

PART 6: SECTOR SUPPLEMENTS

SUPPLEMENT FOR RETIREMENT FUNDS

1. Retirement funds – the macro view and benefits of corporate governance

Retirement funds are an important component of the institutional investor industry which consists of retirement funds, insurance companies and service providers of institutional investors, for example, asset and fund managers and consultants.¹ Retirement funds should hold investee companies accountable for good corporate governance. Retirement funds furthermore carry fiduciary duties to their ultimate beneficiaries - those who contribute to retirement funds and their dependants - to apply the principles of responsible investment towards long-term, sustainable returns. Lastly retirement funds should mandate their service providers to follow responsible investment principles in regards to those investment decisions and activities that are outsourced.

Retirement funds that are well governed, including following and mandating responsible investing principles, and that hold investee companies accountable for good corporate governance, wield significant power to enhance the checks and balances that are essential for an effective overall corporate governance system.

2. Scope

This supplement applies to all 'retirement funds' including the following type of funds in accordance with their definitions in the Income Tax Act, 1962:ⁱ

- pension funds
- provident funds
- preservation funds, and
- retirement annuity funds.

3. Code for Responsible Investing in South Africa (CRISA)

In addition to legislation and King IV, CRISA is a voluntary code applicable to institutional investors, the definition of which includes retirement funds. CRISA and King IV are complementary codes that reinforce and complement each other.

4. Terminology

The following particular definitions apply to this supplement:

'Beneficiaries' includes the members of the fund, their dependents and nominees of the members

'Board' means the board of trustees of the fund as defined in the Pension Funds Act.

'Member' carries the meaning ascribed to it in terms of the Pension Funds Act.

'Pension Funds Act' or 'Act' refers to the Pension Funds Act, 1956

¹ Code for Responsible Investment in South Africa

In order to apply the King IV Code to retirement funds without having to repeat it in its entirety, it is necessary to explain how the terminology used in the Code could be interchanged for terminology applicable to retirement funds. For retirement funds King IV Code references to 'organisation' should be read as the retirement fund. Similarly references to 'governing body' should be interpreted as the board of trustees of the fund. 'Member of the governing body' or those charged with governance duties' should be understood as the board of trustees of the fund. The term 'shareholders' should be read as the members of the retirement fund.

In this supplement the collective noun retirement fund or fund is used as well as the terminology board and trustee.

The use of 'corporate' such as in 'corporate governance' is meant to refer to the governance of organisations that are incorporated to form legal entities separate from their founders. 'Corporate' does not only denote a company or for profit enterprise but all forms of incorporation whether as company, voluntary association, retirement fund, trust, legislated entity or others. The term corporate governance is used to differentiate it from other forms of governance, for example national or political governance.

5. Applying the practices in the Code to retirement funds

Certain recommended practices in the King IV Code are referenced in this supplement to illustrate how they could be customised to meet the needs and requirements of a retirement fund. It would be inaccurate to conclude that those practices in the King IV Code which are not dealt with in this supplement specifically are not applicable to retirement funds.

The essence of King IV as represented by its outcomes and principles apply to retirement funds with the necessary adaptation in terminology and are repeated below for ease of referencing.

5.1 Chapter 1: Leadership, ethics and corporate citizenship

OUTCOME: ETHICAL CULTURE
Principle 1.1: The board should set the tone and lead ethically and effectively.
Principle 1.2: The board should ensure that the retirement fund's ethics is managed effectively.
Principle 1.3: The board should ensure that the retirement fund is a responsible corporate citizen.

The values of accountability, responsibility, fairness and transparency exemplify ethical leadership and should be the cornerstone upon which any organisation is conducted regardless of size and nature of operations. Principle 1.1 and its practices require the board of trustees to set the example for ethical and effective leadership by demonstrating ethical characteristics. Thus governance starts with a focus by the trustees on their own – individual and collective - character and behaviour.

