his office –

- what need of the client he thought would be addressed by the Leaderguard investment;
- what other products were considered by him; and
- why it was thought that the Leaderguard product was the most appropriate for the client.

In essence, he required the financial adviser to account to him as to the extent to which he fulfilled his duties as an advisor, rather than as just a salesman.

The obvious question which follows from this is, if the financial adviser had performed a proper needs analysis and from that analysis derived the view that the Leaderguard investment was an appropriate one, should he be entitled to the commission offered by the seller of the investment ? I do not think so.

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[9] 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."

This approach has been followed by the pension fund adjudicator in South Africa. 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."

As Bogert & Bogert have said in their book, *The Law of Trusts and Trustees*[10], human nature is such that 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.'**

In 1986 the British High Court said quite bluntly

> **'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 authorized.'**[11]

In other words, you cannot be a salesperson and an advisor at the same time. Unfortunately the basis on which advisors and brokers are remunerated often has the effect of blurring their priorities. The FAIS Ombudsman, in one of his judgments, said:

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> **'It is sadly the high commissions which often leads to poor judgment on the part of those offering members of the 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.'** [12]

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[10] 2nd edition, 1960 at s543.

[11] *Re Thompson's Settlement* [1986]/

[12] *CJ du Plessis & another v Wilma Willemse & another*, a determination dated 18 August 2006 which can be found on the ombudsman's website.

I am sure that we have all experienced examples of this, whether in the financial advice that we ourselves have been given or in the advice that we have seen others give funds in which we are involved. I have watched a fund actuary advise a large pension fund to 'outsource' its pensioner liabilities to an insurer and have waited in vain for the advice that this could be done on a 'no commission' basis. I have seen a financial advisor advise my elderly parents to consolidate their meagre investments into a single joint and survivor retirement annuity policy although I had made it clear that my brother and I provided all the guarantees of future financial security that they needed.

The US Employee Retirement Income Security Act prohibits any person who falls within the category of what it calls 'fund fiduciaries', including a fund adviser, from receiving any consideration for his or her personal account from any party dealing with the fund in connection with a transaction involving the assets of the fund.[13]A similar provision would be useful in South Africa. If fund advisors – or their employers - were to be remunerated only by their clients, then that remuneration could be properly controlled and advisors should not be subject to the undue influence that the prospect of indirect remuneration in the form of commissions is likely to have on their advice. Of course, this could mean the end of the 'one-stop shop' because you cannot have, for example, an actuary who gives investment advice to a fund enjoying the benefit of a share incentive scheme or bonuses that are based in part on the success of other parts of the company or related company to which the actuary might direct the fund's business.

In a useful analysis of a wide range of abuses by financial services firms of their positions and access to information, Walter Ingo of New York University argues that –

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> **'the broader the activity-range of financial firms in the presence of imperfect competition,**
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> (1) **the greater the likelihood that the firm will encounter potential conflicts of interest; and**

[13] Section 406(b).

(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.'** [14]

In 2003 the US Securities Exchange Commission took action against research analysts who worked for firms that also provided investment banking services. It found that the analysts had been under pressure to issue positive investment opinions about the firm's investment banking clients even if they did not themselves hold those opinions.[15]

It is not inconceivable that a multi-service organization wanting to secure retirement fund business from a large listed company would be unlikely publicly to make investment recommendation to other clients that reflected badly on that company. The influence of company officials on the decisions of boards of management has been diminished by the right of members to elect at least 50% of the members of those boards, but it has not been eliminated altogether. These circumstances demonstrate that it is not appropriate for an advisory business to be located in the same firm or group of firms as an investment management business unless the firms devise means of ensuring that information cannot pass through the Chinese walls that they erect and no inappropriate pressure is placed on the advisers, whether they are actuaries, lawyers, investment consultants or others.

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In its 2006 Discussion Paper on *Contractual Savings in the Life Insurance Industry*[16] the National Treasury proposed the enactment of a number of measures to improve the position of consumers. Among these were the following:

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[14] Ingo Walter '*Conflicts of Interest and Market Discipline Among Financial Services Firms*' presented at a conference on "Market Discipline: Evidence Across Countries and Industries" October 2003 (available at http://pages.stern.nyu.edu/~iwalter/conflict.pdf , accessed on 12 March 2008).

