think tank

May 2012

Contents

RisCura
good thinking

Regulation 28

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For several months, we have been discussing the changes to Regulation 28 with our clients. A key and important point we take every opportunity to reiterate, is that the recent amendments place very serious and complex obligations on Trustees of retirement funds. It is critical that Trustees fully understand these obligations and develop strategies and systems to comply with the Regulation.

Changes to Regulation 28

The key changes are:

- Embodiment of the principle of **liability-driven investing**. Trustees are now obligated to consider the liability profile of their members when developing investment strategies for the Fund. This applies to defined contribution funds as well as defined benefit funds.
- **Member-level compliance** with Regulation 28. It is no longer sufficient to ensure that the Fund as a whole is compliant. This must now also be done at member level.
- Every retirement fund is now obligated to have an **investment policy statement**. This was previously a recommendation in terms of circular PF130.
- **Environmental, social and governance** issues must be considered in the investment policy statement, including B-BBEE factors.
- The underlying assets in any pooled portfolio must be identified through the application of the **look-through principle** and reported on.
- There must be **daily compliance** with Regulation 28, not just at a point-in-time.
- Funds must **report on a quarterly basis** and must disclose the Fund's daily compliance status in these reports.
- **Hedge funds** and **private equity** are addressed directly.
- The introduction of a **de minimis rule** where no look-through is required for any asset that is less than 5% of total assets.
- **Trustee training** is now a requirement.

Key challenges arising from the changes to Regulation 28

The Trustees will need to:

- Assess the level of compliance of the Fund and members with Regulation 28, as at 31 December 2011 as a starting point.
- Develop a plan to map out the route to becoming compliant, if necessary.
- Apply for exemptions where, and if, necessary.
- Establish systems to monitor compliance on an ongoing basis.
- Address principle-based issues with the Board of Trustees (for example, duty to consider liabilities and ESG).
- Update the investment policy statement, as necessary.
- Update asset manager contracts, as necessary.
- Assess service provider competency and update service provider contracts, where necessary.

There is considerable work required to ensure that a Fund is fully prepared. The date of implementation of the new Regulation was 30 June 2011, and the first compliance report was due in April 2012 for the first quarter of 2012.

Trustees may ask what risk there is in not complying, particularly the difficult requirement of daily compliance monitoring. Apart from the possibility of a qualified audit report and the considerable risks of the FSB taking severe action in cases of breach (remember, Trustees are personally liable), perhaps the most serious risk is that Trustees and their delegated officers will lose a great opportunity to truly understand how the assets of their Fund are invested at every level.

RisCura's view and approach

Regulation 28 is an important piece of legislation that aims to ensure the best interests of retirement fund members are appropriately considered. To meet this aim, Trustees should be aware of the true nature of the assets in which the Fund is invested. This is only possible if the principles embodied in the Regulation are properly and fully implemented.

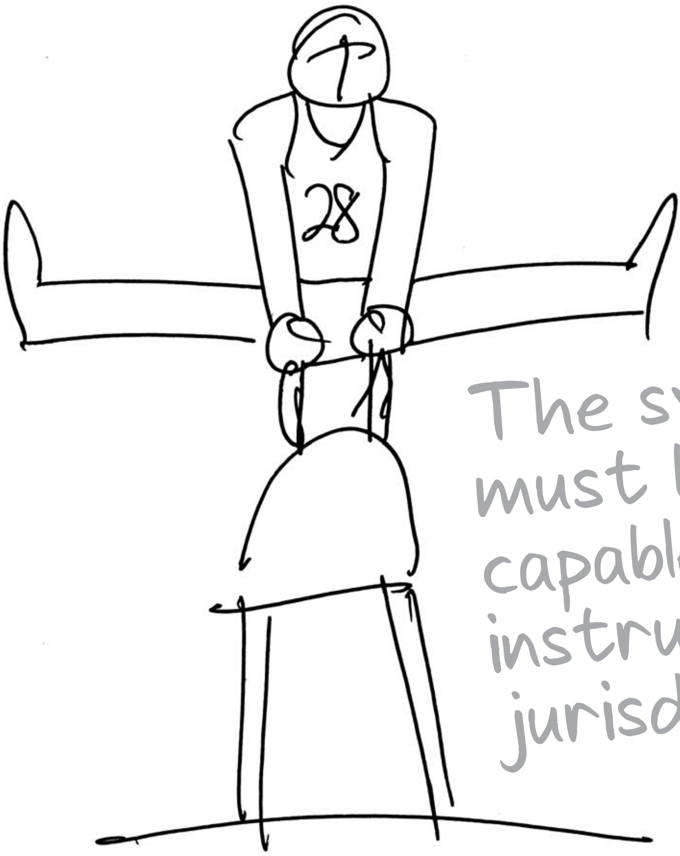
Meeting the compliance and reporting requirements of Regulation 28 is a very data-intensive process. The systems used must be flexible and capable of dealing with instruments from any jurisdiction.