In addition to setting the example through its own character and behaviour, the board should also ensure that the ethics of the fund is managed effectively in accordance with Principle 1.2. Principle 1.2 and its supporting practices

apply to both a retirement fund with its own staff complement to carry out the administration as well as to a fund that outsources those services. When outsourced, the board should satisfy itself that the service providers of the fund manage their ethics effectively through policies, frameworks and processes in place. This is aligned to the requirement for companies to have to oversee the ethical practices within its supply chain.

Compliance with the requirements of Regulation 28 of the Pension Funds Act, 1956 (the Act) and in particular the preamble that states that prudent investing “should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of the fund’s assets, including factors of an environmental social and governance character”, should be seen as an integral part of the fiduciary duties imposed by the Act. Principle 1.3 carries the same sentiment albeit using different terminology. A retirement fund gives substance to its duty to be a responsible corporate citizen by ensuring that its investment analyses and practices, whether executed by the fund itself or a fund administrator, fund manager or other service provider, take account of sustainability including environmental, social and governance (ESG) considerations as provided for in Principle 1 of CRISA. This should be extended to demonstrating its acceptance of ownership responsibilities in its investment arrangements and investment activities as provided for in Principle 2 of CRISA.

5.2 Chapter 2: Performance and reporting

OUTCOME: PERFORMANCE AND VALUE CREATION
Principle 2.1: The board should lead the value creation process by appreciating that strategy, risk and opportunity, performance and sustainable development are inseparable elements.
Principle 2.2: The board should ensure that reports and other disclosures enable stakeholders to make an informed assessment of the performance of the retirement fund and its ability to create value in a sustainable manner.

Principle 2.1 and its supporting practices should be read and understood in the context of a retirement fund’s purpose and strategic objectives. Other than a commercial enterprise, the purpose of a retirement fund is narrowly defined to provide the benefits to the beneficiaries as set out by its rules. Performance and value creation by a retirement funds consist of delivering high investment returns without irresponsible risk-taking and managing expenses so that retirement savings may be maximisedⁱⁱ. For a retirement fund it is critical that a long term view is taken of fund performance and value creation of value for beneficiaries.

The disclosure and reporting requirements addressed in Principle 2.2 of the Code are applicable to retirement funds. Meaningful disclosure is the mechanism by which the board of trustees is held accountable. The practices with regards to disclosure and reports as under Principle 2.2 should be considered by the board as a means for meaningful communication and to demonstrate accountability.

In addition, it is recommended that retirement funds due to the nature of their enterprise follow the disclosure practices as recommended in Principle 5 of CRISA.

5.3 Chapter 3: Governing structures and delegation

OUTCOME: ADEQUATE AND EFFECTIVE CONTROL
Principle 3.1: The board should serve as the focal point and custodian of corporate governance in the fund.
Principle 3.2: The board should ensure that in its composition it comprises a balance of the skills, experience, diversity, independence and knowledge needed to discharge its role and responsibilities.
Principle 3.3: The board should consider creating additional governing structures to assist with the balancing of power and the effective discharge of responsibilities, but without abdicating accountability.
Principle 3.4: The board should ensure that the appointment of, and delegation to, competent executive management contributes to an effective arrangement by which authority and responsibilities are exercised.
Principle 3.5: The board should ensure that the performance evaluations of the board, its structures, its chair and members and the principal officer result in continued improved performance and effectiveness.

Role of the board

In terms of section 7A of the Act every fund is required to have a board which can be expected to:

- determine the fund's purposes, values and strategies
- monitor implementation of those strategies
- exercise leadership, enterprise, integrity and judgment
- ensure proper risk assessment and management
- assess the performance of the board itself and of the fund, and
- ensure that it has or obtains the skills, expertise and facilities that it and the fund need properly to perform their functions.