[15] See speech by Stephen M. Cutler, Director of Enforcement, Securities Exchange Commission, 9 September 2003. It can be found at www.sec.gov/news/speech/spch090903smc.htm. It was accessed on 11 March 2003.

[16] It can be found at:
http://www.treasury.gov.za/documents/Discussion%20Paper%20on%20Contractual%20Savings%20in%20the%20Life

- Requiring intermediaries to declare themselves to prospective policyholders as either –
  - (a) agents of insurers (whether tied or 'independent') who will be remunerated by the insurer if the policies are purchased; or
  - (b) independent financial advisors who will be remunerated by the policyholders for their advice either by direct payment or authorized deductions from the proceeds of their investments in the policies,

  and only allowing the latter to call themselves 'advisors';
- Preventing intermediaries from acting as independent financial advisors for some clients and insurer agents in relation to other prospective policyholders;[17] and
- Improving the quality of investment advice given to members of the public through higher standards of intermediary education and implementing a system of accreditation.

I must mention here that, following a report by Professor Jim Gower called '*Review of Investor Protection*'[18] this 'polarisation' policy was adopted in the UK Financial Services Act of 1986 in relation to life policies, units in collective investment schemes, interests in investment trust savings schemes and stakeholder pension schemes.[19] However, in 1999 the Director-General of Fair Trading declared the policy to be 'significantly anti-competitive' and it is being unwound to the extent that firms that 'distributor firms' which can advise and sell products from a range of product providers will replace the direct sales forces that these product

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-Insurance%20Industry%2030%20March%202006%20final.pdf It was accessed in March 2006.

[17] This recommendation is consistent with that made in the 2002 *Sandler Review* of contractual savings in the United Kingdom.

[18] January 1984, Cmnd.9125.

[19] Frase, D, *Law and Regulation of Investment Management* Sweet & Maxwell, 2004 at p102.

providers have had to engage.[20] It was pointed out that independent financial advisors had tended to service only wealthier customers and there was a need to increase product choice for the majority of consumers.

Frankly I am not persuaded that we should not still have this 'polarisation' policy in South Africa. We can't afford to allow anyone other than the higher-income members of our population sold products under the guise of 'advice' for which they are paying in the form of commissions they do not have the capacity to resist.

So it is my hope that the principles of polarization will be embedded in our new social security and retirement funding legislation. To improve the poor levels of trust now evident in the retirement funding industry, we must have financial advisors and investment advisors who are demonstrably free of incentives that may inappropriately influence the advice that they give, both in regard to

- the asset managers they should select to give effect to these policies and strategies; and
- the investment policies and strategies that their client funds should adopt, including asset allocation and the determination of appropriate benchmarks against which to measure the performance of the funds' assets and their asset managers.

This probably means that, as Anne Cabot-Alletzhauser suggests, fund investment consultants should be paid a lot more and investment managers should be paid a lot less or at least on a different basis, given the roles that they play in the 'value chain'.[21]

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[20] Frase, *Ibid* at 105.

[21] See references in Rusconi at p62 and, in particular, Cabot-Alletzhauser, A. 'The Upside Down Food Chain: Shifting the Food Chain to a Value Chain', *Collective Insight*, published tri-annually by FinWeek, South Africa, Summer 2005.

The Role of the Asset Manager

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An asset manager given a discretionary mandate to make investment decisions on behalf of a fund owes a fiduciary duty to that fund or, in other words, is obliged to act in its best interests without regard for his or her own interests or the interests of anyone else.

As Mason J put it in his judgment in *Transvaal Cold Storage Co. Ltd v Palmer:*[22]

> **'The principal [in this case the fund] 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 confidence, 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.'**

These obligations are enshrined in the US Employee Retirement Income Security Act (ERISA)[23] which provides that every person with discretionary power in relation to a fund is a 'fund fiduciary' and is obliged to act in that capacity solely in the interests of the plan's participants[24] and in accordance with the fund's rules.[25]

Unfortunately, these obligations are often honoured in the breach.