RisCura has developed a proprietary system that is flexible, robust and proven. With the necessary relationships in place, we are able to efficiently and cost effectively fulfill the reporting obligations of the Fund. Our process, apart from producing accurate daily holdings files, determines the exact cause of any breach allowing Trustees to make a properly informed decision.

RisCura's approach to reporting is as follows:

- We obtain details of all Fund holdings at month end and all Fund transactions intra-month, on a look-through basis, from the Fund's asset managers;
- Where applicable, we obtain details of member ownership of each asset manager portfolio from the Fund's unitisation service provider;
- We reconcile this data to provide accurate daily holdings files for the Fund and, where applicable, each member-choice product;
- We evaluate each investment instrument to determine whether all information fields required for competent and consistent classification (e.g. issuer, market capitalisation) are included in our database;
    - For unlisted investment instruments, we obtain all data from the asset manager;
    - For listed instruments, we obtain market-related information directly from market data providers;
- We classify all investment instruments into the correct Regulation 28 categories and carry out a checking process to ensure consistency and accuracy;
- We conduct a daily compliance check at Fund level and, where applicable, member-choice level;
- We report to the Fund on compliance at each level, enabling Trustees to report to the FSB.

We appreciate that Trustees may feel that compliance with Regulation 28 should be simpler than the process above seems to indicate. However, RisCura's role is to take away this burden for our clients. The result is easy-to-understand reporting with clearly marked breaches and indication of near breaches. Our clients have peace of mind knowing that this complex process is well managed on their behalf.



