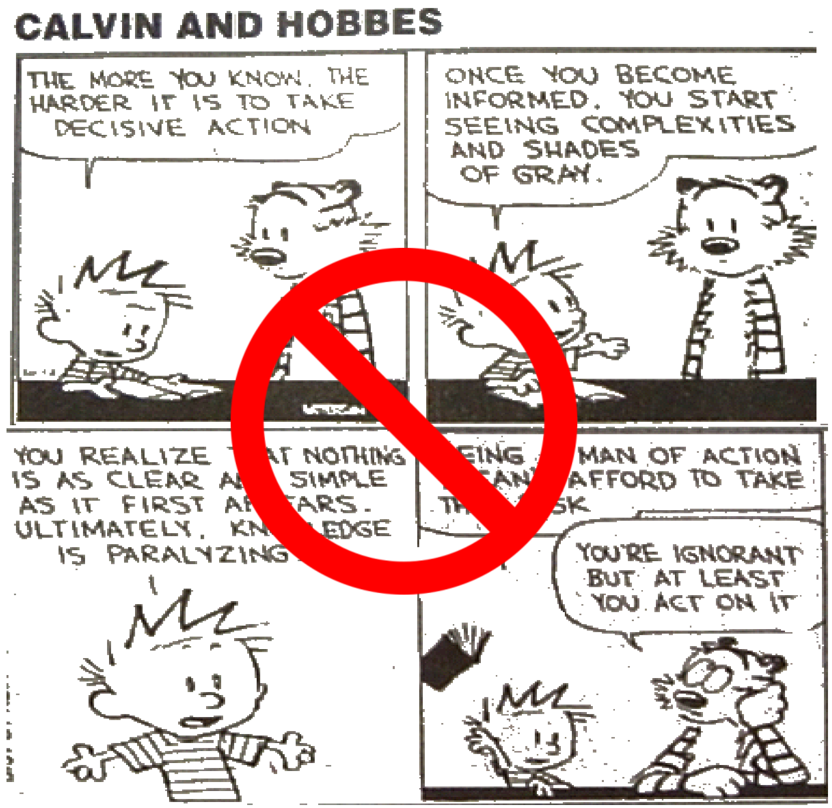
New Trustee Orientation: Things Every Trustee Should Know



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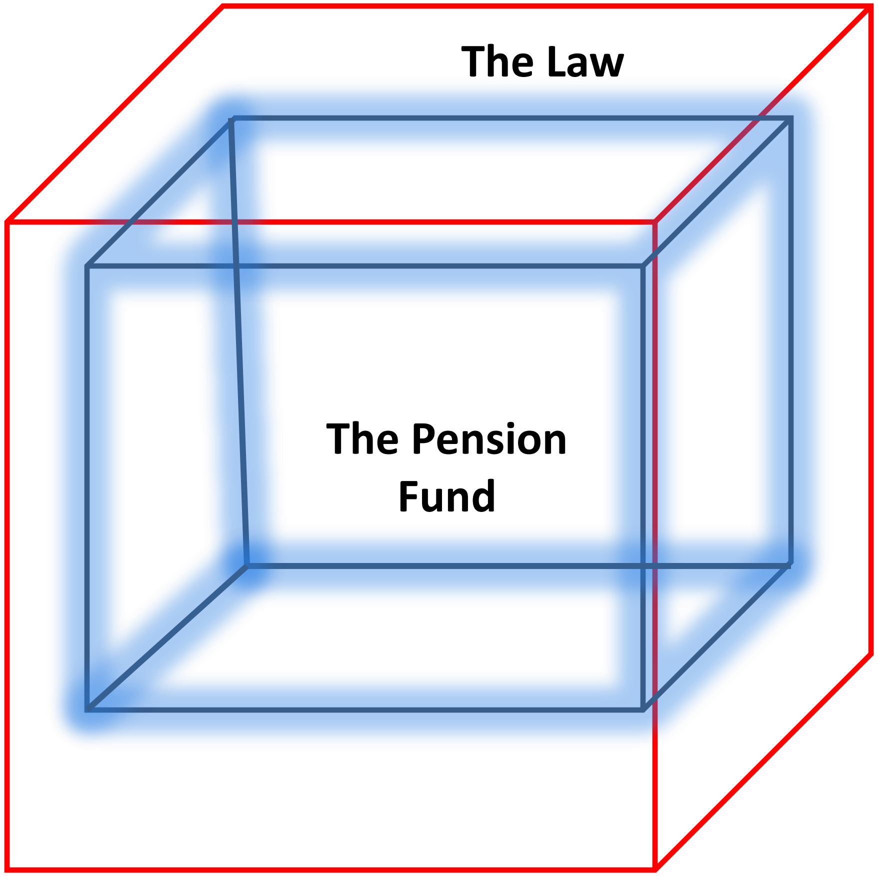
Outline