Rob Rusconi has described some examples of the ways in which conflicts between the interests of funds and their investment consultants and managers and their duties to their clients are not appropriately managed, particularly in relation to independence, fee structures and other incentives, and conflicts between the interests of their various clients. Today I want to describe examples of ways in asset managers and associated professionals may exploit what Rusconi describes as 'information inequity' and other

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[22] 1904 *TS* 3 at 33.

[23] Employee Retirement Income Security Act of 1974, 29 USC ss 1001 – 1461 (1988).

[24] The US legislation is based on the principles of trust law. Our legislation is not and it would be more appropriate in the South African context to say that the agents of a fund must act in its best interests, although its objective is to provide benefits to members. Stein, N. 'ERISA and the Limits of Equity' *Law and Contemporary Problems* 1993.

[25] Section 404(a).

ways in which the balance of power is in their favour to derive unlawful secret profits from their work for retirement funds.

Some of you may recall the 'Greg Blank' case of several years ago.[26] To the best of my knowledge Greg Blank, who was a stockbroker, was the only member of the scam jailed for his role in the scam but there were others, including the asset manager who instructed him, who were convicted and got away with only the payment of admission of guilt fines. One of these was Christo Auret who was an asset manager employed by Lifegro Assurance Company Limited (now Momentum). He was responsible for the management of one of Lifegro's investment portfolios but was fired from that post after the scam in which he was involved was discovered by the surveillance team at the Johannesburg Stock Exchange.

The essence of the scheme was this: Auret, as a member of Lifegro's investment team, would be made aware of shares which Lifegro intended to trade. He took improper advantage of this confidential information when he alerted one Fouche or Coetzee, stockbrokers employed by Ed Hern Rudolph, of Lifegro's intentions. Fouche or Coetzee would then purchase these shares and hold them in a 'holding account' in anticipation of the order coming from Lifegro. When the order came, the shares were sold to it at a profit and Fouche, Coetzee, Auret and others involved in the scam would benefit from the profit realized. Clearly, this arrangement represented a breach by Auret of the duty of good faith he owed his employer and allowed Auret to make a secret profit at the expense of his employer. At common law this meant that Auret was required to pay back to Lifegro the secret profits he derived from this arrangement[27] and would have been required to pay it back even if Lifegro had not suffered a loss as a result of it,[28] which in this case it had. He could also have been required to forfeit his remuneration and his conduct certainly

[26] *S v Blank* 1995 910 *SACR* 62 (A). Blank was sentenced to 8 years in prison for his crimes but, to the best of my knowledge, served only two or three.

[27] *Regal (Hastings) Ltd v Gulliver* 1967 2 *AC* 134 at 153.

[28] To the extent that these benefits are not disclosed and agreed with the fund, they comprise 'secret profits' and in law must be paid back to the fund whether or not the fund could have obtained the benefit of the arrangement for itself. In his judgment in *Transvaal Cold Storage v Palmer* 1904 *TS* 4 at 21 Innes CJ said at p21 -

> 'The doctrine of an agent's liability to account for profits does not rest upon the fact that he has prevented the principal from earning profits; but is based upon his duty in good faith to hand over to his employer every advantage directly or indirectly connected with the agency, save and excepting the remuneration agreed upon.'

justified the termination of his employment by Lifegro and also by the Eskom Pension and Provident Fund which had subsequently employed him. Certainly, had he been an independent agent of Lifegro, he would not only have been required to disgorge the secret profits, he would also have been obliged to refund to Lifegro the asset management fees he had been paid because the scam would have taken place in the course of his work as Lifegro's agent.[29] Finally, Auret's conduct constituted a breach of s2 of what was then the Financial Institutions (Investment of Funds) Act, of 1984. He pleaded guilty to charges of a number of breaches of that section and received a fine.