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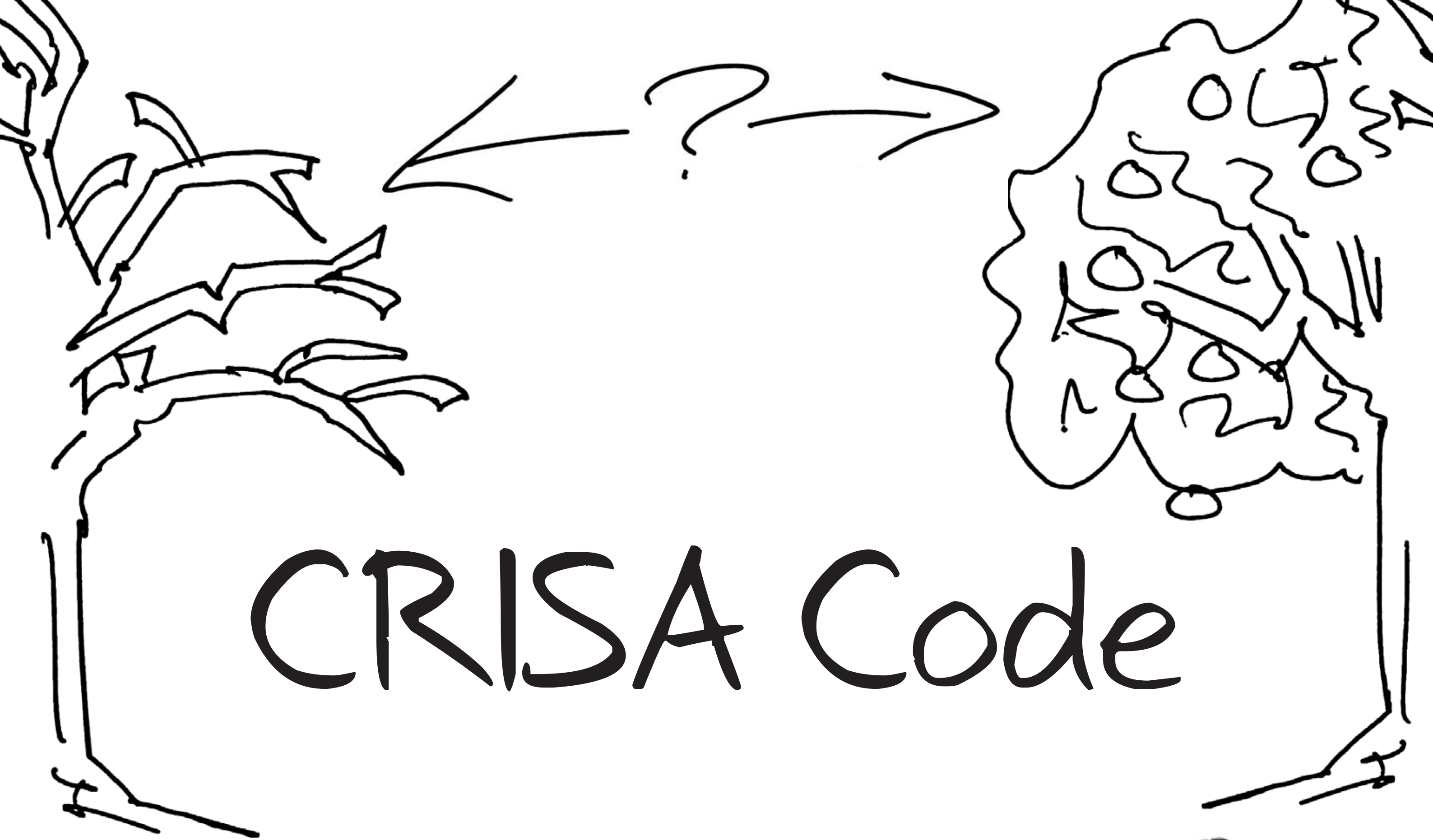


CRISA Code

**A version of this article was originally featured in the Nov/Dec 2011 edition of Today's Trustee*

By Prasheen Singh
Head of Consulting

Responsible Investing - How far will you go?

On 19 July 2011, the final version of the Code for Responsible Investing in South Africa (CRISA) was launched with considerable fanfare in the institutional investment arena. Up until the launch there had been a fair amount of talk in the industry about the topic of Responsible Investing (RI), the UN PRI and the initial drafts of CRISA. However, now is the time for decisions and actions.

Indeed, John Oliphant (who chaired the committee responsible for producing the final CRISA code) was quite strident in his challenge to those of us involved in the long-term savings industry to pledge commitment to the principles of this code. Furthermore, something that many might have overlooked - the code includes an initial milestone of 1 February 2012 as the date by which institutional investors and service providers should indicate their adoption (or not) of the principles and practice recommendations in CRISA on an "apply or explain" basis (i.e. similar to the approach used in reporting on adherence with King III).

Whether you represent the asset owners in the industry or represent one of the various service providers to the asset owners such as investment managers and consultants, the question remains: Will you apply the code or explain it away?

CRISA provides guidance on how institutional investors (owners and their agents) should execute investment analysis, investment activities and exercise rights so as to promote sound and responsible governance.

For reference, the essential elements of CRISA are captured below.

The code has 5 key principles:

1. An institutional investor should incorporate sustainability considerations, including environmental, social and governance (ESG), into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries.
2. An institutional investor should demonstrate its acceptance of ownership responsibilities in its investment arrangements and investment activities.
3. Where appropriate, institutional investors should consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors.
4. An institutional investor should recognise the circumstances and relationships that hold potential for conflicts of interest and should proactively manage these when they occur.
5. Institutional investors should be transparent about the content of their policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments.

