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ANNEXURE B TO CIRCULAR PF 130

GOOD GOVERNANCE GUIDELINES TO AN INVESTMENT POLICY STATEMENT (IPS)

This guideline sets out the following:

- The purpose and scope of the IPS;
- Preparing the IPS;
- Essential elements of the IPS;
- Risk management;
- Voting rights;
- Asset Manager Mandates, and
- Communication

PURPOSE AND SCOPE OF THE IPS GUIDELINES

1 Investments and the allocation of surplus funds should be made in the best interest of members and beneficiaries of the fund. There should be impartiality between different classes of members, and beneficiaries and those of the employer (where it has obligations to the fund). Boards have a fiduciary duty to deal with the investments with due care, diligence and in good faith and ensure that it complies with the rules of the fund, pensions law, the Financial Institutions (Protection of Funds Act) and all other applicable laws.

2 These guidelines contain the minimum standards and the issues that boards should consider when establishing a written IPS. The guidelines should be adapted by each board of fund to suit their particular obligations, objectives and all other factors that may affect the solvency and funding of their fund and its ability to meet its financial obligations. The board of fund should be prepared to explain any deviations from the IPS.

3 The guidelines are intended to serve as a guide only without intending to limit the care that boards of fund are expected to take in the performance of their duties. The IPS should be based on the standards that a reasonable person would apply to the investment portfolio of a fund – the "prudent person portfolio approach".

4 It is recommended that some of the guidelines set out herein should be included in the investment manager mandates rather than the IPS itself.

5 When required, the board of fund must be prepared to deliver a copy of the IPS to the fund's actuary and/or the Financial Services Board.

PREPARING THE IPS

6 In the case of established pension funds, consideration must be given to existent investments when formulating the IPS. Furthermore, additional considerations will have to be applied when dealing with specific funds.

6.1 Defined Benefit Funds:

The board should consider the following to properly understand the obligations of the fund, namely:

6.1.1 Whether contributions are to be increased to keep pace with the cost of living;

6.1.2 Whether the pension formula adjusts to increases in salaries over time or whether such increases need to be granted to keep the formula current;

6.1.3 How fund obligations are spread amongst the categories of members and former members, and, within these categories, by age and time to retirement;

6.1.4 Whether changes in employment levels or conditions will change patterns of retirement;

6.1.5 Important ancillary benefits contingent on full or partial retirement;

6.1.6 Any planned changes to the fund.

In addition, factors relating to solvency ratios and the maturity of the fund as set out more fully below, must also be take into consideration.

6.2 Defined Contribution Funds:

In this instance, the fund may appear to discharge its investment obligations by paying out contributions accumulated in beneficiaries' accounts along with investment returns, even though they may be low. However, it is recommended that the following factors also be taken into account, namely the:

6.2.1 Needs and reasonable benefit expectation of the beneficiaries;

6.2.2 Mix of members and the related growth and risk tolerance levels;

6.2.3 Variation in risk tolerance levels of members of the same age group;

6.2.4 Ability of beneficiaries to choose investment options – in this regard, the board should consider providing ongoing information and training to beneficiaries to enable them to make informed decisions.

In addition, the board should monitor "default' accounts for beneficiaries who have not indicated n investment option, the participation rate and the investments selected by beneficiaries. The purpose of such monitoring being to assess whether changes may be required in communication and/or education programs.

6.3 Investment Policy and Procedures:

In order to be able to determine the fund's investment policy, it is essential that the board of fund has first identified the profile if its beneficiaries. This will enable the to identify what portion of funds will be required for short, medium and long term investments and the risk profile attached to each category of beneficiaries e.g. those retiring in the short term will require low risk, high liquidity. As this is an essential element of determining the investment policy, the board should, where appropriate, obtain the advice and guidance of independent consultants and/or actuaries.

In determining the appropriate IPS, boards should consider the:

6.3.1 Current investments;

6.3.2 Degree of risk tolerance they wish to sustain;

6.3.3 Volatility of contributions;

6.3.4 Current and future liabilities of the fund;

6.3.5 Structure of the pension plan (e.g. defined benefit/contribution pension funds or defined contribution provident funds);

6.3.6 Current financial status of the fund;

6.3.7 Liquidity and cash flow requirements;

6.3.8 Maturity of the fund ; and

6.3.9 Profiles of the beneficiaries.

7 Taking a holistic view of these considerations into account, together with the purpose and objectives of the fund, the board will then be able to determine the appropriate mix of assets to meet the fund's obligations. In arriving at a decision, the board will have to obtain expert opinion and advice. In this regard, care must be taken to avoid a one-sided view e.g. an actuary might have a good understanding of a fund's present and future liabilities, but might not be an expert on investments, whilst on the other hand, and investment manager may only have expertise on a limited class of investments. Therefore, care must be taken that the advice obtained is free from conflicts of interest.