Section 2 of the Financial Institutions (Investment of Funds) Act, of 1984 bears close relation to section 2 of the statute that has replaced it; the Financial Institutions (Protection of Funds) Act, 2001. The section states that:

> **'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] -**
>
> **(a) must, with regard to such funds, observe the utmost good faith and exercise proper care and diligence;**
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> **(b) 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;**
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> **(c) 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.'**

[29] See *Levin v Levy* 1917 *TPD* 702, *Gerry Bouwer Motors (Pty) Ltd v Preller* 1940 *TPD* 130.

In upholding the Eskom Pension Fund's dismissal of Christo Auret as its investment manager, the Deputy President of the Industrial Court, Advocate Bulbulia SC, endorsed the following argument by the fund's counsel:

> **'A pension fund . . . is a financial institution upon which the financial security of thousands of people with no other resources entirely depends. The investment activities of such a fund are to a large extent in the hands of its financial manager. It is vital that the trustees of the Fund, themselves entrusted with the responsibility of overseeing the Fund, are able to trust without qualification the incumbent of such a post. Hence it is a basic operational requirement of such an institution that its financial investment manager is a person whose integrity is beyond reproach. A person who conducted himself as the Applicant did . . . is not a fit and proper person to manage the financial investments of a pension fund . . .'**[30]

What is said here in relation to an in-house investment manager is equally applicable to external ones. Unfortunately there are many ways in which asset managers have been able to make improper use of retirement fund and other client assets for their own benefit or the benefit of third parties.

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The conduct of Christo Auret and his friends is often described as 'front-running'. Boards of trustees must also be mindful of 'ramping' which may take place when someone gives the market an indication that there will soon be a large purchase of certain listed shares. The price of those shares goes up and those responsible for the market rumour can then sell out of that share at a wonderful profit. You may recall that one

[30] See unreported judgment dated 18 June 1996. See the unreported judgment of Judge Cameron of the Labour Court (as he then was) dated 4 May 1997.

individual in the US – who was later identified as a fraud – did that in relation to Goldfields shares a year or two ago.

Then there are those who can engage in 'market timing' and 'late trading'. 'Market timing' can take place when one asset manager instructs a broker to execute a number of trades in a share for different clients of the asset manager. Then, after the trades have been executed, the asset manager decides which trades to allocate to which of its clients.

Of course it is likely to allocate the trades at the best price to those clients most important to it – whether because of their size or the nature of its fee arrangements with them.

'Late trading', on the other hand, takes place when high value clients are allowed to place orders after close of regular trading so that they are able to take advantage of information that was not available to clients before then and they are given the closing price of the day as if the order had been received at close of business.

As I mentioned earlier, it was the JSE Surveillance team that first detected scam involving Greg Blank and others.

The JSE seeks to regulate the conduct of its members and provides in Rule 15.50 of the JSE rules that –

> **'An investment manager:**
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> **15.50.4** **shall avoid any conflict between the interest of him or herself and those of the client and, where a conflict of interest does arise, fair treatment to the client shall be ensured by the manager disclosing details of such conflict in writing to the client, while maintaining the confidentiality of the other client, or the manager shall decline to act for that client.'**

The common law goes further and provides that disclosure of a conflict between the interests of the agent and his or her duty to the principal is insufficient: the agent may only proceed to act in conflict with his or her duty to act in the best interests of the principal if the principal has agreed to it.[31]

The US Employee Retirement Income Security Act prohibits retirement funds from entering into transactions with parties already related to the fund or acting on behalf of a party or receiving any form of remuneration from a party other than the fund in respect of a transaction involving the fund.[32] These parties include fund fiduciaries, employers, employees, trades union, fund service providers, members of boards of management and such like.

Nonetheless, in 2002 or 2003 the Securities Exchange Commission of the US had to take action against an investment adviser for referring transactions to stock brokers that referred business to it, although those brokerages were more expensive than many of their competitors. This suggests that funds should themselves select providers of services related to asset management such as stockbrokers and custodians other than those related to their asset managers. [33]

In August 2003 the SEC was forced to act against Deutshe Asset Management in a case that exposed the potential for conflict between the interests of the investment banking and investment advisory businesses of a single firm. The investment banking division had been retained by Hewlett Packard to advise it in relation to its proposed merger with Compaq. The asset management side of the business, on the other hand, obtained the mandates of its clients who were shareholders of Compaq – some of whom were probably pension funds - to vote against the merger and exercised those votes in compliance with those mandates. Senior officials of the investment banking side of the business then asked the asset managers to attend a presentation by Hewlett Packard on the deal, after which the asset management team re-voted, this time in favour of the deal.[34]