With regards to determining the fund's purpose, values, strategies and monitoring of implementation, the practices under Principle 2.1 deal with this. Leadership, enterprise, integrity and judgement are addressed through Principle 1.1. Risk assessment and management are addressed under Principle 4.1. Guiding practices evaluating the performance of the board are provided under Principle 3.5 and ensuring that the fund has the skills to perform its functions are addressed in Principles 3.2 and 3.4. The recommended practices under these principles are useful in giving effect to the legislated duties of the board of trustees. The legislated duties are furthermore congruent with the overarching role of the board as dealt with in Principle 3.1.

Board composition

Principle 3.2 and its supporting practices apply with the necessary adaptation to retirement funds.

Trustees should act with independence of mind regardless of who elected or appointed them. Trustees must not act as representatives of their 'constituencies' and meetings of the board must not be understood as fora for collective bargaining. Doing so causes conflicts between the interests of those who appointed or elected the trustees and the interests of the fund itself. ⁱⁱⁱ

All trustees are bound by confidentiality of information that comes to their attention during the course of acting as trustees as part of their fiduciary duties as trustees. Such information cannot be disclosed to outside parties such as those who elected the trustees or to members without the express permission by the board on behalf of the fund.

Large funds benefit from independent trustees as it balances objective decision making in the best interest of the fund and its members. It is recommended that at least half of the board of trustees be independent trustees that are appointed from a pool of professional trustees. Such independent trustees should be free from any relationships which could in the opinion of a reasonable and informed outside party affect its objectivity.^{iv}

Even though the election and appointment mechanisms of retirement fund trustees are prescribed, the boards of retirement funds should still strive towards the aspiration expressed in Principle 3.2. This can be achieved by employing the appropriate expertise and resources to assist, guide and advise the board in the execution of its duties. Another manner in which Principle 3.2 can be accomplished is for employers or sponsors to use their powers of appointment to ensure that the board has members with the necessary expertise and experience. Those trustees should not be involved in the employer's decisions vis-à-vis the fund and employers should not use their power of appointment of trustees to ensure some sort of control over funds.^v

As is the case with all organisations, professional development and learning are of critical importance to ensure that those charged with governance are able to execute their duties effectively. Development programmes that are introduced should include competence, expertise and skills in corporate governance and responsible investment (or ESG). A process of engagement with the employees who elect retirement fund trustees in order to convey the nature of trustees' duties and the competencies required is also recommended.

Committees of the board

Principle 3.3 deals with the establishment of board committees. The board of trustees of all funds who undergo a statutory audit should consider having an audit committee to ensure proper oversight of the quality of the audit and independence of the auditor. Retirement funds should also consider investment committees to set investment strategy and monitor performance of investment managers in terms of the strategy. Death and disability committees may be appropriate for larger funds.

Regardless of the actual board committees that are established, the general practices that address board committees under this principle are applicable to retirement funds.

Delegation to management

Principle 3.4 addresses delegation to, competent executive management. Many retirement funds outsource in part or in total the fund's administrative functions and investment activities. Delegation of responsibilities to an outsourced function does not absolve the board from accountability. Oversight of section 13B administrators and other service providers is an integral part of the board's governance role as the board can be held liable for actions

of service providers.

Mechanisms and processes should be introduced for adequate and effective oversight in the same way as the board would have done if all administrative functions and investment activities were conducted by the fund itself. It involves that the board should ensure that there is a clear mandate in place between the retirement fund and the fund administrator and other service providers so that performance and the aspirations of responsible investing are achieved. The board of trustees of a retirement fund should oversee that the fund administrator and other service providers perform in terms of the mandate agreed and that outsourced functions are managed in accordance with the relevant accepted standards.

A specific area where the board of trustees needs to be proactive in its oversight role is on the management of conflicts of interest by service providers. Where various funds' investments are pooled the board should ensure that the interests of the retirement fund is treated fairly amidst the potential competing interests of the investors of co-investment vehicles and parallel funds managed by the same investment manager. Independent trustees could add arm's length expertise in dealing with inherent conflicts of interests. Conflicts may arise in both expense allocations and investment allocations and in the context of valuations. Valuations can be especially complex when dealing with portfolio companies and assets that are difficult to assess. The board should oversee that a conflicts of interest policy that provides for these eventualities is in place and being followed.