CRISA applies to:

- Institutional investors as asset owners. For example, pension funds and insurance companies.
- Service providers of institutional investors. For example, asset and fund managers and consultants.

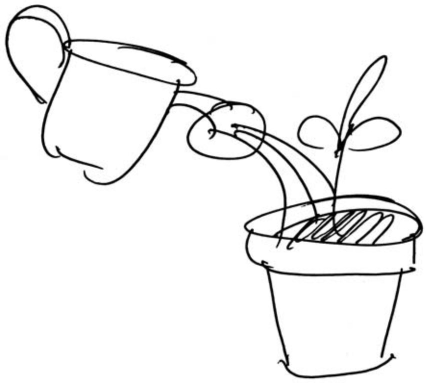
Source: CRISA 2011 - IODSA

Before moving on to the topic of how one might take steps to adopt CRISA as an institutional investor, it's worth pointing out that the final draft of CRISA contains an additional principle that wasn't in the discussion draft. The 4th principle, which requires that institutional investors be mindful of potential conflicts of interest and manage them proactively. This principle isn't something that is so explicitly spelt out in other international codes on RI but the committee obviously felt that it warranted special mention given the more concentrated ownership and governance realities in the South African market when compared to other larger economies.

To date, a lot of commentary and action around the topic of RI has come from investment managers and a few of the big pension funds. However, this code is aimed at all asset owners and their fiduciaries and their investment-related service providers (i.e. all pension / long-term savings funds, life assurers, investment managers, asset consultants).

So, if you are an institutional investor or service provider as defined by CRISA, what do you need to do to address the challenge if you've not done so already?

Firstly, you need to believe. Adopting and practicing the principles of CRISA has considerable operational consequences with uncertain benefits and costs. Indeed it also has potential costs (with possibly no benefits) if you don't adopt the principles. So it can't be ignored. While investment managers need to adjust their investment processes to integrate ESG factors into their analysis and actions, it



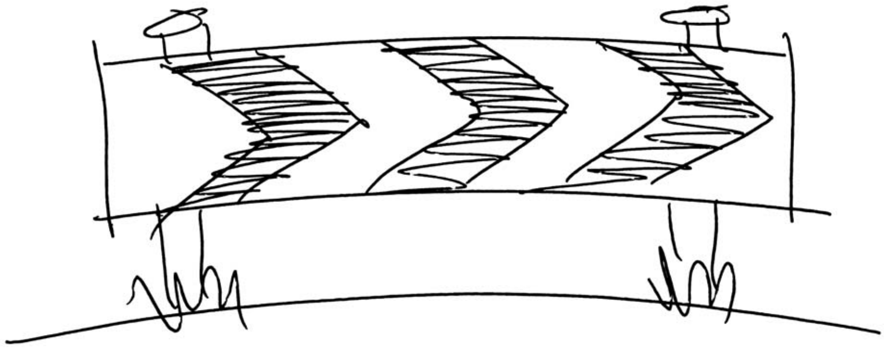
is the owners of the assets they manage that need to believe in the merits of why this should be done. Add to this the fact that from February onwards, institutional investors needed to disclose the extent of their adoption - or intent to adopt - then it's essential that you and your colleagues meaningfully address RI and CRISA as soon as possible.

Why would you do this? Besides believing this is the right thing to do, there is a growing body of evidence that points to the correlation of long-term returns and good ESG practices by companies. However, institutional investors should recall that the preamble to Regulation 28 now states that prudent investing "should give appropriate consideration to any factor that may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character".

We suggest doing the following to consider CRISA:

- Debate the pros and cons of CRISA adoption.
- Decide the extent to which you will adhere to the principles.
- Draw up a Responsible Investing Policy appropriate for your entity.
- Decide what things you need to do in this regard and what things you need your service providers to do.
- Take steps to get these going.
- Review and update mandates / agreements between you and your service providers / clients.
- Engage with your stakeholders about what you are doing (or going to do) and work out how you will regularly disclose your activities and progress to them.

