Association of Public Employee Retirement Systems

Fiduciary Duty 201

The next step in understanding fiduciary duty

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Fiduciary Duty Refresher
The Basics

General Trust Principles

- Fiduciary law stems from the common law of trusts
  - Hundreds of years old, starting in England
  - Developed through decisions of the courts over time
  - Applied to family, business, and charitable trusts even before pension funds

- Parties to a trust
  - Settlors ⇨ Create the trust and set the benefits
  - Trustees ⇨ Carry out the terms and govern the operations of the trust
  - Beneficiaries ⇨ Receive money from the trust
  - The roles of each party are different and often confused

- Actual terms of a trust and specific laws take precedence over general trust law

Sources of Fiduciary Standards for Public Pension Fund Trustees

- Restatement of Trusts
  - Restatement of Trusts 3d: Prudent Investor Rule (1992)
- Statutes
- Regulations
- Court decisions
- Attorney General opinions
- General trust law
- Legal advice
- Industry standards from the UMPIA, UMPERSA, CFA Institute, GFOA, NAPPA, NCPERS, and NCTR
- Aspects of ERISA

General Definition of a Fiduciary

- Exercises any discretionary authority or discretionary control regarding management of the plan;
- Exercises any authority or control (discretionary or otherwise) regarding management or disposition of its assets;
- Renders investment advice regarding plan assets for a fee or other compensation, or has any authority or responsibility to do so; or
- Has any discretionary authority or discretionary responsibility in the administration of such plan.

Who is a Fiduciary?

- Functional Test
  - The test is whether a person has discretion and control over the administration of the system or management of the assets
    - Trustees are the highest level fiduciaries with the broadest responsibility
    - Others may be fiduciaries, too, by contract or by virtue of the work they perform
    - Usually those performing ministerial tasks are not fiduciaries
- A person’s fiduciary duty is limited to the scope of responsibility they are delegated or they assume

Settlor vs. Fiduciary Functions

- Examples of fiduciary functions
  - Administration of the plan
  - Control over plan assets
- The implementation of a settlor decision may involve a fiduciary function
- An individual may have two roles as a board member and an officer or employee of the plan sponsor
- Awareness of which role you are performing is critical

Who is a Fiduciary?

- ❑ Trustees and those designated as such in statutes
- ❑ Staff with decision-making authority and/or control over assets
- ❑ Investment managers
- ❑ Investment consultant(s)
- ❑ The custodian bank
- ❑ The Plan Sponsor
- ❑ The Fund Actuary
- ❑ The Fund Attorney
- ❑ Auditors & Accountants
- ❑ Brokers

Basic Fiduciary Duties

- Public retirement systems operate under the same basic fiduciary duties as corporate pension funds and that is why the Employee Retirement Income Security Act (ERISA) is influential even though it is not controlling
  - Each system has its own enabling statute that defines the applicable duties
- The most important duties are the duties of prudence and loyalty
- The **duty of prudence** requires expertise and more than a good faith attempt to do the right thing
- The **duty of loyalty** requires a steadfast commitment to stay focused on the interests of the beneficiaries of the Fund
- Many other fiduciary duties stem from these two
- The duties are simple to state, but not so simple to follow

Fiduciary Duties

Duty of Prudence

- Care and diligence
- Facts and circumstances
- Assumes skill & knowledge
- Focus on prudent process

Duty of Loyalty

- Act solely in interests of participants
- Exclusively to provide benefits
- Reasonable fees/expenses

Diversification

- Diversify to minimize risk unless imprudent to do so

Follow Plan Document

- To the extent consistent with applicable law

Prohibited Transactions

- No self-dealing
- No transactions benefiting nonparticipants
- No acting against plan interests
- Limited exceptions

Beyond the Basics

Discussion & Application

Duty of Prudence

- Primary areas where duty of prudence usually comes into play
  - Setting the asset allocation
  - Managing risk
  - Selecting investment managers
  - Reviewing performance
  - Retaining expert assistance
  - Documentation of processes – investments and benefits

- Prudence requires good judgment:
  - Trustees deserve to feel comfortable with the decisions they make
  - Sometimes extensive research and discussions are necessary but it is best to avoid “analysis paralysis” and make timely decisions
  - It is not impolite to question the “experts” on staff or from the outside but ignoring expert advice can be dangerous
  - At times you may need to hear what you don’t want to hear from those advising you (staff or consultants)