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[31]See *Malleson v Tanner* 1947 (4) SA 681 (T) cited with approval in the judgment of the FSB Appeal Board in the matter of *WJ Morgan & Associates (Pty) Ltd & others v Johannesburg Securities Exchange South Africa* dated 28 September 2004. The case concerned trades concluded by WJ Morgan Snr, acting as agent of the Joint Municipal Pension Fund, in an attempt to obscure the losses caused to that fund by the trading activities of his son, also acting as the fund's agent. The appeal board held that there was a breach by Morgan Snr and his company of the fiduciary duty that it owed the pension fund by reason of the agreement between them. See paragraph 46.5 of the judgment.

[32] Section 406(b)(2) and (3).

[33] See speech by Stephen M. Cutler, Director of Enforcement, Securities Exchange Commission, 9 September 2003. It can be found at www.sec.gov/news/speech/spch090903smc.htm.

[34] See speech by Stephen M. Cutler, Director of Enforcement, Securities Exchange Commission, 9 September 2003. It can be found at www.sec.gov/news/speech/spch090903smc.htm.

Deutshe Asset Management was fined $570 000.00 for failing to disclose to its clients the conflict between their interests and its own interests.

It indicates that boards of funds should require their asset managers to advise them as soon as they foresee the potential for a conflict between their own interests and the interests of the clients, so that the funds themselves can decide whether they are happy with the arrangements the asset manager proposes to make to ensure that the conflict does not disadvantage the funds, or terminate their mandates, either altogether, or in relation to the exercise of a particular power, such as the power to exercise the fund's votes in relation to a particular transaction.

Conclusion

It seems clear from the statutes and common law that I have canvassed in this paper that we have the laws that we need, but they either not properly understood or they are simply ignored. So it might be helpful to re-write some of our laws to make the duties owed by various product and service providers to their clients and customers more specific. We also need better regulation. As Ingo Walter of New York University says, the exploitation of conflicts of interest would not be possible in conditions of 'perfect competition' and in the absence of 'asymmetric information'.[35] So we need laws that will require improved disclosure, in a manner which will enable consumers of financial products and services to properly compare them and make informed decisions. We need to carefully examine whether the retirement funding industry is a truly competitive one and if there are any barriers to entry that could and should be removed.

Unfortunately, the problem in this country, as in others, is that laws are not enough. For example, one author in the US[36] said in 1993 –

> **'Experience with the statute [ERISA] suggests, however, that the shape of the standards used to restrain self-interested behaviour may be less important**

[35] Ingo Walter "Conflicts of Interest and Market Discipline Among Financial Services Firms" presented at a conference on "Market Discipline: Evidence Across Countries and Industries" October 2003 (available at http://pages.stern.nyu.edu/~iwalter/conflict.pdf accessed 12 March 2008)

[36] Stein, N 'ERISA and the Limits of Equity' *Law and Contemporary Problems* 1993.

> **than effective monitoring of such behaviour; some actors will ignore even exacting standards if they believe that there is little risk of apprehension.'**

'Sounds like home, doesn't it?

So, for me, what boards of management need to do is to try to shift the balance of power away from potential product and service providers and towards their funds. To do this they may need to merge with other fund or join with other funds in umbrella arrangements. We need large funds with significant assets so that they may be well-placed to set the terms of their relationships with their service and product advisers. For example, CalPERS, that well known massive US retirement fund, is helping to lead the way by refusing to reward its asset managers on the basis of the size of its assets under their management or for increases in the value of their assets for reasons which are unrelated to the skill and effort of the asset managers. Then, each consolidated fund should engage in a 'due diligence' exercise before selecting any investment advisor or asset manager. It should also require those tendering for the work to answer, in writing, a series of questions designed to identify the potential for conflicts between the interests of the fund and the interests of the service and product provider or the interests of other of its clients to have an adverse impact on the quality of the service or product being offered to the fund. For example, a fund could ask the following questions of a person or organization offering investment advice to the fund:

1. What is the full range of income-generating services that your firm offers? [37]

2. Will you as an adviser receive any financial reward from anyone other than this fund, including a bonus or salary increase from your own firm, if you recommend products or services provided by a firm or any other organization to which it is directly or indirectly related ?