There is a lot to do. It's not expected that all would have been in place by February, but it is hoped that the first steps will have been taken with momentum growing thereafter. If you lack 'knowledge' or 'resources' there are consultants and advisors able to help you. However, if you lack 'time' no one can address that but you. Have you started yet?



The landscape of proxy voting at South African Asset Managers

By Jimmy Winfield

Jimmy Winfield is a senior lecturer at the University of Cape Town, where he teaches courses in Business Ethics and Financial Reporting. He is a co-author of Understanding Financial Statements*, a popular MBA textbook, and has written often about ethics for Accountancy SA.*

Report Excerpt:

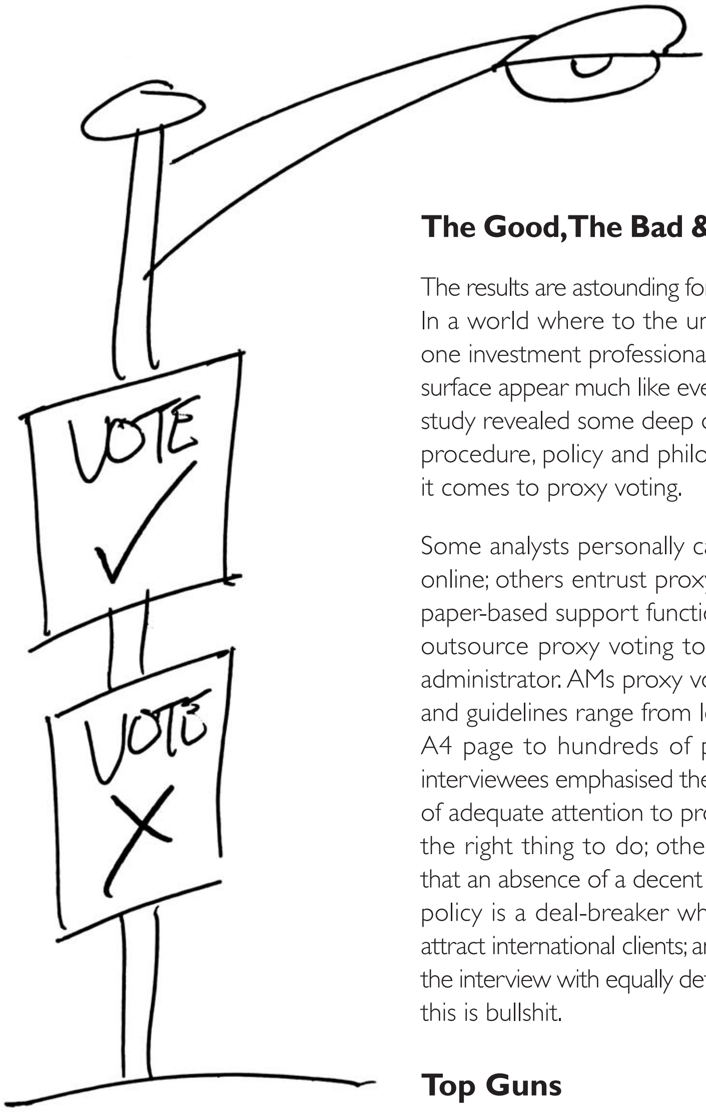
If you had the power to improve your situation just by raising a hand, would you nonetheless refuse to exercise this power no matter how bad things are, no matter how much better they could be?

A company's shareholders have the power to effect meaningful change, thanks to their right to a proxy vote at general meetings. Company law bestows this right with good reason: the issues on which votes are required are integral to the sustainability and performance of an investment. As always, the right to vote comes with a duty to use it wisely. Not doing so would be, at best, wasteful, if not downright irresponsible.

