Seven Pillars Institute
Moral Cents Vol. 8 Issue 1, Winter/Spring 2019

Transparency in Pension Funds: A Commutative Approach

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Abstract: Transparency in financial transactions is vital according to the tenets of commutative justice. In contrast, opacity encourages information asymmetries and engenders substantial distrust and risk. This paper studies widespread opacity in pension funds. There is a lack of transparency in portfolio composition, and thus attendent risks, unanticipated fees including management fees, underlying fund fees, inactivity fees, contribution charges, exit fees, and platform fees. Current regulations have proved inadequate to increase transparency in pension funds and rules such as those found in the ERISA require updating and strenghtening.

Introduction

Transparency in financial transactions is vital according to the tenets of commutative justice. At its core, transparency enables fair exchange between two parties. It encourages timely, relevant and meaningful disclosure while fostering trust and good will. The undisclosed risks and hidden expenses in pension funds therefore, pose an ethical problem. Although the modern solutions of laws and regulations are effective, they are not without flaws.

Commutative Justice

The distilled concept of commutative justice may be presented as the idea of fair and equitable exchange between individuals; to give each person what she deserves – *suum cuique*.[1] The purpose of the maxim is to balance the interests of parties intending to exchange. The names by which to address commutative justice varies yet the principle unequivocally remains the same. Aristotle refers to a "special justice;" Aquinas a "particular justice;" Adam Smith a "commutative justice." The methods we use to exchange goods and services have evolved beyond the age of the Greeks, but the ethical ideals of commutative justice still have relevance in the present commercial world.

[1] Plato. *The Republic*. 4.433.

Commutative justice is defined by four requirements: [2]

1. A reflection of market price

The price of an item in exchange ought to, under commutative justice, reflect the market price. The requirements are not intended to be economic laws.[3] They are ethical blueprints which parties may use to conduct business fairly. As such, goods and services which have no inherent market value are not precluded. The first requirement additionally does not demand the assigned price of each good or service to mirror the market exactly as it is subject to economic and legal conventions. The convergence of the market and actual price should be the first step; however, it cannot be the only step. Commutative justice couples the values together in a presumption that both are equivalent. The prevailing market price is not always the fair value, particularly in the modern economy.[4] Due to the presumptive nature of the market price, the first requirement serves as a preliminary guideline for commutative justice.

2. Appropriate exchange

Commutative justice requires an "appropriate" exchange. Appropriateness in an exchange is defined as whether the good or service could be contemplated to be a "sham." A sham transaction serves no business purpose and adds no value.[5] It is created for the purpose of deception which contravenes the tenet of fair exchange. The deception is followed by the flow of "unjust incomes" from the purchaser to the vendor.[6] Trade derived from intentional misrepresentation is proscribed under commutative justice as it is an artificial and inappropriate inflation. Vendors pass the test of appropriateness if they do nothing to misrepresent or mislead the purchaser and vice versa. The principle of caveat emptor applies in cases of unabetted self-delusions. This could be contextualised under Adam Smith, who posits that "we may fulfil all the rules of justice by sitting still and doing nothing."[7] Individuals are only culpable if they actively encourage sham transactions.

[2] Koslowski, P. *Principles of Ethical Economy*. 2001. Page 186.
[3] Ibid at page 185.
[4] Kay, J. "Fair value is not the same as market price." *Financial Times*, 2013, https://www.ft.com/content/652040be-a5c4-11e2-b7dc-00144feabdc0.
[5] "What is sham transaction?" *Business dictionary,* 2019. http://www.businessdictionary.com/definition/sham-transaction.html.
[6] Ibid 2. At page 192.
[7] Smith, A. *The Theory of Moral Sentiments*. 1759. Page 73.

