Ruling Hits Umbrella Funds' Strategy
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Ruling hits umbrella funds' strategy

FSB's appeal board decides the funds cannot create subfunds to ensure their investments are protected

REBECCA JANSCH
& TSHEPO MUNENE
Shepstone & Wylie Attorneys

UMBRELLA funds have typically attempted to draft their rules so that the assets and liabilities of members in each subfund will be ring-fenced from other subfunds and the umbrella fund as a whole.

This has given members of umbrella funds a sense of security that their investments are protected and that any surpluses arising in a particular subfund as well as any deficits will be dealt with separately from the umbrella fund and the other subfunds within it.

A recent decision of the Appeal Board of the Financial Services Board (FSB) has, however, now confirmed this practice to be unlawful, finding that umbrella funds cannot with their rules create subfunds with separate legal personality from each other and from the umbrella fund in which they are "housed". The board found that in this regard, such rules would be contrary to the substantive provisions of the Pension Funds Act, 1956 in that the act contemplates the cross-subsidisation between subfunds in an umbrella fund in the event of shortfalls or deficits that may arise in the fund. It was argued that the rules creating the required separation between the subfunds within the umbrella structure could be registered under the provisions of section 2(5) of the act.

This section provides that the registrar may exempt a fund from compliance with a section of the act if practicalities impede the strict application of that specific provision. The funds bringing the appeal had applied to be exempted from, among others, sections 15H and 15I of the act.

Section 15H provides that credit surpluses in a fund shall be reduced proportionally by the amount of the deficit within the fund. Section 15I goes on to provide that during liquidation of a fund, any credit surpluses "shall be applied" in an "order of priority" as prescribed. Section 15I provides that, of first priority, are the rights and reasonable benefit expectations of the members participating in the distribution.

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According to the appeal board, it could not be argued that practicalities impede the strict application of the aforementioned sections of the act, as simple bookkeeping entries were all that was required in order to comply with the act.

Therefore, the board found that any rule attempting to create separate legal personality in respect of each subfund would be substantively in conflict with the act and that the registrar does not have the power in these circumstances to grant an exemption from the act. Section 2(5) only gives the registrar the power to grant an exemption with regards to administrative matters and not matters of substance.

The board recognised the contested provisions of the act may be unfair and inequitable as applied to umbrella funds; however, it found that section 2(5) of the act does not empower the registrar to grant exemptions on the ground of unfairness — and rather that the issue is one that needs to be rectified by Parliament.

Case References:

- Old Mutual Superfund Defined Benefit Pension Fund and Old Mutual Superfund Defined Benefit Provident Fund // Registrar of Pension Funds A48/2015
- Old Mutual Superfund Pension Fund and Old Mutual Superfund Provident Fund // Registrar of Pension Funds A2/2016

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