8 The same cautionary applies to setting effective performance appraisals e.g. an asset manager might wish to constrain effective performance appraisal levels and the vendor of a specific financial product may overlook the disclosure of commissions to offset fees for service.

9 The purpose of formulating an investment policy is to:

9.1 Communicate the investment philosophy to the fund managers and beneficiaries;

9.2 Describe the investment objectives and the overall risk philosophy;

9.3 Define how investment managers will be selected, remunerated and, where necessary, replaced in a manner that encourages compliance to the IPS goals and objectives;

9.4 Communicate the investment strategy for evaluation purposes;

9.5 Identify those involved in the investment process and the expectations.

10 In formulating the IPS, the board of fund must address the following issues, in conjunction with legislative and regulatory compliance, namely:

10.1 Categories of investments;

10.2 Diversification of investments to mitigate risk;

10.3 The mix of assets and the expected rate of return;

10.4 The liquidity requirements;

10.5 Voting rights attached to the investments;

10.6 Valuation procedures for investments not publicly traded;

10.7 Related party transactions.

11 All investments must conform to the requirements of Regulation 28 and/or any other statutory and/or regulatory requirements imposed from time to time. The IPS, along with the financial statements, should be reviewed at least annually and there should be procedures in place to monitor compliance with the same. Procedures should be in place to identify responsibilities and accountability, describe the processes for recommending, approving and implementing investment decisions and formulating the frequency of reporting and monitoring of performance. Similarly, a procedure should be formulated setting out clearly how the asset managers will be monitored, rewarded, or replaced. The implementation of these procedures should be carried out by people who are suitably skilled, whether they are officers of the fund or sub-committees of the board or under contract. Procedures should be formulated for the process of valuing investments that are not

regularly traded as well as the fund's exposure to fluctuations in interest rates, foreign exchange, inflation and market prices.

12 For monitoring and ease of reference purposes, boards should maintain records of the fund's investment portfolio to enable analysis of:

12.1 Asset quality and diversification;

12.2 Interest rate and any maturity mismatching;

12.3 Diversification of income sources;

12.4 A comparison of current assets measured against the IPS limits.

13 Furthermore, areas of potential conflict of interest should be identified and recommendations made as to how those tasked with the investment of funds are to deal with the same as outlined in the fund's code of conduct and other policies.

ESSENTAL ELEMENTS OF THE IPS

14 All IPS should be reviewed at least annually to ensure that they take into account any changes in economic conditions or obligations of the fund. Taking the above factors into account, it is recommended that the below mentioned elements be included in the IPS:

14.1 Asset mix and rate of return expectations:

The IPS should stipulate the:

- Expected rate of return of the portfolio;
- Anticipated volatility of the rate, setting parameters;
- Time frame for the expected returns; and
- Monitoring of performance against the stated expectations (linked to the stated expectations should be an explanation of the action that the board will take if the stipulated targets are not met).

Examples of the rate of return expectations are the following:

- A real rate of return of "x" percent over a given period; or
- A nominal rate of return; or
- A rate of return over an agreed benchmark portfolio.

14.2 Categories of Investments:

- In order to protect the fund from arbitrary investment decisions and/or investments that may be in conflict with the fund's risk profile, limits should be placed on the range of authorized investments. Such investments should be defined taking into account the building of a portfolio that meets the needs of the fund and avoids the concentration of investments in any particular market sector.
- Depending on the risk profile of the fund, limitations could also be placed on the quality of the assets with stipulations of the action required if such assets become downgraded to a quality below that stated in the IPS.
- In the event that the use of derivatives by asset managers are to be authorized, and provided such investments are allowed in terms of the fund rules and are within regulatory or statutory limitations, the investment in derivatives should be properly and clearly regulated. Should they decide to permit this form of investment, s of fund should have a clear understanding of the use and risks of derivatives and how they will be measured. Such regulations should include stipulations relating to:

- A list of acceptable derivative instruments;
  - The proportion of assets that may be invested;
  - The purpose for which they are to be used (hedging, index replication etc.);
  - The managers authorized to use derivatives and the limits placed on them;
  - Where the derivative products are to be obtained; and
  - How over-the-counter products are to be managed.

