



Warriors, a R15 million sponsorship for the Boland Cavaliers rugby team, and the purchase of the Durban-based soccer club, Manning Rangers for R1,5 million.

On 1 February 2007, however, Fidentia was placed under provisional curatorship by the High Court of South Africa (Cape of Good Hope Provincial Division) on application by the executive officer of the Financial Services Board (FSB). The FSB told the court that its inspectors could not trace over R680 million of the more than R1,6 billion of investors' funds managed by Fidentia Asset Management (Pty).

This came as a severe shock. By this time, the group had grown through takeovers and the establishment of new ventures to an estimated total of 70 companies under the Fidentia banner. Prosperity seemed to be the order of the day. Investors reaped returns of more than 28% per annum on some asset classes. The staff benefited from a restaurant-style canteen and a gym with personal trainers – all paid for by the company – at the group's luxury Century City office complex in Cape Town.

### Can dented confidence be restored?

Every so often, the goodwill built by business with investors is replaced by suspicion and mistrust when corporate misconduct is uncovered. Internationally, trust in large business organisations has been dented by the likes of Exxon, Enron, Arthur Anderson and WorldCom. South Africa has also had its examples, such as the Leisurenet and Macmed cases. Even the South African financial services industry, long recognised as one of the best controlled in the world, has had its image tarnished by the Masterbond, Saambou and Regal Bank scandals, and now by Fidentia. In the Fidentia case, public anger was fuelled by the fact that much of the money is owed to poor widows and orphans as beneficiaries of the Mineworkers Provident Fund, which was entrusted to Fidentia for administration.

Not only do such scandals cause investors to lose faith in business, they also cause a loss of faith in the systems and processes that are supposed to protect them – such as the Companies Act and others. When corporate wrongdoing is revealed, investors may rightfully question how strong the regulatory environment is in exercising control.

Authorities should learn from these cases

# How safe is safe?

How safe are investor funds when placed in companies that appear to be highly successful? The Fidentia case provides valuable lessons.

by Pieter Steenkamp and Daniel Malan

Fidentia became an active player in the South African financial services industry in 2005, only a few years after its inception. Its dramatic rise was achieved through aggressive takeovers together with the boosting of its public image by

employing well-known sports personalities and providing huge sponsorships for sports teams, charities and various events. Its sports involvement included a R4,9 million agreement with the Eastern Cape Warriors cricket team to become the Fidentia

## The regulatory system in South Africa

The main regulatory authorities currently associated with the financial services industry are:

- the South African Reserve Bank (SARB), and
- the Financial Services Board (FSB).

The FSB regulates the financial markets and institutions, including insurers, fund managers and broking operations, but excluding banks. Banks are regulated by the SARB. The mission of the FSB is to promote sound and efficient financial institutions and services together with mechanisms for investor protection.

The FSB and SARB work closely with a variety of bodies, namely the Office of the Registrar of Companies (CIPRO) and the Department of Trade and Industry (DTI), to fulfil their regulatory and supervisory duties via the Policy Board for Financial Services and Regulation and the minister of Finance.

The expansion of the South African economy brought an increased demand for financial services. This has put pressure on the FSB and other regulatory frameworks to control these services and to ensure that ethical standards are observed. The FSB met this challenge with a few notable developments, including promulgating and updating several pieces of legislation such as:

- the Financial Advisory and Intermediary Services (FAIS) Act, 2002,
- the Security Services Act (SSA), 2004, and
- the Financial Services Ombud Schemes Act, 2004.

The FAIS Act of 2002 was a major focus of the FSB and allows for better identification and supervision of financial services providers. This legislation was strengthened by the implementation of a supervisory framework aimed at early detection of non-compliance with the Acts. By also working closely with the Financial Intelligence Centre (FIC), the FSB has shifted its emphasis from compliance-based supervision to risk-based supervision. All of this is aimed at strengthening the credibility and integrity of the financial sector, which is now very important and fragile with the entry of previously neglected, mostly poor, consumers.

FSB investigations have resulted in various prosecutions including curatorships. According to FSB sources, they supervised 13 367 retirement funds at 31 March 2006. By that time they had conducted eleven inspections, which led to five funds being placed under curatorship during 2005.

and develop or amend legislation to strengthen the protection of shareholders and investors. The emphasis on corporate governance, internationally and in South Africa, particularly reflects this concern. In South Africa, the Companies Act is being redrafted and, with the revised King III Report on corporate governance, the financial authorities aim to incorporate the lessons learnt from recent corporate scandals to a significant extent.

Research done at the University of Stellenbosch Business School (USB) investigated the Fidentia case to see what lessons can be learnt from this particular example, and what can be done to prevent investors from being lured into potentially fraudulent operations.

### Revelations from the Fidentia trial

The USB research examined the Fidentia case in

detail to find out in what way good corporate governance was not adhered to, and what could be the tell-tale signs that should make investors wary. For the purposes of the study, a vast number of articles, other literature sources and court judgments were perused.