3. Does anyone else to whom you are directly or indirectly related by way of employment, shareholding or otherwise, have an interest in the products or services

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[37] Rusconi p25.

that you might recommend to this firm? More particularly, are there other organizations to which your firm is directly or indirectly related and which make products or services available to retirement funds or other institutional investors? If so, please describe the nature of the interest and the measures your firm has put in place to ensure that it does not impede the fulfilment of your duty to act in this fund's best interests ? (These may include Chinese Walls, policies on disclosure and declining to act in particular transactions and suchlike).

4. Does your firm have any measures in place to prevent the disclosure of confidential information in relation to this fund to persons other than those directly involved in providing services to it ?

5. Can you foresee any possible conflict between your exercise of your duties to this fund and the exercise of your duties to any of your other clients ?

6. Will you undertake to inform this fund as soon as the potential for such a conflict becomes evident to you and before you exercise any powers or make any decisions which may be affected by that conflict ?

Finally, the fund should ensure that its agreements with service or product providers contain appropriate safeguards. Fee arrangements should be made explicit and those with its advisers should preferably expressed in rand terms and be based on fees for service,[38] preferably expressed as an hourly rate[39] based on the advisors' skills, experience and available resources. The adviser must be required to report responsibly and transparently on all facts which may be 'material to its customers'[40] including their sources of information on which its advice is based, and to explain the approach it adopts and the basis for its advice[41] and should be subject to regular evaluation. [42]

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[38] Rusconi p25.
[39] Rusconi p72.
[40] Rusconi p27.
[41] Rusconi p64.
[42] Rusconi p63.

Similar questions should be put to potential investment managers. In addition, they should be asked what procedures they have in place to demonstrate that preferential treatment is not given to clients with more attractive management fees and that its staff remuneration policies do not encourage inappropriate behaviour.[43]

Agreements with asset managers should contain provisions similar to those I have described. In addition, the basis on which the asset manager will be remunerated should demonstrate an alignment of the interests of the service provider with the interests of the client or should on be a pure fee-for-service basis.[44] The full extent of the discretion conferred on the asset manager should be set out and should not include choosing the custodians of the fund's assets or the stockbrokers through which the fund's trades will be conducted. These should be selected by the board of the fund. However, if the fund does decide to leave the choice of broker to the asset manger, the asset manager must be required to demonstrate that those it has selected have been chosen on the basis of their skill and price and that no other services are provided by the brokers to the asset managers for which there is no reasonable charge.[45]The board must, furthermore, determine its own investment policies and strategies, including proxy voting policies, and these should form the basis of the asset management agreement. The asset manager should be required to allow the fund to subject the trades that it conducts on behalf of its clients and others to scrutiny by organizations such as Electronic Trustee[46] so that they can demonstrate that those trades are conducted in the best interests of the clients taking into account the costs of the trades.

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> 'Managers will need to install robust processes to ensure that they can demonstrate that preferential treatment is not given to funds with more attractive management fees and that staff remuneration policies do not encourage inappropriate behaviour. Areas that will need to be addressed included customer order priority, allocation and release of internal research recommendations.'

Investment Management Association, DATA and Fitzorovia Performance Fees for Investment Funds, Technical Discussion Paper by the IMA and the Depositary and Trustee Association, in conjunction with Fitzrovia International Ltd. Cited in Rusconi (2008) at p70.

44 Rusconi p25.

45 Rusconi at p110.

46 It is described on its website as 'a programmable, automated, near real-time monitoring, recording and analysis system that records and analyses investment activity. Providing users with a comprehensive overview of individual decisions which added and lost value. Simultaneously the system records and calculates transaction fees which includes brokerage, regulator charges, trading impact, timing and related issues.' See www.electronictrustee.com