Prudence Standards Evolve Over Time

- As prudence standards evolve over time, fiduciaries need to keep up
- Due diligence practices of the past may not be enough
- Investments with the potential for high returns are often higher risk and require more due diligence
- Decisions must be made using contemporary standards of prudent investors/experts
  - More specialized advice from independent consultants/service providers
  - More written opinions rather than verbal “off the cuff” comments
  - Know the common and best practices

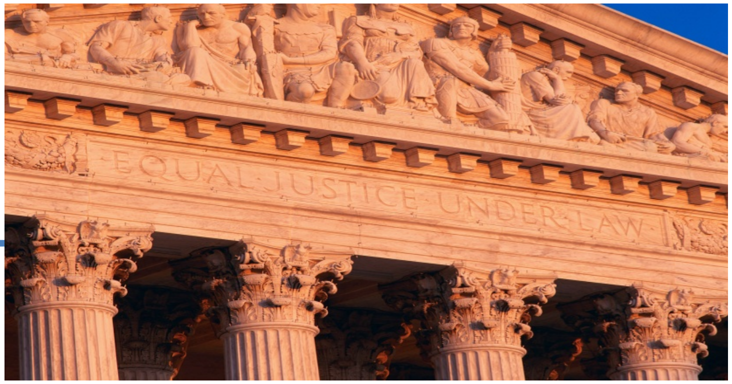
Duty of Prudence

- Delegation is allowed and even encouraged
  - Failure to delegate may be a fiduciary breach
- Degree to which a board delegates is a governance decision
- Prudent delegation to service providers requires:
  - Check credentials, experience, expertise, quality of work, reasonableness of fees, etc.
  - Make delegations within the firm’s and individual’s area of expertise
  - Clearly state delegations in writing
  - Regularly and carefully monitor service providers
  - Evaluate performance against relevant standards and benchmarks
  - Make changes, if necessary
- Diligence and oversight does not require micro-management of the staff
  - *Steer the ship, set the course, but allow the staff to handle the rowing*

Breaches of the Duty of Prudence

- Examples of fiduciary breaches of the duty of prudence include:
  - Overly risky investments with no expected sufficient return
  - Poor oversight of investments
  - Poor performing managers and not doing anything about it
  - Unjustified expenditures by board members
  - Unreasonable administrative expenses
  - Improper selection of service providers
  - Failure to hire experts if the Board doesn't have the necessary expertise

Duty of Prudence



"The test of prudence is one of conduct and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment and not whether his investment succeeded or failed."

Donovan V. Cunningham

Take-Away Points About the Duty of Prudence

- When times are tough, the boards of public funds are more closely scrutinized by the media, the membership, elected officials, and the general public

- Careful, thorough, and scrupulous behavior is expected of trustees and those who work for them

- From a legal perspective, a good decision-making process is more important than a good outcome

- Trustees are not expected to be perfect, but they are expected to be prudent

Duty of Prudence
Case Study Discussion

Duty of Loyalty

- In addition to the duty of prudence, trustees must follow **the duty of loyalty**
- The duty requires that fiduciaries act **solely** for the fund and its beneficiaries
- This is known as the **"exclusive benefit rule"**
- Unlike the duty of prudence, the duty of loyalty has remained rigid over time
- Interpretation of loyalty:
  - When creating policies or making other decisions for the Fund, the fiduciaries can **"only wear one hat "**
  - The law has been very clear about the requirements of loyalty
  - Courts have been strict and consistent in their rulings
  - Trustees are not to balance interests of outside parties
  - Trustees are not to act in their own self-interest

Duty of Loyalty

- This is one of the most troublesome areas for public fund fiduciaries
- **Your fiduciary duty is owed to all the members and beneficiaries of the trust**
- **Duty of Impartiality**
- There will be those who expect you to represent them and be their advocates when you serve on the Board, but
  - No **fiduciary** duty is owed to whoever appointed you
  - No **fiduciary** duty is owed to local businesses
  - No **fiduciary** duty is owed to taxpayers
  - No **fiduciary** duty is owed to employers
  - No **fiduciary** duty is owed to the Legislature or Executive Branch
  - No **different fiduciary duty** is owed to a subset of the membership who elected you
- **Regardless of how one comes to serve on the Board, the fiduciary duty is the same for all trustees**

