THE FUND AND ITS SERVICE PROVIDERS

Pension funds generate vast amounts of money by way of contributions even when their members are relatively poor as is most often the case in South Africa. This has two necessary consequences that the ingenuity of politicians, lawyers and moralists has never been able to avoid or prevent. The first is that the administration, investment and distribution of the funds in the 21^{st} Century demands special skills that only specialists can offer. In earlier times it was thought that this need could be avoided by imposing substantial limitations on the scope of permissible investments for pension funds. But that was an age with little inflation where putting money in "the 4 percents" and relying on the power of compound interest was a guarantee of future wealth. That is no longer true so we must perforce invest pension money in shares and more sophisticated financial instruments such as derivatives. It is rumoured that the sound financial position of the University of Cambridge was due to the investments it made during the Depression on the *ad hoc* advice of John Maynard Keynes after reading his morning newspaper over breakfast. However, few of us can claim the skills of the greatest economist of the 20^{th} Century, so we still need pension fund administrators, investment advisers, asset managers and other parties to provide the specialised skills that pension funds need in this day and age if they are to discharge their central function of providing reasonable pensions to their members. These are the service providers about whom I am asked to speak, although judging by the attendance list it is rather more a case of "to whom" I am expected to speak. I will try to mind my manners and move on instead to fraud and theft.

The second necessary consequence of the availability of large amounts of money is that there is always a temptation for those in a position to do so to appropriate as much of it as they can lay their hands on and rather more than is regarded by society as acceptable.

Many will resist the temptation and content themselves with remuneration commensurate with the services they render. However others misheard the Lord's Prayer at school and thought it said "lead me to temptation". Depending on the temperament and moral persuasion of this group their depredations on the funds will range from the marginal – no-one will notice another quarter percent on the fees – to the egregious, where the funds are treated as a private piggy bank. For some reason the name of the late Robert Maxwell springs to mind, although we have some home-grown examples with whom I am sure that many of you are familiar!

These two necessary consequences – as certain in their own way as Benjamin Franklin's death and taxes – make it relatively easy to identify the ideal pension fund administrator. What you are looking for is a highly intelligent and financially astute Franciscan monk whose vows of poverty are beyond reproach or temptation. I wish you well in searching for this person, but in the mean time you may have to put up with rather more worldly organisations and people. That being so ordinary human experience suggests that it is a good idea to have someone to keep an eye on what goes on in regard to the administration of pension funds. Whilst I would not wish to deprecate the work of the press and my old friend Bruce Cameron in this regard, I have something rather more formal and structured in mind. However much we may admire free markets and denounce the "nanny state" the fact that ordinary people place large sums of money intended to secure their old age in the hands of third parties, who may be tempted to appropriate it to their own ends or may simply be foolish in the way in which they deal with it, dictates the necessity for regulators.

The need for regulation is however a relatively recent phenomenon as it usually is. Regulation tends to follow after innovation and then only when the need for it has been demonstrated by some or other disaster. Before that time arises it is the lawyers and the courts which have to struggle with things when they go wrong and it is in that context that the expressions “fiduciary duty”, “duty of care”, “due skill and care” and the like evolve to strike fear into the hearts and minds of the service providers and provide profit for lawyers. They become more confusing when they are incorporated without explanation into protective legislation, as for example in the provisions of the Financial Institutions (Protection of Funds) Act[1]. However it is possible to grapple with these concepts without becoming lost in a forest of legalese.

At the outset let me identify two central difficulties that tend to cloud the understanding of these concepts. The first is that they are general notions covering a very wide field of human activity and are necessarily expressed in broad and general terms without further definition. That means that their scope will always be a little fuzzy at the edges in dealing with new circumstances where past precedent is not available as a guide. Secondly and because of this indeterminate aspect and their high-sounding nature they can readily be used for pejorative purposes by regulators, aggrieved parties, the press or lawyers who are not certain of the right answer but who wish either to scare their clients into submission or at least cover their own backs with the advice they give. This is not always fair, but it can be frightening to those who are trying to do their best in a difficult environment. No-one wishes to be accused of breaching a duty of care or a fiduciary duty because of the implication of moral wrongdoing attached to these expressions. Let me try therefore to strip away some of this mystique.

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1 Act 28 of 2001, section 2. Here the expression is that the person to whom the section applies must exercise proper care and diligence, but it is probable that the courts will interpret this as meaning that they must act without negligence in the conventional sense.