- Introduction—The Pension Box
- The Law: The Outer Limits
- Fiduciary Duties
- Investment Operations
- Benefits Administration
- Plan Funding
- Plan Operations
- Questions

Introduction—The Pension Box

- **This is the first of potentially a series of presentations outlining the duties, responsibilities, obligations of a public pension plan trustee**
  - **A 101 course for new public pension trustees**
- **The purpose of this specific presentation is to define the width, breadth, and depth of the pension world that public pension fund trustees operate in**
  - **A high level overview of the Pension Box and surrounding environment**



Introduction: The Pension Box

The Law

Pension Board of Trustees

Fiduciary Duties

Duty of Loyalty

Duty of Prudence

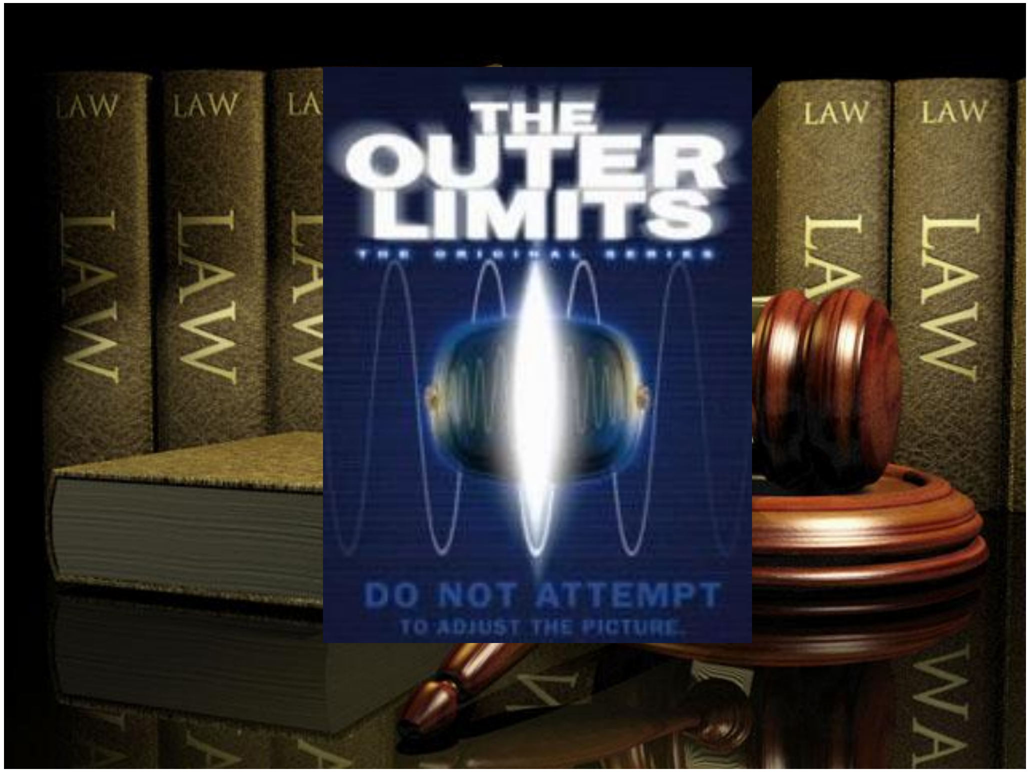
Benefits Administration

Plan Funding

Plan Operations

Investment Operations

The Law: The Outer Limits



The Law: The Outer Limits

- **Every trustee should have a working understanding of the laws/ordinances that govern/impact his or her plan**
- **These laws/ordinances may include:**
  - **Statutory/Ordinance Plan Document**
  - **State trust laws**
  - **State Sunshine Act**
  - **State Right-to-Know Law**
  - **State Ethics Law**
  - **State Adverse Interest Act**
  - **Divorce Code**
  - **Pension Forfeiture Act**