The obligation is amplified for asset managers (AMs), where failure to take voting seriously would also be a dereliction of the fiduciary duty to act in their client's best interest. Returns cannot be maximised simply by voting with the feet; by invoking the so-called Wall Street rule and selling the shares. Particularly in the concentrated South African market, AMs often hold too large a stake to be able to disinvest without eroding the share price. Besides, a well-informed vote may not only prevent a loss: it has the power to create value by significantly improving the fundamentals of the underlying business.

For these reasons, and in light of recent global events, proxy voting has recently become the subject of much attention as an essential tool for investment professionals to act as good stewards of their (and for AMs, their clients) assets.

Internationally, institutional investors have developed proxy voting policies, and voting records are closely monitored, in an attempt to ensure that the right to vote is used effectively. In order to determine how proxy votes are exercised on behalf of clients in South Africa, a study of most of the country's larger AMs was conducted last year. The study included a comprehensive analysis of their proxy voting policies and a series of wide-ranging interviews of senior personnel.



“...this study revealed some deep differences in procedure, policy and philosophy when it comes to proxy voting.”

The Good, The Bad & the Ugly

The results are astounding for their variety. In a world where to the untrained eye, one investment professional may on the surface appear much like every other, this study revealed some deep differences in procedure, policy and philosophy when it comes to proxy voting.

Some analysts personally capture votes online; others entrust proxy voting to a paper-based support function; still more outsource proxy voting to an external administrator. AMs proxy voting policies and guidelines range from less than one A4 page to hundreds of pages. Some interviewees emphasised the importance of adequate attention to proxy voting as the right thing to do; others explained that an absence of a decent proxy voting policy is a deal-breaker when trying to attract international clients; another began the interview with equally definitive words: this is bullshit.

Top Guns

A small handful of AMs stood out as excited, passionate and serious about the opportunity to use proxy voting and other means of stewardship as tools to deliver the best possible service to clients. Typically, these AMs do most or all of the following:

- they have comprehensive proxy voting policies that offer clear guidance, while still allowing for flexibility in each voting decision
- they scrupulously inform clients of the policies as well as their voting records they generate, and acquire detailed research about the issues surrounding upcoming votes
- they are not afraid to engage management on difficult issues like allocation of capital, strategic direction and under-performing directors
- they require and train analysts themselves to prepare recommendations for proxy voting, and portfolio managers to actively oversee these recommendations

Unsurprisingly perhaps, these AMs are characteristically those whose marketing emphasises their responsible investing platform.

There are relatively few such industry leaders in the proxy voting arena, with the majority of AMs falling woefully short of these high standards, as evidenced by both the analysis of policy and the follow-up interviews.

Policy Academy

The first half of the study involved an analysis of AMs proxy voting policies as of December 2010. Independence was assured by redacting all references to AM’s names, which were replaced with randomly allocated letters: Manager A, B and so on. The analysis was designed to establish how well each policy serves three vital functions:

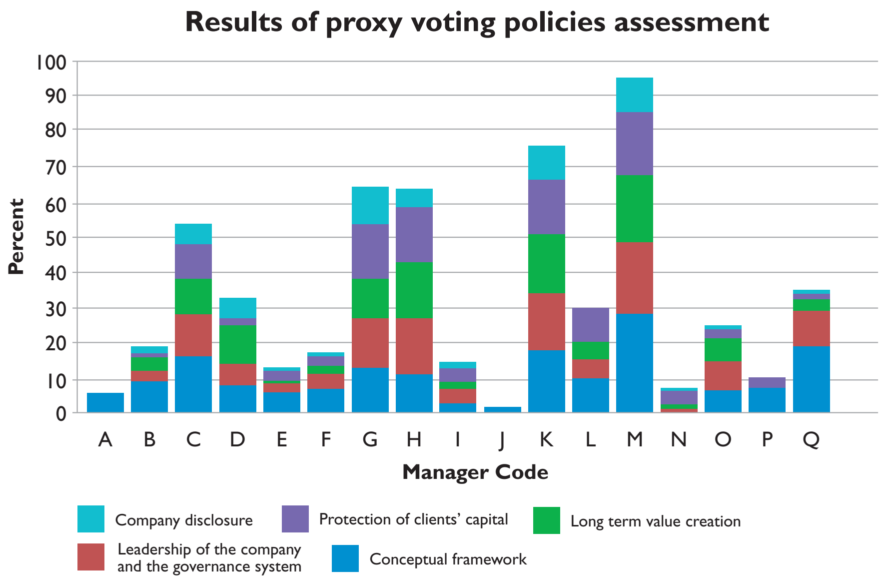
1. Providing a workable guideline to internal decision-makers
2. Fully disclosing to clients how the AM enacts its stewardship responsibilities on their behalf
3. Clearly signalling to investee companies what is expected from them