I will start with the notion of a duty of care and do so mindful of the fact that our courts now prefer to refer to it as a legal duty in order to avoid confusion with the corresponding expression in the English law of negligence, which covers a different field. It is reasonably simple to express this duty as a matter of principle. It is the duty that the law – and for that read courts – imposes upon people not to cause harm to others either in their person or in their property. If a person owes such a duty and fails to take reasonable care to prevent the harm they are negligent and liable to compensate the injured party. As a simple example every time you get into your car you undertake a duty of care to hundreds or, on a Johannesburg freeway at rush hour, thousands of people. That duty is to drive in such a fashion that you do not cause harm to others either by hitting their cars or by injuring their bodies, although my experience on the M1 in the morning suggests that most drivers are either not aware of this duty or not concerned to comply with it.

The notion of a legal duty not to cause harm to others permeates society whether it is the duty of the electrician to wire the appliances in your house properly so that the house does not burn down, or the duty of the teacher to supervise the children in the playground to ensure they don't injure themselves, or the duty of the policeman to protect defenceless and vulnerable people from attack.

In the financial field where people are looking after other people's money or advising how it is to be invested the duty is to exercise reasonable care to protect the funds and place them in appropriate investments designed to fit the purpose for which they have been invested. Negligent advice as to an investment is a breach of that duty.[2] Because the giving

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2 *Durr v ABSA Bank Ltd and another* 1997 (3) SA 448 (SCA).

of investment advice is a task that requires skill the duty resting upon such a person is correspondingly higher. Negligence can take many forms and there may be overlaps between the duties of different service providers. An asset manager that chooses investments that are too speculative having regard to the circumstances and needs of the client is negligent. This does not mean that risk may not be acceptable to certain clients but the level of risk must be appropriate to that client. This is important in regard to pension funds and is reflected in the current litigation arising from the Fedsure debacle of a few years ago. The administrator that chose that asset manager may have taken insufficient care in selecting the asset manager and chosen someone who was not competent or honest. That too will be a breach of a legal duty and negligent. Sometimes the negligence lies in failing adequately to identify the risks to which the client is exposed whilst extolling the potential benefits of the investment. In other cases it may lie in an excess of caution. Risk must be balanced by return. The Biblical story of the king who travelled to a far country and left his servants with amounts to be invested on his behalf is an illustration of this. You will recall that the one servant took his talent of gold and buried it in the ground so that he could return it intact to his employer upon the latter's return. That approach was as much a breach of a duty of care as if the servant had taken the money to the Biblical equivalent of a casino.

How do you identify the nature and scope of the legal duty to avoid harm that will rest upon you in the administration and investment of pension funds? I suspect that this is the most difficult question facing service providers who are concerned with the need to comply with their obligations. The duty must be something different from a duty to avoid loss or we would never find people willing to take on the task of pension fund administration. Loss after all may arise purely fortuitously, as any pension fund administrator whose investments were hit by the decline in markets after the events of September 11, 2001 will testify. I am afraid that I cannot give you an answer that will guarantee that you are not sued if things go wrong or are perceived to have gone wrong. Nor can I give an answer that will satisfy the foolish or the foolhardy or the dishonest. My only comfort lies in knowing that they are not looking for the kind of advice that I am dispensing.

I do however suggest that there is a checklist that can be used as a guide to determine what is required of you as a service provider. Firstly is everything you do appropriate to the fact that you are dealing with pensions and long-term expectations of ordinary people? In simple language is this a pension fund you would join on the basis of the quality of the services you render or would you personally prefer it if your affairs were in someone else's hands? Secondly, you stand on the right side of an asymmetrical information divide. In other words you know more than those whose interests you are representing particularly pension fund trustees and the members themselves. Are you ensuring that the advantage you have and the skills you are being paid to deploy are being used solely for the benefit of the fund and its members without you taking advantage of that information gap to benefit yourself? Thirdly do you ensure that there are no short cuts taken in the advice you are giving or the research you are undertaking or the attention you pay to what you are doing? Fourthly is the reliance placed on your skill and expertise justified by the application of that skill and expertise to the task at hand? Lastly, and on the assumption that she is dear to you, would you be happy if your mother and grandmother were a member or pensioner of a pension fund having the benefit of your efforts? If you can answer all those questions in the affirmative, or more probably can say that your company has systems in place to ensure that they can be answered in the affirmative, you are probably reasonably safe, but as a last word of advice I wouldn't let your professional indemnity cover lapse.

Assuming you have done all in your power to ensure that you comply with your legal duty not to cause harm to your clients, you may feel quite proud of yourself and a little virtuous and then a little voice whispers in your ear: "It's all well and good to be careful but what about your fiduciary obligations?" One of the interesting features I noticed when browsing through the advertising material in your conference pack was that I only found one reference to fiduciary obligations and that was an offer to help a fund with its fiduciary obligations. I have no difficulty with the notion that trustees of a pension fund owe it fiduciary duties[3] but is it so confined? Are there others involved in pension fund administration and particularly the administrators themselves who are subject to fiduciary obligations and in any event what do we mean when we speak of fiduciary obligations?