3. Mutual advantage

The notion of mutual benefit is at the root of the purpose of trade. While the magnitude of both benefits is not required to be equal, commutative justice requires both parties to gain an advantage. Neither party should suffer a loss of wealth after the transaction as no party to an exchange intends to voluntarily lose wealth. Aquinas regards mutual exchange as a process whereby a "person should pay back to the other just so much as he has become richer out of that which belonged to the other."[8] The calculation of wealth or the state of being "richer" is necessarily a subjective measurement. The values of goods and services and the advantage to be gained differs individually. For instance, the subjective value of a rare jewel to an appraiser likely exceeds the value of the jewel another. Exchange highlights the morality in personal transactions and individual preferences. Although mutual advantages cater to subjectivity, it does not supersede the other requirements of commutative justice.

4. A balance of interests

The fourth requirement of commutative justice applies in situations of uncertainty. In any contract or exchange it is required that one party examines the interests of the other. A fair contract is "a contract that goes beyond the price arising from mere balancing of one's own interests and strives for a fair balance."[9] If one is faced with a moral dilemma and unsure about the application of the tenets of commutative justice, it is imperative to first examine the interests of all the contracting parties. The preliminary test for whether an agreement is equitable must be considered from the position of the other person. An agreement should only be concluded after bilaterally balancing the interests.

The principles of commutative justice are not esoteric ideas limited to philosophical thinking. They address the moral foundation of commercial transactions. Smith considers commutative justice so fundamental that he compares it to grammar.[10] Much like grammar, the applications of the rules should not be congratulated as it ought to be already deeply ingrained in our thoughts.[11]

Commutative Justice Demands Transparency

In a speech in 2002, the commissioner of the Securities and Exchange Commission (SEC) defined financial transparency as "timely, meaningful and

[8] Aquinas, T. *Summa Theologica*. 1485. Volume 3.
[9] Ibid 2. At page 201.
[10] Ibid 8. At page 157.
[11] Klein, D. *Commutative, Distributive, and Estimative Justice in Adam Smith*. 2017.

reliable disclosures about a company's financial performance."[12] The definition of transparency remains unchanged, yet its meaning has since evolved to accentuate its importance to the modern economy. New meaning has been imported to the SEC's characterisation of timely, meaningful and reliable disclosure. The Transparency Task Force postulates that there is a strong correlation between financial transparency and the intrinsic values of "truthfulness and trustworthiness."[13] Opacity therefore disrupts the underlying foundation of fair business practice.

Transparency is crucial under the requirements of commutative justice. The market value of any good or service cannot be accurately defined without meaningful and reliable disclosures. Hidden fees and unreliable information inhibit a consumer's capacity to value his transactions. Without comparable values, participants in business transactions are reticent of participating in fair and equal exchanges. It becomes advantageous to conceal defects which contravenes the precepts of an appropriate exchange. Opacity encourages information asymmetries and engenders substantial distrust and risk.[14] The realisable mutual advantages gained from transactions become obfuscated due to the risk of uncertainty. Transparency is a "pro-ethical condition," an inseparable part of commutative justice, and its fulfilment enables equitable business exchange.[15]

Transparency in Pension Funds

Pension funds are institutions which are integral to society as they manage the wealth of others. Mismanagement in the industry has significant ramifications for lives of those who are willing to place their trust in such funds.[16] The precept of transparency is vital to fostering trust and confidence. However, some funds omit key information which may affect a consumer's willingness to opt in.

I. Active v Passive

Actively managed funds are overseen by investment teams who are responsible for allocating the wealth of the investors. They may decide to invest in different

[12] Glassman, C. "Opening Remarks before the Symposium on Enhancing Financial Transparency," 2002. https://www.sec.gov/news/speech/spch565.htm.
[13] "About the Transparency Task Force." *Transparency Task Force*. 2019. https://www.transparencytaskforce.org.
[14] Merrill, H. *Consequences of Information Asymmetry on Corporate Risk Management*. 2017.
[15] Tan Bhala, K. "Ethics of Tax Breaks on Bank Fines." *Seven Pillars Institute*. 2016. https://sevenpillarsinstitute.org/ethics-tax-breaks-bank-fines/.
[16] Brandon, E. "The 10 Biggest Pension Failures." *U.S. News*. 2009. https://money.usnews.com/money/blogs/planning-to-retire/2009/09/04/the-10-biggest-pension-failures.