14.3 Diversification:

In principle, investment risks can be reduced through investing in diverse asset types, industries and geographic regions. However, diversification usually carries a cost in the form of transaction fees, custody costs etc as well as potentially lower returns. Therefore, a balance between the mitigation of risk and the related costs must be maintained. Accordingly the degree of diversification will be determined by the fund's size, risk profile and the inherent risk of the particular investment.

One way to achieve diversification at low costs is to invest in investment vehicles that have been formed to hold a diverse portfolio. Selection of the appropriate vehicle should not only be on the basis of past performance and track record but also on the synergies between the policies of the particular fund and those set out in the IPS.

14.4 Liquidity requirements:

As mentioned above, investments should be made taking into account the fund's cash flow needs in the coming year to avoid having to liquidate medium or long term investments to cover short term requirements. By the same token, it might not be necessary for a portfolio to hold unnecessary amounts of cash or low yielding liquid assets. Accordingly the fund should have a clear idea of what its cash flow requirements will be.

14.5 Pledging and borrowing of assets:

It might be preferable for funds to borrow against assets in order to meet short term cash flow needs. Similarly it may be necessary for a fund to pledge assets for the purposes in engaging in futures contracts. However, in order to protect the fund from placing the investments at risk, clear limits and procedures should be established for such borrowing or pledging to occur and these should be closely monitored. Furthermore, it should be established whether such activities are authorized in terms of the fund's rules or subject to any regulatory or statutory restrictions.

CAVEAT: Accordingly extreme care and caution should be taken when considering the possibility of such activities.

14.6 Lending against the fund:

To the extent that it is permitted by the rules and statutory or regulatory restrictions, the IPS should clearly set out the circumstances under which funds may be lent against the fund. Such policies and procedures should set out:

- The circumstances under which the lending may occur;
- Who is authorized to commit the fund to the loan and under what limits;
- The maximum exposure of the fund in aggregate;
- The interest rate and collateral required; and
- Margin requirements.

Accordingly extreme care and caution should be taken when considering the possibility of such activities.

14.7 Management fees and compensation:

Management fees, custodial fees and transaction costs must be taken into account when considering asset managers. The board of fund must decide between active or passive asset management and determine whether the concomitant costs of active management are justified by the returns achieved. In order to make this assessment of performance over a given period, it may be useful to secure expert advice, however, care should be taken to avoid a conflict of interests.

Payment of fees should be linked to clearly defined responsibilities and those tasked with particular functions should be accountable. There should be mechanisms in place to ensure proper monitoring including the relevant checks and balances to alert the board to any significant losses and deviations from authorized policy.

The remuneration of asset managers must not encourage deviation from the mandate assigned to them nor encourage unethical behaviour. Costs and fees paid by the fund to asset managers and administrators should be subject to full disclosure and transparency and communicated to the beneficiaries.

14.8 Socially Responsible Investment:

The issue of socially responsible investment often raises the question of whether such investments offer the best returns on the investment. However, there are various ways to achieve such investments. The first is to invest in companies that meet certain prescribed criteria, whilst the other is, through shareholder activism, to influence the behaviour of companies in which funds are already invested to encourage them to meet corporate governance and good citizenship best practice standards.

The primary obligation of s is to provide optimum returns for its beneficiaries. However, once these returns have been met, funds should consider socially responsible investments. Boards of fund should consider how shareholder activism can be applied to promote good governance and citizenship in companies in which their funds are already invested. Such activities may actually enhance the performance of the companies and therefore the returns to the fund.

It is recommended that s of fund apply their minds to formulating a suitable policy regarding such investments as well as incorporating shareholder activism into their investment mandates. Examples of how this can be done are elaborated in more detail below.

RISK MANGEMENT

15 There will always be an element of risk in the investments of a fund. Furthermore, the risk tolerance level of a fund will be influenced by factors such as the age profile of its beneficiaries. The board of fund's responsibility is to manage and, where possible, mitigate the risks to which the fund is exposed. For it to perform this function effectively it needs to be aware of the types of risk to which a fund can be exposed. A separate risk assessment conducted by an independent expert may be required by the board, from time to time to assess the effectiveness of governance structures, mandates, terms of reference used, etc.