In regard to the oversight of management, the practices as recommended in the Code under Principle 3.4 are helpful guidance. These practices should be applied by retirement fund trustees with the necessary adaptation in relation to the section 13B administrator and other service providers.

Another matter that falls under Principle 3.4 is the appointment of the principal officer. In terms of the Act, the principal officer is required not to be a trustee and may not act as the chairman. It should not be interpreted that the principal officer is excluded from responsibility towards the fund. Legislation dictates that the fund appoints the principal officer which function should be assumed by the board of trustees on behalf of the fund. Hence, the principal officer is accountable to the board of trustees and the board, in turn, is accountable to the members of the fund. The board is secondarily also accountable to the sponsoring employer of the fund as the retirement fund is fulfilling an obligation on behalf of the employer.

Performance evaluations

Principle 3.5 and its supporting practices in relation to performance assessments are applicable to NPOs.

5.4 Chapter 4: Governance functional areas

OUTCOME: ADEQUATE AND EFFECTIVE CONTROL

Principle 4.1: The board should govern risk and opportunity in a way that supports the fund to set and achieve strategic objectives.

Principle 4.2: The board should govern technology and information in a way that supports the fund to set and achieve strategic objectives.
Principle 4.3: The board should govern compliance with laws and ensure consideration of adherence to non-binding rules, codes and standards.
Principle 4.4: The board should ensure that the fund remunerates fairly, responsibly and transparently so as to promote the creation of value in a sustainable manner.
Principle 4.5: The board should ensure that assurance results in an adequate and effective control environment and integrity of reports for better decision-making.

The recommended practices under Principles 4.1 to 4.5 should be interpreted and applied in conjunction with the relevant legislative and regulatory provisions. Where retirement funds are not able to implement the recommended structures and functions due to capacity and resource constraints, it is recommended that a shared services model be considered or that practices be applied on proportional basis.

5.5 Chapter 5: Stakeholder relationships

OUTCOME: TRUST, GOOD REPUTATION AND LEGITIMACY

Principle 5.1: As part of its decision-making in the best interests of the fund, the board should ensure that a stakeholder-inclusive approach is adopted, which takes into account and balances their legitimate and reasonable needs, interests and expectations.

Principle 5.2: The governing body should ensure that the fund responsibly exercises its rights, obligations, legitimate and reasonable needs, interests and expectations, as holder of beneficial interest in the securities of a company.

Principle 5.1 addresses stakeholder relationships. The stakeholders of a retirement fund include amongst others the members of the fund, their dependents and nominees of the members, the participating employer, the sponsor (if different from the participating employer) and the Registrar of Retirement Funds. The recommended practices under this principle assist with establishing stakeholder relationships that results in the governance outcome of trust, good reputation and legitimacy.

Principle 5.2 invokes the application of the responsible investing as advocated through CRISA and which should be applied by all retirement funds as a matter of sound governance.

ⁱ Financial Services Board, Role of Trustees, booklet developed by the Office of the Registrar of Pension Funds as a supervisor of the retirement fund industry in collaboration with the Consumer Education Department

ⁱⁱ Stewart, F. and J. Yermo (2008), "Pension Fund Governance: Challenges and Potential Solutions", OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing, © OECD. doi:10.1787/241402256531

ⁱⁱⁱ Hunter, R, The Governance Of Pension Funds, Paper to be presented by Rosemary Hunter to the annual convention of the Financial Planning Institute Durban, April 2002

^{iv} PF Circular 130

^y Hunter, R, The Governance Of Pension Funds, Paper to be presented by Rosemary Hunter to the annual convention of the Financial Planning Institute Durban, April 2002

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