equities, markets or businesses in an attempt to beat the market benchmark. Conversely, a passively managed fund tracks indexes and does not require active human involvement. Investment options which are actively managed are costlier as they are said to involve superior expertise. This comes at the cost of the investors. Empirical evidence demonstrates that actively managed funds do not substantially outperform their passive counterparts.[17] Since 1991, UK active fund managers on average performed 16 basis points (0.16%) higher than the market; compared to passive funds, investors receive £0.16 extra for every £100 invested. In the US, over a 15-year investment horizon, only 7.67% of large capital funds, and even fewer small capital funds, succeeded in beating the market.[18]

According to CEM Benchmarking, active managers absorb three-quarters of the value they create for pensioners, through fees charged. To that effect, the principal at CEM claims that "a lot of value that is being created has been returned to the asset management industry rather than to the pension funds and their members."[19] Due its costs, pension funds which elected to be actively managed demonstrated a loss.[20] The exact nature of pension investment options are, at times, undisclosed. For instance, the allocation of US fund assets in "alternative investments" has more than doubled from 11% to 25%.[21] Alternative investments, unlike fixed income and equity, are illiquid and typically include an amalgamation of private equity, hedge funds, real estate and commodities. They may carry higher returns in exchange for higher risk. Some pension funds provide details on "long-term performance but do not detail the results of individual investment strategies."[22] Managers are incentivised to keep investment strategies to themselves and as alternative investments generally lack an established platform of exchange, it is unclear which strategies, active or passive, were selected from the pool of alternative investments. Surely the SEC's "meaningful disclosure" applies. Investors ought to have the right to know the risks that they are undertaking. By extension, investment funds should be transparent as to how they are managed. Consumers ought to be able to comprehensively compare funds rather than being compelled to look at the superficial one-digit percentage imprinted next to the "returns" column.

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17 Walker, O. "Active fund managers beat market by just 16p for every £100 invested." *The Financial Times.* 2018. https://www.ft.com/content/f0297fca-028c-11e8-9650-9c0ad2d7c5b5.
18 Perry, M. "More evidence that it's very hard to 'beat the market' over time, 95% of finance professionals can't do it." *AEI.* 2018. http://www.aei.org/publication/more-evidence-that-its-very-hard-to-beat-the-market-over-time-95-of-financial-professionals-cant-do-it/.
19 "Active fund managers beat the market by just 16p for every £100 invested." *The Irish Times.* 2018. https://www.irishtimes.com/business/personal-finance/active-fund-managers-beat-market-by-just-16p-for-every-100-invested-1.3372150.
20 Ibid 17.
21 "Making State Pension Investments More Transparent." *The PEW Charitable Trust.* 2016.
22 Ibid.

Funds under active management in the United States account for 71% of the total.[23] Associated risks with such a management style is not advertised. The potential consequences of the risks can be depicted by the Japanese pension fund – The Government Pension Investment Fund (GPIF). The GPIF is 20% actively managed.[24] In the fiscal quarter ended December 2018, the GPIF reported a loss of 9.1% (Y$136 Billion) as a consequence of a manoeuvre to increase risky assets and decrease domestic bond holdings.[25] The management style can pertain to greater risks and it is imperative that there is adequate transparency.