The Law: The Outer Limits

- **In addition to state and local laws, be aware of potential Federal laws that may apply, e.g.:**
  - **Internal Revenue Code**
    - **Tax qualification requirements**
    - **Reporting requirements**
    - **415(b benefits limits**
    - **401(a)(17) limits on contribution**
  - **SEC laws, rules and regulations**

Fiduciary Duties

Prudence

+

=

Complete Trustee

Fiduciary Duties

- **What are those duties?**
- **Although others may state them differently, (e.g., duty of diligence, duty of obedience, duty of honest administration, duty of confidentiality, duty of care, etc.), from my perspective they can be boiled down to two basic duties:**
  - **A duty of undivided loyalty to the beneficiaries of the trust, i.e. the members of the pension plan**
  - **A duty of prudence in the management and administration of the pension plan**

Fiduciary Duties

- The duty of loyalty requires one in a fiduciary relationship to manage and operate the pension fund for the sole and exclusive benefit of its members
  - Sometimes referred to as the Exclusive Benefit Rule
- In essence, this duty establishes the expected standard of behavior of a trustee or other fiduciary operating the pension plan or any other trust
- What is that standard?
- A standard of strict integrity that puts the interests of the members of the pension plan first and all other interests, particularly the fiduciary's own interest, last
  - In other words, a pension plan fiduciary must unconditionally sacrifice his or her own self-interest and the interests of all others to the interests and benefit of the members of the plan

Fiduciary Duties

- The **duty of prudence** requires the plan's trustees and staff to manage all aspects of the pension system, whether it is investments, benefits administration or internal administration, in a prudent manner
- Generally the level or standard of prudence required is the conduct that a prudent person, or the more recent trend, a prudent expert or prudent investor, would exhibit in a similar situation

Fiduciary Duties

- **Unlike the duty of loyalty, which governs the motivation/values of the trustee, the duty of prudence focuses on the trustee's competence, e.g.:**
  - **The level of procedural and substantive due diligence before an investment is made or a service provider is retained**
  - **The use and amount of diversification of the plan's assets**
  - **The control and management of plan costs, both administrative and investment related**
  - **The level of monitoring of the plan's investment performance**
  - **Timely and accurate administration of the plan's benefits**
  - **The existence and observance of proper policies, practices and procedures, e.g. business continuity plans, conflict of interest policy, governance rules, investment guidelines, proxy voting guidelines, benefits appeals process etc.**

Fiduciary Duties

- Further, while the duty of loyalty has remained somewhat inviolate, the standard of competence imposed by the duty of prudence has evolved to keep pace with the changing skills needed to operate increasingly more sophisticated trust funds, of which, public pension funds are the prime example
- Hence the move to the more stringent prudent investor or prudent expert standard of care

Fiduciary Duties

- **All of this sounds good, but the real question is what do the duties of loyalty and prudence practically mean in the real world of managing a public pension plan, particularly in light of…..**

Fiduciary Duties

….this environment?

Theft of Services

Increased Federal Oversight

Imprudent Investments

Placement Agents

Self-dealing

Nepotism

Indifference to Duties

Volatile Markets

Budgetary Constraints

Increased Complexity

Global Economy

Pay-to-Play

Pension spiking

Economically Targeted Investments

Funding Issues

Abdication of Responsibility

Increased Public Scrutiny

Divestment Movements

Conflicts of Interest

Political Pressure & Patronage Issues

Failed Investments

Investment Operations

Basic Fiduciary Duties for Investing Plan Assets

- **The fiduciary duties for investing plan assets are the same as for any fiduciary function:**
  - **Duty of Loyalty (Exclusive Purpose Rule)**
  - **Duty to Act with Prudence**
    - **Duty to Diversify Plan Assets**
    - **Duty to Follow Plan Documents**

Who is a Fiduciary for Investment Purposes?

- **A fiduciary is any person who:**
  - Exercises any discretionary authority or discretionary control regarding management of the plan;
  - Exercises any authority of control (discretionary or otherwise) regarding management or disposition of its assets;
  - Renders investment advice regarding plan assets for a fee or other compensation, whether direct or indirect, or has any authority or responsibility to do so;

    or
  - Has any discretionary authority or discretionary responsibility in the administration of such plan.

