



Montana Public Employee Retirement Administration
Fiduciary Training
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Agenda

- Opening Remarks
- General Trust Law
- Basic Parties to a Trust and Their Roles
- Trust Law Evolution
- Who is a Fiduciary
- Duty of Loyalty
- Duty of Prudence
- Duty to Follow Plan Documents
- Fiduciary Liability
- Co-fiduciary Liability
- Prevention and Avoidance of Fiduciary Liability
- Closing Comments

General Trust Law

- Fiduciary law stems from the common law of trusts

- Public retirement systems and state investment boards across the country are set up as trusts which are distinct legal entities

- Three parties are involved with a trust
 - Settlers
 - Trustees
 - Beneficiaries

- The roles of each party are different and often confused, especially in recent times

Basic Parties to a Trust and Their Roles

- Trusts are established by a **Settlor**
 - The settlor is the entity that creates the plan and determines what benefits will be provided
 - The Legislature is usually the settlor for statewide public pension plans

- The trusts are overseen and managed by **Trustees**
 - Whenever there is a trust, someone or some entity is a trustee
 - Public pension plans almost always have boards of trustees rather than just one trustee
 - The trustees are responsible for paying the benefits, making the investments, or handling both responsibilities

- Those who receive benefits under the trust are **Beneficiaries**

Trust Law Evolution

- Common law of trusts
 - Hundreds of years old, starting in England
 - Developed by the courts over time
 - Applied to family, business, and charitable trusts even before pension funds

- General trust law contains standards that apply to all trusts

- The Restatement of Trusts explains trust principles, illustrates governing rules, summarizes notable court decisions, and includes secondary sources of information

- Specific Montana state law takes precedence over general trust law

- In 1974, a federal law clarified trust law as it applied to private sector pension funds

The Influence of Federal Law

- The Employee Retirement Income Security Act of 1974 is commonly called **ERISA**
- ERISA, in regulating private sector employee benefit plans, established higher fiduciary standards than had existed for other types of trust fund fiduciaries under the common law
- Technically, ERISA does not apply to public pension plans like PERA
- It is very influential because it reflects relevant trust law and its “spirit” is typically followed by the courts in the absence of a stated standard
- The fiduciary standards of many public pension plans are modeled after 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?

- 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
- Some internal (executive) staff are fiduciaries
- Investment managers and consultants for the DB plan and the DC plan are fiduciaries but other outside service providers are not (auditors, actuaries, etc.)
- The test is whether a person has discretion and control over the administration of the plan or management of the assets
- Usually those performing ministerial tasks are not fiduciaries
- A person's fiduciary duty is defined by the scope of responsibility they are delegated or they assume

Key Fiduciary Duties

- The **three** most important duties are the duty of prudence, the duty of loyalty, and the duty to follow the plan documents
- The duty of **loyalty** requires a steadfast commitment to stay focused on the interests of the members and beneficiaries of the retirement system
- The duty of **prudence** requires expertise and more than a good faith attempt to try to do the right thing
- The duty to **follow the plan documents** for a public retirement system means following state laws and administrative rules
- Many other fiduciary duties stem from these key fiduciary duties
- These duties are simple to state, but not so simple to follow

Duty of Loyalty

*“Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. **A trustee is held to something stricter than the morals of the marketplace.** Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of **undivided loyalty** by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”*

Justice Benjamin Cardozo, 1928

The Exclusive Benefit Rule

- The duty of loyalty requires that fiduciaries act “**solely**” for the trust and its members and beneficiaries
- This is known as the “**exclusive benefit rule**”
- The duty of loyalty has remained rigid over time and courts have been strict and consistent
- Interpretation of loyalty:
 - When creating policies or making other decisions for the retirement system, the fiduciaries can “**only wear one hat** ”
 - Trustees are not to balance interests of outside parties
 - Trustees are not to act in their own self-interest

Loyalty to Whom?

- Each trustee has a fiduciary duty that is owed to **all** the members and beneficiaries of the trust
- 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 the local business community
 - No **fiduciary** duty is owed to taxpayers of the state
 - No **fiduciary** duty is owed to employers who contribute to the plan
 - 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**

Conflicts of Interest

- The law relating to conflicts of interest comes from the duty of loyalty
- **Avoid** conflicts of interest, or even the appearance of conflicts
- 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
- Fiduciary duty takes precedence over other duties
- The laws are complex so if in doubt about whether or not you have a conflict of interest, seek legal advice from the Chief Legal Counsel

Final 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 violating the trust of the membership

Duty of Prudence

Prudent: exercising sound judgment in practical matters; cautious in conduct; sensible; not rash

Webster's Dictionary

*“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

Duty of Prudence

- The **duty of prudence** is an ever-evolving standard of care
 - Prudence is required in all decisions, not just investment decisions
 - Due diligence practices of the past may not be enough
- The duty requires trustees and other fiduciaries:
 - To act with the care, skill, prudence, and diligence used by others under the same circumstances, acting in the same capacity
 - To be “prudent experts” – familiar with such matters, or to seek expert advice
- **Prudence, not perfection, is required**
 - Trustees are not guarantors that every decision they make will be perfect
 - However, a pure, thorough, scrupulous, and well-documented process will protect fiduciaries

Variety of Terms

- Prudent man: ordinary care that you would use with your own property; a lower reasonableness standard than is expected today for board members
- Prudent person: politically correct version of “prudent man”
- Prudent investor: comes from the Uniform Prudent Investor Act, adopted in nearly all states and follows modern portfolio theory
- Prudent expert: the ERISA standard which is the highest standard of care; this is the recommended standard