II. Unanticipated Fees

Unanticipated fees contravene the principles of commutative justice and transparency. Such fees are harmful to investors and may be summarised, according to the chairman of the SEC, as "complex, obscure or hidden fess."[26] There are many forms of unanticipated fees, including (not exhaustive): management fees, underlying fund fees, inactivity fees, contribution charges, exit fees, and platform fees.[27] The chair of the Transparency Task Force suggests that there are over 100 types of costs being "routinely applied to pensions… many of which are being hidden away from the consumer."[28] Disclosure of these charged should normally be expected of a pension and constructed in a way which allows ordinary consumers to easily understand the costs and benefits. Yet 37% of the largest US state sponsored pension funds report gross returns, without deducting the management fees.[29] The technique entices unsuspecting pensioners seeking higher returns. It is estimated that undisclosed management fees may equal up to 1.5% or more of managed pension assets each year. [30]

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23 Hunnicutt, T. "Index funds to surpass active fund assets in U.S. by 2024: Moody's." *Reuters*. 2017. https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN.

24 Rust, S. "Japan's GPIF strengthens manager performance link in new fee structure." *IPE*. 2018. https://www.ipe.com/news/asset-managers/japans-gpif-strengthens-manager-performance-link-in-new-fee-structure/www.ipe.com/news/asset-managers/japans-gpif-strengthens-manager-performance-link-in-new-fee-structure/10025155.fullarticle.

25 Ujikane, K. Nozawa, S. "World's Largest Pension Fund Reports Record 136 Billion Loss in Three Months." *Bloomberg*. 2019. https://www.bloomberg.com/news/articles/2019-02-01/world-s-biggest-pension-fund-reports-record-136-billion-loss.

26 Clayton, J. "Governance and Transparency at the Commission and in Our Markets." *U.S. Securities and Exchange Commission*. 2017. https://www.sec.gov/news/speech/speech-clayton-2017-11-08.

27 "What are pension charges?" *Pension Bees*. 2018. https://www.pensionbee.com/pensions-explained/pension-basics/what-pension-charges-will-i-pay.

28 Cumbo, J. "Asset managers under fire over hidden pension fees." *Financial Times*. 2016. https://www.ft.com/content/9b82851e-1e92-11e6-a7bc-ee846770ec15.

29 Ibid 21.

30 Ibid 21.

The cost structures of pensions have become so complex that the chief economist of the Bank of England could not understand them.[31] If a prominent economist cannot comprehensively identify all the costs associated with a pension fund, ordinary consumers have barely any chance. Some funds intentionally obfuscate the total costs of an investment through confusing contractual legalese. Though it may not be illegal, it should be considered unethical. Transparency considers bilateral interests, all the costs associated with a pension fund should be immediately clear. There are numerous examples of unanticipated fees in pension funds.[32][33][34] Although there are laws, such as the UK Markets in Financial Instrument Directive (MiFID), which protect consumer interests, they have yet to take effect globally. Ultimately it should be the ethical responsibility of fund managers rather than the regulators to disclose all the associated costs.

III. Risks

The risks associated with investing into a pension fund exceeds the nominal risk of investments made on one's behalf. Any investment fund carries a risk of default, yet pension funds typically fail to disclose whether there is adequate capital funding to repay all its liabilities. Accounting regulations require a percentage of the pension to be cash, and the rest to be stock.[35] Hence, its total value may fluctuate depending on the value of its investments. If the value of the fund fluctuates, so does its capacity to repay its creditors – specifically the investors. For instance, the Global Financial Crisis (GFC) reduced the value of US pension assets from $2.7 trillion to $2.02 trillion.[36] In the event of failure, an underfunded fund will inevitably default on its obligations which potentially deprives investors of their savings.