Practicing Loyalty

- Avoid conflicts of interest, or even the appearance of conflicts
  - Know what conflicts of interest laws and policies apply; ignorance is not an excuse
- If avoidance is impossible, disclose your conflicts promptly and manage them to the best of your ability
- Sometimes this means recusing yourself from votes or forgoing other actions you would like to take and leaving the room during the discussion
- Fiduciary duty takes precedence over other duties
- The courts are extremely strict on fiduciaries who have conflicts of interest
  - The “court of public opinion” is very strict as well
- The laws are complex so if in doubt about whether or not you have a conflict of interest, seek legal advice from your Legal Counsel

Breaches of the Duty of Loyalty

- Some examples of fiduciary breaches of the duty of loyalty:
  - Economically targeted investment "carve outs" that do not meet established investment criteria and/or cause unnecessary expense and add no value
    - Some PA pension fund laws permit consideration of whether an investment enhances and promotes the general welfare of the State and its citizens (e.g. employment, housing, economic activity)
  - Kickbacks from investment managers
  - Enriching family members through plan business
  - Conflicts of interest
  - Making a below market rate loan
  - Using plan assets for settlor functions

Take-Away Points About the Duty of Loyalty

- Pension scandals in the corporate world have made many employees worry about their retirement security

- Public pension funds have had their share of trouble and bad press, too

- An unwavering commitment to act solely for the benefit of the trust and its members and beneficiaries is expected of trustees

- Disappointing others outside the pension fund is not as serious or costly as breaching your fiduciary duty of loyalty and violating the trust of the membership

Duty of Loyalty
Case Study Discussion

Duty to Pay Only Reasonable Plan Expenses

- Under ERISA and many state laws

  A fiduciary with respect to a retirement system or pension fund established under this Code shall discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries ….<u>for the exclusive purpose of…defraying reasonable expenses of administering the retirement system or pension fund</u>

- The duty to pay only reasonable plan expenses stems from the duty of prudence
  - Paying expenses from plan assets is a fiduciary decision

- Expenses must be reasonable and necessary for the administration of the plan – not for settlor functions

- **General Test**: Expenses would not have been incurred "**but for**" the administration of the plan

- Reasonable does not mean the least expensive

What is the Appropriate Role of the Board in Pension Reform?

“Neutral Administrator”	“Advisor” or “Educator”	“Protector”	“Innovator”	“Advocate” or “Activist”
follow the statutory parameters as established	give costs and implications of benefit changes, but offer no recommendations	act on legislative amendments only when the actuarial stability of the System is threatened	design and recommend changes to benefits and funding sources	lobby for changes in state laws to sustain the System; lobby against illegal or ill-advised proposed changes

- You should not use trust assets for settlor functions
- What role has the Board had?
- What role is needed going forward?
- Identify what changes in the law, policies, staffing, and budget are needed to assume a different role.

Duty to Diversify

- Diversification can be considered as part of the duty of prudence
- Diversification is required so as to minimize the risk of a large loss, unless under the circumstances it is clearly prudent not to do so
- For DB plans, the Modern Portfolio Theory is usually considered
  - Diversify plan assets unless it has been reasonably determined that the trust is better served by not diversifying
  - Consider each investment within the context of the entire portfolio
  - Create an “optimal” portfolio given the board’s risk/return preferences

Duty to Follow the Trust Document

- The trust document for public pension funds consists of the constitution, statutes, and rules containing investment parameters, benefit provisions, and organizational restrictions

- Sometimes obscure state laws must be considered (banking, insurance, securities, procurement, etc.)

- Federal laws or regulations (incorporated by reference)