The Applicable Standard

- MPERA's standard of prudence compared to the ERISA standard
- ERISA Standard:
 - Trustees will be judged by those who serve in the same or similar capacity and who act with the care, skill, prudence, and diligence under the circumstances then prevailing than a prudent person (expert) acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims
- Being prudent means:
 - Trustees must **use** all the personal skills and experience they have and **share** their insights with the other trustees
 - If trustees are not experts, they are to become experts or hire experts
- The peer group for comparisons will be other public retirement systems and investment boards **nationwide**

Being Prudent with Expenses

- The duty to pay only reasonable plan expenses stems from the duty of prudence
 - Paying expenses from plan assets is a fiduciary decision
 - This duty is often the subject of media attention but rarely the basis for fiduciary liability
- **Expenses must be fairly allocated among the various plans the board has responsibility for**
- **Expenses must only be used for the administration of the plans and not for “settlor functions”**
- Reasonable does not mean the least expensive; no need to be skimpy
- The biggest expenses today often involve multi-year technology projects and investment management fees

Final Points about the Duty of Prudence

- When times are tough, the boards of public retirement systems 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 to Follow Plan Documents

- The “plan documents” for public pension funds consist of the statutes (or ordinances) and rules containing benefit provisions, investment parameters, and organizational restrictions
- Sometimes obscure state laws must be considered (banking, insurance, securities, procurement, open meetings/records, etc.)
- Federal laws such as the Internal Revenue Code also must be followed even if they are not specifically mentioned in the state statutes

Legal Interpretations of Plan Documents

- The statutes covering benefit eligibility (including the eligible person, age, service credit, etc.) are not always clear and often leave out necessary details
- Legal interpretations of statutes are usually necessary for certain circumstances not specifically covered in the law
- Legal opinions from the State Attorney General, in-house legal counsel, and outside legal counsel often address ambiguities in the statutes
- Policies and procedures the Board has adopted and the past standard practices of the organization come into play; it is important to follow precedents

Compliance with the Duty Can Be Difficult

- The fiduciary role a trustee has is not the same thing as an advocacy role which unions, associations, or plaintiff's attorneys often have
- This is confusing to some boards because the law also requires that trustees act solely in the best interest of the members and beneficiaries
- "Best interest" does not mean a board can violate or intentionally misinterpret the statutes; the two duties must be reconciled
- Trustees must treat everyone fairly under the provisions in the statute which is not the same as treating everyone equally
- Boards must be reasonable and cannot be arbitrary and capricious (unpredictable)
- Sometimes the boards must act as neutral decision-makers when they have quasi-judicial responsibilities

Final Points about the Duty to Follow Plan Documents

- The plan documents are created by legislatures through the state statutes they enact; sometimes state constitutional provisions are also part of the plan documents
- A board's administrative rules also become part of the overall plan documents for a public retirement system
- Frequently boards of trustees and staffs find they need legal interpretations of plan documents in order to comply with them
- The fiduciary duty to follow plan documents is one of the most difficult for trustees because it directly impacts the financial well-being of individual members and beneficiaries

Fiduciary Liability

- The laws governing public fund fiduciaries may impose liability for a breach of duty; however, sovereign immunity laws may apply

- Generally, fiduciaries who fail to discharge any of their fiduciary responsibilities:
 - shall be personally liable to make good to such plan any losses to the plan resulting from each such breach

 - shall also be personally liable to restore any profits which have been made through use of plan assets

 - shall be subject to such other equitable or remedial relief as a court may deem appropriate

- A trustee acting within the scope of his or her responsibility may be protected but if acting outside the scope, protection is rarely afforded even through insurance

Co-Fiduciary Liability

- Co-fiduciary liability means “you are your brother’s keeper”
- Liability can result if a fiduciary enables, knowingly participates in, or knowingly undertakes to conceal a breach by another fiduciary
- For liability to attach, you must have actual knowledge of an action that you know to be a breach
- A fiduciary has a duty to speak up and take reasonable steps to prevent or halt a co-fiduciary’s breach
- Resignation from a board of trustees is usually not sufficient
- Remember this as the “**duty to squeal**”

Prevention and Avoidance of Fiduciary Liability

- Thoughtfully establish and carefully document prudent processes
- Maintain a good governance structure
 - A thorough decision-making process
 - Rigorous risk identification and management
 - Clearly defined roles and responsibilities
- When delegating duties, perform on-going oversight
- Establish appropriate reporting and disclosure
- Follow the policies and processes you have in place
- Periodically review policies and processes and, if needed, revise them
- Obtain independent expert advice when needed (law, actuarial, benefits, audits, investments, etc.)

Practical Advice

- Prompt and thorough new trustee orientations are becoming the trend across the country and these orientations focus on many topics including fiduciary responsibility
- Board self-evaluations and Executive Director evaluations are more regular and meaningful than ever before; they often include discussions about compliance with fiduciary duties
- More and more board policies stress the need for ongoing training programs for trustees and staff
- Annual fiduciary education sessions are quite common
- Heightened awareness of fiduciary pitfalls is important to all who act in a fiduciary capacity (trustees, staff, consultants, and others)

Closing Comments

- Any surprises in what was presented?
- Any concerns about how you are handling your fiduciary duties?
- Any follow-up needed because of today's discussions?
- Being a trustee on a public retirement board is certainly a great honor, but it is not only an honor
- It is hard work and carries with it enormous responsibility
- Make sure you have enough information and the right advice so that you can fulfill your fiduciary responsibilities
- The members and beneficiaries deserve the best