Basic Fiduciary Duty Standards for Investments – PRUDENCE

Prudence: Fiduciaries have the duty to invest plan assets prudently and in the best interests of the plan's participants (and their beneficiaries)

Procedural prudence – measured at the time an investment is made, without regard to "20-20" hindsight, focuses on the fiduciary's methodology in selecting a particular investment;

Substantive prudence – focuses on the actual merits of the fiduciary's decision – focuses on the fiduciary's conduct in investigating, evaluating and making the challenged investment

Prudent Expert – Prudence standard is not that of a prudent lay person but rather that of a prudent fiduciary with experience dealing with similar enterprise

Delegation of Investment Fiduciary Responsibilities

- Fiduciary law grants fiduciaries broad power to delegate their investment management authority to an investment manager.
- Plan fiduciaries who appoint a qualified investment manager to manage the plan's assets relieve themselves, the plans sponsoring employer(s) and all other fiduciaries (other than the investment manager) from liability for the acts or omissions of the investment with respect to the investment of plan assets under the control of the investment manager.
- Fiduciary liability will not be avoided with respect to the acts and omissions of the investment manager if the: (a) appointment was imprudent; (b) fiduciary fails to monitor the conduct of the appointee; (c) fiduciary would be liable as a co-fiduciary.
- Delegation of Investment Duties to Plan Participant-Directed Trust – when a plan consists of individual accounts – for instance, money purchase pension plans, profit-sharing plans or 401k plans.

Prudent Selection of Investment Managers and Consultants

- **Prudent Selection Process**
- **Questions to Ask**
- **Relationship between Managers and Consultants**
- **Identifying Conflicts of Interest**
- **Fee Arrangements and Contractual Issues**

Monitoring an Investment Manager

- Whose responsibility is it?
- Review of Compliance with Investment Policy Statement
    - Specific Guidelines for Each Manager
    - Addressing Violation of Guidelines
- Review of Performance and Business Structure
    - Quarterly performance reviews
    - Form ADV Part II Updates

Establishing Investment Policies/Guidelines

- **Investment Policy Statement: an employee benefit plan must have a statement of investment policy designed to further the purposes of the plan and its funding policy consistent with fiduciary obligations.**
- **Need a written statement with guidelines or general instructions concerning the various types of categories of investment management decisions, which may include proxy voting decisions.**

Establishing Investment Guidelines (cont.)

- **Funding Policy:** Trustees should determine the goals, time horizons, liquidity and other related issues to address the benefit objectives of the plan's participants base.
- **Risk Tolerance:** The liquidity of each plan, its maturity, and the size of the plan all must be considered by trustees to determine the risk tolerance of the portfolio.
- **Asset Allocation:** Trustees must evaluate the many different classes of assets, including domestic and international equities traded on public stock exchanges, fixed income securities in various ranges of duration and risk, cash and stable-income funds, as well as real estate vehicles, mortgage-backed securities, and alternative investments such as private equity holdings and hedge funds. The investment policy statement will typically include an acceptable range of allocation to each asset class, with a target asset allocation for that class somewhere near the middle of the range.

Diversification of Investment Portfolio

- ERISA requires the fiduciary responsible for plan investments to diversify the plan's investment portfolio so as to minimize the risk of large losses to trust principal.
- The theory behind the diversification requirement is that potential losses in one area of the plan's portfolio due to a particular economic event will be offset by gains in another area.
- Diversification is usually achieved by limiting the proportion of trust assets invested in any one type of investment and instead committing the assets to different classes of investments that are characterized by different types of risks.

Selecting an Investment

A fiduciary must give “ appropriate consideration” to the following criteria in making investment decisions:

- The investment must fit within the context of the plan’s overall portfolio;
- The design of the portfolio, including the investment, must be reasonable for the purposes of the plan;
- The risk of loss and opportunity for gain (or other returns) must be favorable, relative to alternative investments.
- The investment must fit into the diversification of the portfolio;
- The investment must not affect adversely the liquidity and current return of the entire portfolio relative to anticipated cash flow requirements of the plan
- The investment must take into consideration the projected return of the portfolio relative to the funding objectives of the plan.

Selecting an Investment (cont.)