- Legal opinions

Potential Fiduciary Liability

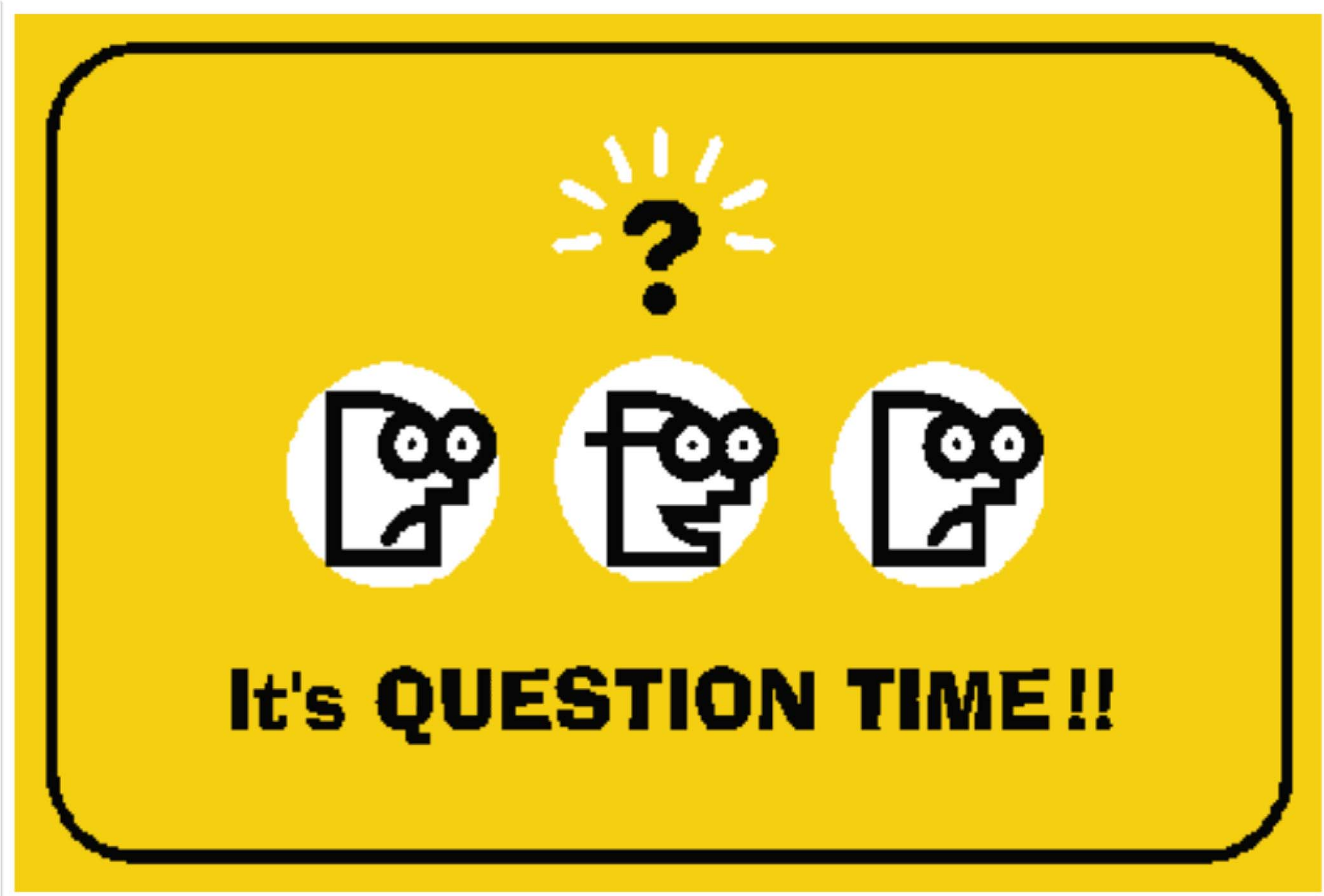
- Personal actions violating the trust
- Breaches of loyalty or prudence
- Criminal actions
- Consequences
  - Personal liability for losses
  - Restoration of profits
  - Other equitable or remedial relief
  - Loss of reputation

- **Co-fiduciary liability:**
  - **"you are your brother's keeper"**
  - If you know of a violation and do nothing about it, you are breaching **your** fiduciary duty
  - Trustees have a duty to remedy the fiduciary breaches of other fiduciaries
  - It is important to have a good process in place to deal with this

Ways to Limit Liability

- External Protections
  - Sovereign or governmental immunity
  - Indemnification
  - Fiduciary liability insurance
  - Directors and Officers (D&O) insurance
  - Errors and Omissions (E&O) insurance
  - Fidelity bonds

- Prudent Processes as protections *a.k.a* "good governance"
  - Adopt sound written policies and procedures
  - Demonstrate that a prudent process was followed
    - Preparation for meetings
    - Good advice from true experts
    - Thorough documentation of the decision-making process
  - Verify compliance
  - Require ongoing education
  - Establish a culture of adherence to the highest ethical standards


It's QUESTION TIME !!