The study assessed the managers’ policies with respect to five different factors, with each factor divided into sub-components that were individually scored. The factors (weighted according to their importance in order to obtain an overall score) were:

1. Conceptual framework
2. Leadership of the company and the governance system
3. Long-term value creation
4. Protection of clients’ capital
5. Company disclosure

The scores for each component were added together to give a total score out of 100. As can be seen in the accompanying chart of proxy voting policy scores, most of the managers achieved an overall score below 30, indicating that on the whole, the quality of the policies is fairly low. Even the average score was little more than 30. One of the main reasons for this is that policies are typically presented as a relatively simplistic (and in some cases, copied) set of rules, rather than as the cornerstone of the stewardship function that it should be.

For the full report, visit
bit.ly/ProxyVotingReport

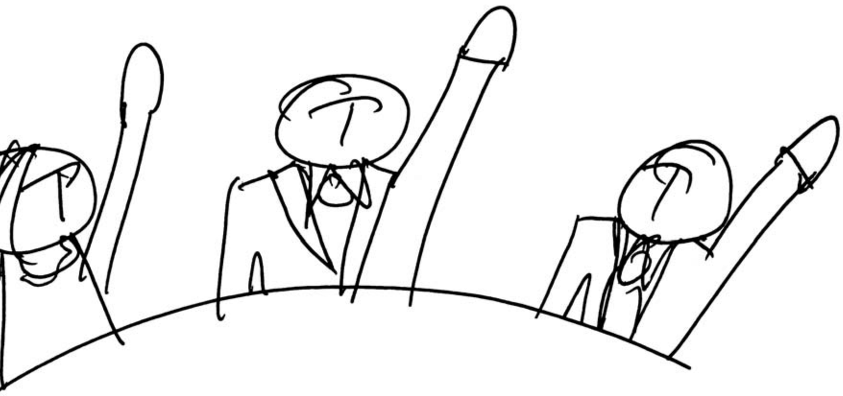


Back to the Future

It is clear from this study that the proxy voting space for asset managers in South Africa is under-developed. There are very few sources of quality research relating to voting items and relatively little research is generated internally by AMs. Policy documents are typically weak and do not communicate effectively to clients, internal investment professionals or investee companies. The majority of managers appear to treat proxy voting as a box-ticking exercise, without giving thought to ways in which responsible voting can create value for clients.

However, there are a small number of AMs who do strive to leverage these opportunities effectively. Many of the personalities driving these strategies are involved in broader initiatives to focus investors' minds on stewardship and responsible investing, like CRISA, which will hopefully reduce unnecessary risk-taking and improve the sustainability of client returns. South Africa was partially insulated from the crisis that has put the issue of stewardship under the magnifying glass of investors overseas; the sooner such initiatives bring this issue into focus locally, the better.

A new investment dynamic is emerging, in which genuinely active managers recognise the link that stewardship has with the welfare of their clients' assets, not to mention with the society and environment within which they and their clients live. As these responsible institutional investors are shown over time to outperform the skeptics and cynics, investors locally will follow the international trend and move their assets to those who use their right to vote wisely.



Research Sponsored by RisCura

RisCura has undertaken this reasearch with external partners in order to better understand proxy voting in South Africa and gain greater insight into its use as a tool for investors in this market.

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