VOTING RIGHTS

16 It has been argued that the voting rights attached to shares of the companies in which s are invested should be considered an asset of the fund. Accordingly, the board of fund would be expected to apply the same fiduciary care and consideration to this asset as it does to the financial investments it makes. Indeed, there is an inclination internationally to require s of fund to be more proactive in ensuring that the voting rights are utilised effectively by the asset managers in accordance with the shareholder activism obligations of the .

17 In order to fulfil this obligation, and in accordance with the recommendations of King II, the board of fund should formulate and develop appropriate voting policies and incorporate these in their mandates to the asset managers including the monitoring and reporting of the same. Such policy should also be disclosed to the beneficiaries along with the steps taken by the board of fund to monitor the effective implementation of the same by the asset managers. More in this regard is incorporated under the asset manager mandate recommendations detailed below.

RECOMMENDATIONS FOR INCLUSION IN ASSET MANGEMENT MANDATES

18 The relevant portions of the IPS should be included in the mandates to asset managers. This will include the category of investments, risk profile, diversification policies etc. as stipulated above. In addition, it will contain the expected rate of return and the actions to be taken in the event of the said managers not meeting performance targets. Furthermore, in order for the board of fund to effectively monitor the fund's performance, the reporting frequency and performance targets should be clearly spelt out.

19 In addition, and in order to ensure that the asset managers practice the same corporate governance standards and best practices that s are expected to maintain, and in order to met their fiduciary obligations relating to voting and shareholder activism issues, the mandates should also require the asset managers to report on the following matters, as recommended by the International Corporate Governance Network, namely:

19.1 The corporate governance policies of the asset managers detailing how they are applied in investment policies;

19.2 The voting guidelines followed by the asset managers and how these are aligned to the policies formulated by the board;

19.3 Information on the companies in which the fund's assets have been invested and the relevant percentages;

19.4 An explanation of actions taken by the asset managers in important matters;

19.5 An explanation how the asset managers monitor, measure and review the companies in which they are invested in accordance with stated policies and guidelines;

19.6 A summary of voting records indicating the percentages voted and whether the votes were cast for or against management as well as full records in important matters;

19.7 The resources allocated by the asset managers to execute corporate governance policies;

19.8 Where no resources have been applied, and explanation how they have "weighed the various arguments coming to this decision and an indication of what developments would make them change their decision."

19.9 Details of any conflicts of interests in companies in which they are invested;

19.10 A description of procedures they have developed to deal with the stated conflicts;

19.11 Details of agents to whom they have outsourced their responsibilities and an explanation of how these agents are monitored to ensure governance polices are properly implemented.

This information should be reported to the board of fund at least annually to enable the board in turn to report meaningfully to the beneficiaries on how it has applied and monitored its governance responsibilities.

COMMUNICATION:

20 Monitoring and reporting on IPS:-

The IPS should be reviewed regularly to ensure that it continues to meet the objectives of the fund and any deviations or changes should be explained to the beneficiaries.

Effective and regular communication between the board, the beneficiaries and the asset managers is essential, not only for the purposes of transparency and disclosure, but also to establish proper and regular monitoring of the fund performance, adherence to the terms of the mandate and the IPS.

The IPS should be disclosed to fund beneficiaries, investment managers and, where required, to the relevant regulatory authorities.

There should be regular, reporting to the beneficiaries, preferably quarterly, in a manner and a form which is easily understood, on relevant performance, risk/return and fund matters especially relating to any changes, that the might deem appropriate.

Refer to the relevant guidance issued by the Registrar from time to time which sets out the minimum disclosure to beneficiaries and the frequency thereof.

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PRESCRIBED INVESTMENT AND LENDING LIMITS FOR PENSION FUNDS

To be provided from time to time via Regulation and Directives

INVESTMENT POLICIES AND PROCEDURE GUIDELINES

To be updated by FSB from time to time

COMMUNICATION: MINIMUM DISCLOSURE TO MEMBERS, DEFERRED MEMBERS, DEPENDANTS, PENSIONERS AND BENEFICIARIES OF DECEASED MEMBERS

To be updated by FSB from time to time in circulars, etc.