CLIFFORD CHANCE

Client briefing

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# Prudent pension investments: Court nullifies Dutch Central Bank instruction

The Court of Rotterdam recently nullified a binding instruction given by the Dutch Central Bank ("DNB") relating to the application of the prudent person rule. DNB had instructed a pension fund to reduce its investments in gold from 13% to 3% of its total investments. The Court also ruled that it will investigate whether DNB is liable for losses incurred by the pension fund, said to be estimated at approximately €10 million.

## Key issues

- Prudent person rule
- The "gold case"
- Conclusion

## Prudent person rule

**The prudent person rule under the Dutch Pension Act governs the investment policies of Dutch pension funds. It is an open standard which in short implies, among other things, that pension assets: (i) must be invested in the best interests of participants and beneficiaries and in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole; and (ii) must be properly diversified.**

Unfortunately there is limited Dutch case law to assist with the interpretation of this open standard. Apart from the "gold case", there is only one other case regarding a DNB binding instruction relating to the prudent person rule.

That case however, which was upheld in Court, gives limited guidance for interpretation of the prudent person rule.

## The gold case

In the "gold case", the pension fund's assets were roughly allocated as follows: 78% government bonds, 13% commodities (gold), 8% cash and 1% real estate. DNB instructed the pension fund to reduce its gold allocation to 3%. The pension fund appealed against this instruction. The Court ruled that DNB's substantiation of the binding instruction was insufficient for several reasons.

Firstly, DNB reasoned that as 55% of the 22% of the fund's non-government bond assets was invested in gold, the pension fund became excessively dependent on the gold investment. The Court considered that this is a mere quantitative argument that fails to take into account the diversification of the assets in the pension fund's overall portfolio. According to the Court, DNB could not successfully argue why a 3% gold allocation would be in line with the prudent person rule, whilst a 13% allocation would not.

Secondly, DNB argued that the gold investment was risky and volatile by referring to the fall of gold prices in the 1980s. The Court ruled that this was not very convincing, especially considering that the pension fund had argued that the gold price had been stable for the previous ten years.

Thirdly, generic arguments of DNB, including that no other pension fund has a similar investment policy as the relevant pension fund, were rejected by the Court. According to the Court, a pension fund should be free to select an asset allocation that accurately corresponds to the nature and duration of the liabilities, as long as the objective of the prudent person rule is achieved

Since the prudent person rule is an open standard, high justification requirements apply to DNB's decisions in this respect. Furthermore, DNB decisions must be tailor-made for each pension fund.

Even after the Court had given DNB another opportunity to clarify its justification of the binding instruction in accordance with the above mentioned justification guidelines, the Court ruled that it remained unclear: (i) in which manner DNB had applied a tailor-made interpretation of the prudent person rule; and (ii) whether DNB's interpretation was sufficiently apparent for the pension fund. DNB's binding instruction was consequently nullified and the Court will investigate DNB's liability for the pension fund's losses which derived from the pension fund's obligation to comply with the instruction.

## Conclusion

The Court's ruling in the "gold case" has somewhat clarified the application of the prudent person rule. DNB must look at the specific situation of each pension fund and the alignment between the fund's asset allocation and the nature and duration of the liabilities. Furthermore, DNB should be able to give a case-specific explanation as to why it considers a certain allocation of assets to be conflicting with the prudent person rule.

The case shows that providing such case-specific explanation is a complicated and challenging task for DNB, which may in part be caused by the lack of case law or explanatory notes on the rule's interpretation.

If however DNB does succeed to provide such a tailor-made justification, the Dutch Courts have limited room to rule on the merits of that justification; under Dutch law they are only allowed to perform a test of reasonableness, which principally means that DNB is free to give its own interpretation to the prudent person rule, provided that such interpretation remains within the boundaries of the EU and Dutch law and that it is sufficiently motivated.

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