## In the Fidentia case, public anger was fuelled by the fact that much of the money is owed to poor widows and orphans

Fidentia Asset Management (FAM) became an authorised financial services provider on 30 September 2004. It was approved as an investment manager under the Stock Exchange Control Act, No 1 of 1985, and the Financial Markets Control Act,

No 55 of 1989. Arthur Brown and Graham Maddock were the key individuals of FAM as required by legislation to oversee the activities of a registered financial services provider. Another director of FAM at the time applied to be a key individual, but was rejected by the Registrar. He subsequently resigned as director.

Fidentia grew through a number of takeovers and acquisitions. One of the more notable acquisitions was mCubed Unit Trust and its administration management company in 2005.

In a complex sequence of takeovers and management buyouts, Fidentia managed to get R1,2 billion from the Mineworkers Provident Fund (MPF) into its account. The MPF basically exists to provide benefits to the dependants of deceased members and has about 46 000 widows and orphans as beneficiaries. The original entities in which the funds were kept were changed to Living Hands (Pty) Limited and the Living Hands Umbrella Trust.

In another move, Fidentia secured an investment of R200 million from the Transport Education Training Authority (TETA). Fidentia management guaranteed the Authority significant returns and assured the TETA management that its investment would be kept with reputable financial institutions. It was stated that, while two other main contenders offered rates of 8 and 8,5 per cent, Fidentia offered TETA a return of 10,5 per cent.

At the time when FAM was placed under provisional curatorship, the question arose: Where did FAM, the regulatory system, or investors go wrong? The USB study found that some of the answers lay in the economic climate, the corporate strategy adopted by Fidentia, and Fidentia's disregard for sound corporate governance principles.

### A macro climate favouring high-flyers

The first observation points to the favourable eco-

nomical climate. The positive economic growth rate of recent years, especially the almost 5 per cent for 2005 (the highest since 1984), has created an environment for financial establishments to do well and expand. At the same time, more consumers

came into the market as innovative financial products and IT improvements and innovations made the delivery of financial services to a broader consumer base possible.

Owing to the strong economy, the JSE Securities Exchange did extremely well. Investor firms achieved good returns on investments and administration income did well. The favourable economic climate was also conducive to the entry of new players into the financial market. This was perhaps the reason why the phenomenal growth of a newcomer did not raise too many eyebrows.

### **Fidentia's corporate strategy**

Fidentia's strategy appeared to be highly successful, as evidenced by the exceptionally high growth in assets. The company employed two clever strategic approaches. On the one hand, it achieved high levels of strategic synergy through its acquisitions and partnerships and, on the other hand, it focused on the financial and investment industry which yielded high returns at the time.

What turned out to be a problem, as was discovered later during the investigation, was that it had paid too much for many of its assets. This was specifically evident in what it paid for property. But at the time this was not so noticeable because the company focused on acquisitions with existing client bases and investments under administration. Besides, as it turned out, Fidentia had control over investment funds which, allegedly, it could misappropriate for balancing short-term commitments.

Good strategic management insight on Fidentia's side would have questioned the sustainability of this approach in the long term.

### **Corporate governance**

Many of the problems can be attributed to inadequate corporate governance on the part of Fidentia. This can be seen from how the company seemingly neglected long-term strategic sustainability, but there are many other instances of its total disrespect for sound corporate governance principles.

#### **The power of CEOs**

One of the recommendations in the King Report that could have reduced investor risk in the Fidentia case is aimed at avoiding a situation of blind trust

in chief executive officers (CEOs). It is unhealthy when CEOs have almost unlimited powers and are seldom challenged by colleagues.

That was the case at Fidentia. The roles of CEO and chairman of Fidentia were not split, and the other directors seemed never to question the actions of the CEO/chairman.

#### **Fiduciary responsibilities**

In terms of common law, once someone accepts an appointment as a director, he or she is obliged to display the utmost good faith towards the company, and in dealing on behalf of the company. In particular, this applies to situations of conflict between the director's personal interests and the interest of the company. Directors should not compete improperly with the company or misappropriate opportunities pursued by the company, and should disclose any interests that are in conflict with those of the company.

In court, the judge recorded that the chairman had manipulated certain funds of Fidentia to the detriment of shareholders, investors, and possibly also creditors. This conduct breached both common law and statutory law in so far as

submit statements in 2005 and 2006. During the FSB investigation, inspectors found that record-keeping was almost non-existent. The inadequate accounting records severely hampered a forensic investigation into Fidentia's affairs. For example, R689 million of client funds under administration could not be accounted for. The inspectors concluded that these funds could have been misappropriated by the Fidentia group and/or the directors.

Several other instances of misrepresentation of transactions were discovered, for example:

- The nature of the investments held by FAM on behalf of its clients was disguised. Fidentia claimed to hold a promissory note from a certain PLJ Namibia worth R150 million, but PLJ Namibia has been found to be without any assets to support the note. It was likely that the note was being used to inflate the value of client assets fictitiously.
- Funds received from clients to be invested were most likely channelled to defray business expenses and to acquire property and private equity investments for the Fidentia group.