The answer to the second part of that question is deceptively simple. A fiduciary duty is a duty of good faith that one person or party owes to another in the context of their dealings with or on behalf of that other party. Such a duty arises whenever the nature of the relationship between two parties is such that the one person is in a position to benefit themselves at the expense of the other or obtain an undue advantage from that other or turn their position in the relationship to secure any advantage not contemplated when the relationship was established. The principle was summarised in the following terms by Chief Justice Innes, one of our greatest judges, slightly updated to take account of modern sensibilities and realities:

> "Where one person stands to another in a position of confidence involving a duty to protect the interests of that other, he or she is not allowed to make a secret profit at the other's expense or place themselves in a position where their interests conflict with their duty. The principle underlies an extensive field of legal relationship. A guardian to his ward, a solicitor to her client, an agent to his or her principal, afford examples of persons occupying such a position. … The doctrine is to be found in the civil law (*Digest* 18.1. 34.7),

[3] This was accepted in *Tek Corporation Provident Fund and Others v Lorentz* 1999 (4) SA 884 (SCA), para 15. Interestingly enough in the same case it was accepted that the employer owed some obligations of good faith to its employees and the fund.

> and must of necessity form part of every civilised system of jurisprudence. It prevents an agent from properly entering into any transaction which would cause … interests and … duty to clash. If employed to buy, he cannot sell his own property; if employed to sell, she cannot buy her own property, nor can they make any profit from the agency save the agreed remuneration; all such profit belongs not to the agent, but to the principal. There is only one way by which such transactions can be validated, and that is by the free consent of the principal following upon a full disclosure by the agent. In such a case the special relationship *quoad* that transaction falls away and the parties deal at arms length with one another."[4]

In that passage we find the answer to the entire controversy over "bulking". There is nothing wrong with the practice at all. Indeed in many circumstances not to engage in bulking would be wrong because it would involve a failure by the administrator or asset manager to seek to maximise the return on the funds under administration. That might well be a breach of the duty of care owed to the fund in regard to the proper management of the funds under administration. What was wrong about the practice is that it appears to have involved administrators using their clients' money to generate a profit for themselves. That was impermissible because it disregarded the simple principle expressed as follows by Chief Justice Innes:

> "… it rests upon the broad doctrine that a man, who stands in a position of trust towards another, cannot, in matters affected by that position, advance his own interests (e.g., by making a profit) at that other's expense."

The other interesting aspect of that decision is that it indicates that a wide variety of people may owe fiduciary duties to others. There is no closed list of categories. Guardians to their wards; attorneys to their clients; agents to their principals; directors to their companies; employees to their employers; trustees and executors to the beneficiaries of the trust or estate are all examples of fiduciary relationships. Such relationships are most often to be found in situations where the one party is handling money or assets on behalf of another but it is by no

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4 *Robinson v Randfontein Estates Gold Mining Company Ltd* 1921 AD 168 at 177-8. The principle was forcefully reaffirmed in *Phillips v Fieldstone Africa (Pty) Ltd and another* 2004 (3) SA 465 (SCA).

means confined to that. An interior decorator who undertakes to decorate your house at a fee of 10% of the cost of redecoration – already astronomic – who then takes a commission from the suppliers from whom the furniture and furnishings are ordered is making a secret profit from a relationship in which they stood in a position of trust. That is a breach of a fiduciary duty.

So the existence of a fiduciary duty depends entirely upon the nature of the relationship between the parties. Wherever that relationship involves elements of trust and dependency, where the one party is constrained to depend upon the other to discharge a duty or perform an obligation, it is likely that the court will infer a duty to act in good faith in performing that duty or discharging that obligation. The performance of that fiduciary duty will require that the person burdened by that duty places the interests of the other party ahead of their own. Primarily this means that conflicts of interest must be avoided. It is popular in management circles at present to speak of the management of conflicts and there was a stage when there was a vogue for setting up "Chinese walls" as part of this process. Sadly for those engaged in this activity I must tell you that the law generally does not speak of managing conflicts of interest but of avoiding them entirely. As to Chinese walls no court of which I am aware in any jurisdiction in the world has thought that they are helpful or effective.[5] No court will ever look kindly upon a conflict of interest between the interests of a party standing in a relationship of trust to another and the interests of that other.