- Determining Asset Allocation
  - Conducting an Asset Allocation Study
  - Various Types of Asset Allocation Analyses
  - Which Asset Classes Should Be Considered
  - Risk Measurement
  - Liabilities – Cash Flow Considerations
  - Modern Portfolio Theory
  - Efficient Frontier Modeling
  - Implementing the Asset Allocation Study
  - How Often Should it Be Reviewed/renewed
- Types of Qualified Investment Advisors/Vehicles
- Fiduciary Standards
- Referring Back to Your Asset Allocation/Investment Policy
- The Selection process
- Key factors to Consider the Process
- Making a Selection
- Implementing a Selected Advisor/Vehicle
- Monitoring Your Advisors/Vehicles

Alternative Investments

- **Alternative investments are generally investments other than publicly-traded stocks and bonds.**
- **Objectives of alternative investments**
    - **increase returns**
    - **reduce risks**
    - **provide diversification**
    - **create a more "efficient" asset allocation**
- **Four common categories:**
    - **Private Equity- private companies owned via buyout or venture capital structure**
    - **Hedge Funds of Funds**
    - **Real Estate**
    - **Other (Infrastructure; portable alpha; 130/30,etc.)**

<u>Indemnification and Insurance</u>

- **Trustees are personally liable for any losses to a plan resulting from a fiduciary breach**
- **Pennsylvania does not provide any specific immunity for plan fiduciaries**
- **The status of the Board's sovereign immunity is uncertain.**
- **Consequently, <u>fiduciary liability insurance</u> is necessary to protect against personal liability.**

Benefits Administration

Benefits Administration

- The heart and soul of a pension plan is the actual processing and payment of the benefits to the plan's beneficiaries
- As a trustee you need to have a basic understanding of the benefits structure
- Typically the benefit in the public arena is a defined benefit
  - Benefit is based on a formula—years of service x final average salary x a % multiplier = maximum single life annuity
- Plan goal—timely and accurate payments to members
- To achieve this goal you need timely and "clean" data
- Accurate employer reporting is critical
  - Salary
  - Service
  - Termination date
  - Demographic information, e.g. DOB, Gender, DOD, etc.
  - Employer and employee contributions

Benefits Administration

- Possible types of payments
  - Monthly annuity
  - Disability benefit
  - Death in service benefit—Active "Dead"
  - Guaranteed death benefit—Retired "Dead"
  - Survivor annuities
  - Alternate payees
  - Refund of contributions and interest

Benefits Administration

- In addition to processing the benefits, you also have obligations to provide timely and accurate information about your benefits to your plan's members including:
  - Benefit option selection information
  - Annual statements of accounts
  - Retirement estimates
  - Plan performance
  - Plan changes
  - Plan investment options if the plan has a defined contribution component

Plan Funding

Plan Funding

- **If you are in the business of paying benefits you are also in the business of ensuring that the benefits are properly funded over the long term**
- **Thus a trustee needs to also have a working knowledge of actuarial science**

Of all the actuaries at the firm, none could match the zeal of Earnest T. Cromwell.

Plan Funding

- Actuaries perform three basic functions:
  – Verify accuracy of benefit calculation procedures
  – Assess financial solvency of pension fund (funded status)
  – Recommend an annual employer contribution rate to the plan trustees
    - Based on results of the annual actuarial valuation

Plan Funding

- **Although the annual actuarial valuation to determine a plan's employer contribution rate is fairly complex, its goal is relatively simple**
  - **To ensure that the plan has sufficient funds to meet all benefit and expense requirements of the plan in accordance with the plan's cost methodology, e.g. entry age normal**

Plan Funding

- **The actuarial valuation ensures adequate funding of the pension plan by determining:**
  - **The liabilities of the fund, based on:**
    - **Membership data**
    - **Benefits provisions**
    - **Certain actuarial assumptions**
    - **Actual experience**
  - **The assets of the fund, based on:**
    - **Market value of the assets**
    - **Actuarial value of the assets**
    - **Certain actuarial assumptions**
    - **Actual experience**
- **The funding sources make up any "shortfall" between the assets and liabilities**

Plan Funding

- Actuarial Assumptions
  - Demographic
    - Service retirement
    - Disability
    - Death in active service
    - Withdrawal
    - Death after retirement
  - Economic
    - Investment rate of return on assets
    - Salary growth

Plan Operations

Plan Operations

- **In addition to all the other areas mentioned, a trustee must be concerned about ensuring adequate support for the marquee functions including:**
  - **Proper accounting—general, employer reporting and investment**
  - **Internal/external audits**
  - **Personnel/human resources**
  - **Business continuity planning**
  - **Management of administrative budget**
  - **Information technology**
  - **Data stewardship/security**
  - **Facilities management**
  - **Media relations**

Questions?