If underfunding carries so much default risk, company pension plans should be obligated to disclose the status of the funds. Yet, companies are only obligated to disclose the information in a footnote in an annual report.[37] Average pensioners cannot be expected to scavenge information from the footnotes of annual

[31] Wallace, T. Morgan, T. "Bank of England chief economist: Nobody understands pensions, including me." *The Telegraph*. 2018. https://www.telegraph.co.uk/business/2016/05/18/bank-of-england-chief-economist-nobody-understands-pensions-incl/.
[32] Jackson, R. "Pension savers are paying £120 billion a year in hidden fees." *Love Money*. 2016. https://www.lovemoney.com/news/53355/pension-hidden-charges-fees-investment-administration.
[33] "Hidden costs and charges." *BBC*. 2018. https://www.bbc.co.uk/programmes/m0001jpx.
[34] Cumbo, J. "Fraud incidents soar at pension funds." *The Financial Times*. 2012. https://www.ft.com/content/bc8c0fa6-baea-11e1-b445-00144feabdc0.
[35] "Underfunded Pension Plan." *Investopedia*. 2018. https://www.investopedia.com/terms/u/underfunded_pension_plan.asp.
[36] Malanga, S. "State Pensions are Woefully Underfunded – What Happens In the Next Downturn?" *Investor's Business Daily*. 2018. https://www.investors.com/politics/commentary/state-pensions-underfunded/.
[37] Ibid 27.

reports. In the interest of transparency, if a pension plan is underfunded, disclosure should be mandatory before the contract is signed. Investors should be warned of all the risks they are incurring by undertaking the investment.

In 2007, one year before the GFC, the level of funding for state pensions in the U.S. was at 92%.[38] During the GFC in 2008, the level of funding fell to 61%. In 2016, the level of funding only improved to 68%. Pensions funds are not riskless and the truism that "every investment carries risk" should not impede a manager's ethical obligation to disclose all the risks which an investor would undertake.

Status Quo and Challenges

Transparency in the investment industry is regulated by government authorities. Pertinent legislative directives include the authorities such as MiFID I and II,[39] the Stewardship Code,[40] the Employee Retirement Income Security Act (ERISA) and so forth.[41] Government issued legislations enhances the standards of reporting.

(a) MiFID II

The European Commission's Markets in Financial Instruments Directive 2018 (MiFID II) applies to, inter alia, any activity relating to the "provision of investment services."[42] As such, European pension funds fall under this directive. Notable provisions in the MiFID II improves transparency in the relationship between investors and fund managers:

i) Article 23 requires disclosure of any conflicts of interest
ii) Article 24(2) requires financial instruments to meet the needs of the intended market
iii) Article 24(3) requires all information provided to clients and potential clients to be fair and not misleading
iv) Article 24(4) requires appropriate information to be provided in a timely manner. The information includes all cost related charges, "execution venues," and investment strategies

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38 Pierog, K. "Battered by Great Recession, underfunded public pensions to persist." *Reuters*. 2018. https://www.reuters.com/article/us-financial-crisis2008-municipals-pensi/battered-by-great-recession-underfunded-public-pensions-to-persist-idUSKBN1H20EG.
39 "Markets in financial instruments (MiFID) and investment services." *Europa*. 2008. https://web.archive.org/web/20090228235223/http://europa.eu/scadplus/leg/en/lvb/l24036e.htm.
40 "UK Stewardship Code." *Financial Reporting Council*. 2019. https://www.frc.org.uk/investors/uk-stewardship-code.
41 Employee Retirement Income Security Act of 1974.
42 Directive 2014 of the European Parliament and of the Council. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02014L0065-20160701.

v) Article 24(5) requires information provided to consumers to be "in a comprehensible form in such a manner that clients or potential clients are reasonably able to understand the nature and risks of the investment"

vi) Article 27 requires investment firms to provide the best possible result for clients, taking into account the "price, costs, speed, likelihood of execution and settlement, size, nature, or any other consideration relevant to the execution of the order"

Before MiFID II, fund managers received gratuitous data research from banks and analysts. The costs of the research were absorbed by clients.[43] The introduction of the directive forces managers to disclose the amount payed to brokers and banks for research which imports greater transparency into the process.