Another dubious move was the use of a director's

## **It is unhealthy when CEOs have almost unlimited powers and are seldom challenged by colleagues**

it constituted the fraudulent misrepresentation by directors of their interest in transactions. It was further pointed out that some properties acquired by FAM were registered in the name of a family trust. It also emerged that building improvements to the office complex served the purpose of an exclusive lifestyle centre operated by the chairman's wife, apparently without rent being paid to the company. Examples such as these suggest that the Fidentia directors violated their fiduciary obligations to the company with which they had been entrusted.

#### **Auditing and accounting records**

It is required of any company to keep accurate records of all accounts, to have its accounts audited, and to submit annual audited accounts to the Registrar.

FAM did not comply in several respects. It had last submitted audited financial statements for the year ending February 2004, failing to

accounting firm as company auditor. This director turned out to be one of the key suspects in the Fidentia saga. He signed off the last FAM auditor's report in 2004, after he had become a director of Fidentia Holdings.

#### **Reporting to clients**

The Discretionary Code for financial services providers sets out certain requirements for reporting to their clients. Moreover, the Financial Intelligence Act stipulates that client money should be clearly discernable from the assets of the management company.

FAM did not adhere to these requirements. It allegedly made substantial calculation errors in reporting to clients and often obfuscated the distinction between clients' and FAM's assets. As far as inaccurate reporting is concerned, errors to the value of R204 million were reported on statements sent to clients within the Living Hands Portfolio.

### Company secretary

According to the Companies Act (S268A), it is mandatory to appoint a company secretary for a public company. This is also a JSE-listing requirement. But private companies like Fidentia are under no obligation to appoint a company secretary. However, the responsibilities and benefits associated with a company secretary may well have contributed to reducing the risks for investors in Fidentia.

The company secretary has four areas of responsibility: the board, the company, the shareholders, and other stakeholders. Through the board, the company secretary has a pivotal role to play with regard to ethics and corporate governance, and gives the board and directors appropriate guidance as to their roles, responsibilities and duties. The position of company secretary is evidence that a company gives serious consideration to corporate governance matters.

It is unclear whether Fidentia ever had an appointed company secretary. In any case, such a person never played any prominent role or had any impact on the acts of the directors.

### Risk management

The King II Report (2002) on Corporate Governance pays substantial attention to the need for risk management. It describes risk management as a process of internal controls to manage risk at a level acceptable to the board. Boards are advised to set up a risk committee consisting of executive directors and senior managers, who are accountable to the board. This committee then judges independently how effectively the company manages its risks. The King II Report recommendations even make provision for a confidential reporting or 'whistle-blowing' process.

There is no evidence that Fidentia had implemented any form of a risk committee. This signified that risk to the company and investors was not high on the directors' agenda.

### General levels of honesty and sound conduct

In the wake of the Fidentia investigations, several

findings were made that put the general levels of conduct and honesty in question. The curators drew attention to instances of apparent dishonesty, reckless trading, and misrepresentation of facts by the directors and other senior officials of Fidentia. At least one client representative is facing charges of fraud and theft, as well as corruption involving alleged kickbacks of almost R5 million received in connection with Fidentia transactions.

## For a financial institution, the red lights should flash when accounting processes start to run behind schedule

Personal honesty is also at issue. Key role-players at times claimed to hold degrees from universities, claims which were subsequently denied by the institutions.

### Warning signals for investors and regulators

The USB study found that it is difficult to identify clear signals that would warn investors or the regulatory system of irregularities. Many of the factors that emerged in the Fidentia case were only discovered after intensive inspections and investigations. In general, it is extremely difficult to detect well-disguised dishonesty or fraudulent behaviour, as this case may well demonstrate.

But there are a few aspects that should raise the suspicion of investors and trustees of funds and force them to do much deeper due diligence investigations before making their decisions.

What will alert investors that their funds may not be in safe hands?

- Are the numbers and the composition of the board reassuring? If there are too few directors and the same person is the chair of the board and the CEO of the company, the situation may lead to an unhealthy concentration of power in a few hands.
- Does the company have a company secretary with sufficient powers vested in the position,

even if it is a private company? And does the company have an effective risk management committee? The absence of these two functions may well mean that the company is not concerned about good corporate governance and, more than likely, that directors do not want people and processes that can look over their shoulders.

- Are auditing and financial reporting processes up to date? For a financial institution, the red

lights should flash when accounting processes start to run behind schedule.

- Who are the auditors? Is there sufficient distance between the auditing company and the company in question? If not, the potential for disguising transactions increases.

In a vibrant economy it may be easy to overlook fast growth and almost instant prosperity as warning signs, but when one has to place vast sums of money on behalf of other beneficiaries, perhaps these things should call for deeper investigation. ■



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This is an extract from research conducted by Pieter Steenkamp (pksteenkamp@gmail.com) as his MBA study project at the USB, under the supervision of Daniel Malan, USB senior lecturer. The research report, titled *Fidentia: A strategic and corporate governance analysis*, was presented in December 2007.



### Write to us :

Are there other checks that you would include in your due diligence investigation, when engaging in business partnerships?  
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