Does this affect pension fund administrators. In my view there can be little doubt that it does. After all their task is the administration of the pension fund and the usual reason for their being appointed is that the trustees of the fund cannot themselves deploy the skills

5 See in this regard the sceptical judgment of the House of Lords in *Prince Jefri Bolkiah v KPMG (a firm)* [1999] 1 All ER 517 (HL) at 529f-530h.

necessary to administer the fund or it is not of a size or nature that makes 'in house' management an acceptable option. In many ways the administrators stand in the shoes of the trustees and act as agents on their behalf in performing their statutory functions, whilst the trustees assume a role of oversight. Why then should they not owe a fiduciary duty to the fund in the same way as do the trustees? I would not go so far as to say that they owe a duty directly to the members as that raises other issues and the fund and its trustees bear the primary responsibility for protecting members' interests. Let us look at the matter from a different direction. Is there the potential in this situation for conflicts to arise between the interests of the pension fund, representing as it does the interests of its members, and the administrator. The answer must clearly be in the affirmative as the "bulking" issue demonstrated. It is rare in that situation for the courts to say that no fiduciary interest is engaged and for my part I can see no reason why the court should do so in this case.

What then is the primary obligation that arises in this situation? Overwhelmingly it is to prevent conflicts of interest arising in the first place. What kind of conflicts are we concerned about? We have seen the case of a conflict of financial interests. That is the most obvious one but what of other conflicts such as can arise where the pension fund administrator or the group of companies to which it belongs offers a "one stop" shop in regard to financial services so that it is more than just an administrator. I have in mind the instances within the group where they also act as advisers on pension issues and may advise the management of a company as well as administering the fund. Let me take an old example, which I suspect is now a thing of the past. What if management wishes to change from a defined benefit fund to a defined contribution fund. Is there not a conflict of interest in the administrator advising management on how to undertake that process? Let me bring matters up to date. What happens if the pension fund administrator needs the services of a stockbroker or a specialised asset manager and lo and behold it has one in the same group? How often does it happen that it makes use of a third party? Do I hear a cry of "Never" from somewhere in the room? Yet that is a conflict of interest situation.

I suspect that such conflicts are an ever-present reality in South Africa with its relatively small financial markets and the relatively small number of large players in that market. That means that parties caught up in such situations must deal with them and again there is no obscurity about how to deal with them. The problem is only resolved by a full disclosure of the nature of the potential conflict and independent and informed consent from the side of the trustees to the situation proceeding. It is interesting to note in an era where the drumbeat of transparency is sounded all the time that the principle I have articulated was laid down in 1921.

Full disclosure is never easy. I have been asked whether it is full disclosure when you find a mention of something in clause 17(3)(b) (ii) on the reverse of page 5 of the standard conditions of contract. One would hope that the fact that the question has to be asked in that form should suggest the answer. What full disclosure requires is that the nature of the conflict is clearly stated and identified; that the alternative courses of action are clearly identified and placed before the trustees; that there is a full disclosure of relevant information and that no improper pressure is brought to bear on the trustees in reaching their decision. In regard to disclosure a good rule of thumb is to ask: "What would I want to know if I had to make this decision?" In regard to improper pressure what I have in mind is dark hints that deciding in one way "may cause our Board to reconsider the relationship."

Against this background do administrators have more to fear from the proposed amendments to the Pension Funds Act to introduce sections 13B(4) to (9). In my view not a lot. Certainly I do not think that it materially expands the duties already resting on administrators. Subsection 4 provides that:

"(4) A person who has been granted approval by the registrar (hereafter referred to as "administrator") must-

(a) avoid conflict between the interests of the administrator and the interests of the fund;
(b) administer the fund in a responsible manner;
(c) keep proper records;
(d) employ adequately trained staff and ensure that they are properly supervised;
(e) have well-defined compliance procedures;
(f) maintain adequate financial resources to meet its commitments and to manage the risks to which the fund is exposed;
(g) accept accountability to the registrar and maintain an open and co-operative relationship with the office of the registrar; and
(h) furnish to the registrar the information requested by the registrar and promptly inform the registrar about anything else that might reasonably be expected to be disclosed to the office of the registrar."

I can see little in this that is not already the legal position as I have been discussing earlier in this address. I would be surprised to learn that reputable administrators do not already do these things. It will still be necessary for the courts in disputed instances to spell out what constitutes a conflict of interest and what constitutes administration of the fund in a responsible way. What will change lies in the powers to be given to the regulator in cases of non-compliance, but that is a regulatory issue rather than an issue of the duties owed by administrators to funds. If you sleep soundly at nights under the present regime you have nothing to fear from the new one. If you don't, never fear. The exercise by the registrar of these new powers may lift the burdens of administering pension funds off your shoulders forever!

Thank you very much.