(b) The Stewardship Code

The UK Stewardship Code is a set of principles governing the conduct of those who manage assets on behalf of others. The principles are general guidelines to follow. The seven principles are:

1. Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
2. Institutional investors should have a robust policy on managing conflicts of interest
3. Institutional investors should monitor their investee companies
4. Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities
5. Institutional investors should be willing to act collectively with other investors where appropriate
6. Institutional investors should have a clear policy on voting and disclosure of voting activities
7. Institutional investors should report periodically on their Stewardship and voting activities

The wording of the Stewardship Code, with the use of "should" instead of "must" or "shall," and the lack of specificity weakens it as an authority for fund managers. Indeed, the overall benefit to the Code has been unimpressive with

[43] Stafford, P. "What is Mifid II and how will it affect EU's financial industry?" *Financial Times*. 2017. https://www.ft.com/content/ae935520-96ff-11e7-b83c-9588e51488a0.

many firms failing to comply with the requirements.[44] Consequently, there are plans to amend the Stewardship Code in the near future.[45]

(c) *Employee Retirement Income Security Act*

The US Employee Retirement Income Security Act (ERISA) covers the US standards for pension funds. Notable parts include:

i) Part 1 which outlines disclosure and reporting requirements
ii) Part 3 which outlines the minimum standards of funding
iii) Part 4 which defines the fiduciary responsibility of the pension

Although there have been amendments to the ERISA, the reporting standards required are still slightly archaic.[46] There is no requirement for the publication of policies online. It is estimated that 20% of US state pensions only provide investment policies when requested rather than giving the public access online.[47] Since 1974, when the ERISA was written into law, society has shifted towards a largely digital environment. As such, the laws should facilitate the change and require pensions to disclose their policies online in the interest of transparency.

Government legislations are coupled with government regulators which conduct investigations and report related findings. Regulators such as the Financial Conduct Authority (FCA)[48] and the Securities and Exchange Commission (SEC)[49] serve to police the conduct of the pensions. Along with the regulators, there are non-government organisations such as the Transparency Task Force (TTF)[50] and Transparency International[51] which supplement the effort for transparency by spreading awareness.

The implementation of transparency, however, is not entirely without issues. The requirements of transparency in mutual funds is in direct competition with the principle of trade secrecy. To what extent should transparency usurp an investment fund's right to withhold its trading techniques from the public? Under distributive justice the answer is clear; the needs of the public should trump the needs of the business. However, if the requirements of commutative justice hold,

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44 Baxter, S. "Five years on: Is the Stewardship Code working?" *Professional Pensions*. 2015. https://www.professionalpensions.com/professional-pensions/analysis/2403345/five-years-on-is-the-stewardship-code-working.
45 Walker, O. "UK stewardship code in line for significant overhaul." *Financial Times*. 2019. https://www.ft.com/content/e581e639-0ab9-3fbe-aed6-39f7a9b20734.
46 "ERISA Amendments Overview." FindLaw. 2019. https://employment.findlaw.com/wages-and-benefits/erisa-amendments-overview.html.
47 Ibid 21.
48 "About us." *Financial Conduct Authority*. 2019. https://www.fca.org.uk/about.
49 "What we do." U.S. *Securities and exchange commission*. 2019. https://www.sec.gov/Article/whatwedo.html.
50 Ibid 13.
51 "What is transparency international?" *Transparency International*. 2019. https://www.transparency.org/about.

an exchange ought to balance the interests of both parties. Despite this, transparency must prevail. As Smith posits, the tenets of commutative justice are so fundamental that compliance should not even be acknowledged. Transparency is an ethical condition without which an equitable exchange would not exist. As such, it should not be examined as a term in the contract – rather it should be considered as a prerequisite to any contract.

Conclusion

Pension funds contain undisclosed pitfalls which distort an investor's perception of their value. This contravenes the foundation of transparency and commutative justice. Parties entering into a contract should be fully aware of the consequences of their own undertaking. Ultimately, the public should support efforts to encourage improved disclosure as it will invariably affect the well being of all investors.

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