



Montana Public Employee Retirement Administration

Montana Public Employees' Retirement Board Fiduciary Duty Training



Agenda

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





Opening Remarks

"We shall strive for perfection. We shall not achieve it immediately — but we still shall strive. We may make mistakes — but they must never be mistakes which result from faintness of heart or abandonment of moral principle."

- FDR, 4th Inaugural,
January 20, 1945





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.

IRC § 4975(e)(3)



Who is a Fiduciary?

- Members of the MPERB are trustees over our defined benefit and defined contribution plans and 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 generally not (auditors, actuaries, etc.)
- The test is whether a person has discretionary authority or control over the administration of the plan or management or disposition of the assets (IRC § 4975(e)(3))
- 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



Why does it Matter that you are a Fiduciary?

- In fiduciary relationships, the law demands a higher than ordinary degree of care and responsibility from the dominant or trusted party.
- The 9th Circuit has noted with respect to fiduciary responsibilities that “These duties are the highest known to the law.”

Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996).





Constitutionalized in Montana

Article VIII Sec. 15 Montana Constitution

(1) Public retirement systems shall be funded on an actuarially sound basis.

Public retirement system assets, including income and actuarially required contributions, shall not be encumbered, diverted, reduced, or terminated and shall be held in trust to provide benefits to participants and their beneficiaries and to defray administrative expenses.

(2) **The governing boards of public retirement systems shall administer the system, including actuarial determinations, as fiduciaries of system participants and their beneficiaries.**





Sources of Fiduciary 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 can often be confused



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, or making the investments, or handling both responsibilities in some cases

- 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 MPERA
- 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
- Internal Revenue Code



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 (i.e. adherence to the trust)
- 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** (or adherence to the trust) 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 always so easy 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
Meinhard v. Salmon, 249 N.Y. 458, 464 (Ct. App. 1928)*



The Exclusive Benefit Rule

- The duty of loyalty requires that fiduciaries act “**solely**” for the trust and its members and beneficiaries (IRC 401 § (a)(2))
- 19-2-505, MCA - “The assets of the retirement systems, including assets of retirement accounts, may not be used for or diverted to any purpose other than for the exclusive benefit of the members and their beneficiaries and for paying the reasonable administrative expenses of the retirement systems administered by the board.”
- 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, 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 (Duty of Impartiality)
 - 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

- **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, must avoid self-dealing or self-enrichment
- 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. Your fiduciary duty takes precedence over other duties
- You must adhere to state ethics laws for “gifts of substantial value” under 2-2-102, MCA. Acceptance of gifts give the appearance of undue influence
- 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



Conflicts of Interest

2-2-105, MCA. Ethical requirements for public officers and public employees.

(4) When a public employee who is a member of a quasi-judicial board or commission or of a board, commission, or committee with rulemaking authority is required to take official action on a matter as to which the public employee has a conflict created by a personal or private interest that would directly give rise to an appearance of impropriety as to the public employee's influence, benefit, or detriment in regard to the matter, the public employee *shall disclose the interest creating the conflict prior to participating in the official action.*

(5) A public officer or public employee *may not perform an official act directly and substantially affecting a business or other undertaking to its economic detriment when the officer or employee has a substantial personal interest in a competing firm or undertaking.*



Duty of Loyalty - Prohibited Transactions

- Internal Revenue Code Section § 503(a) provides that a governmental plan may lose its tax qualified status if it is deemed to have engaged in a “*prohibited transaction*” as defined in IRC Section 503(b).
- Any such transaction could provide a basis for the IRS to revoke the tax qualified status.
- Generally, a prohibited transaction is a transaction between the plan and the governmental sponsor which involves:
 - Loan of assets to the sponsor.
 - Purchase of securities or other property for more than adequate consideration.
 - Selling substantial securities or other property for less than adequate consideration.
 - Any other transaction which results in a diversion of trust assets.

Internal Revenue Code, § 503(b)



Prohibited Transactions – Remedies

Remedies are:

- Disgorgement and Restoration
- Excise Taxes
- Civil Penalties
- Criminal Fine and Imprisonment



Final Points About the Duty of Loyalty

- Pension scandals in the corporate world have made many employees worry about their retirement security
- 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, 716 F.2d 1455, 1467 (5th Cir. 1983))



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
 - The “prudence standard is not that of a prudent lay person, but . . . rather that of a prudent fiduciary with experience dealing with a similar expertise.” *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1998)
 - 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 person: ordinary care that you would use with your own property; a lower reasonableness standard than is expected today for board members
- 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

- What is applicable standard for the MPERB?
- 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 that 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
 - “[This is not a search for subjective good faith - ***A pure heart and empty head are not enough.*** . . .] *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983))
- The peer group for comparisons will be other public retirement systems and investment boards **nationwide**



Duty of Prudence – Delegation

➤ “A trustee has a duty personally to perform the responsibilities of the trusteeship except as a ***prudent person might delegate those responsibilities to others***. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a ***prudent person*** would in act in similar circumstances.”

– Rest. 3d Trusts, supra (Prudent Investor Rule, § 171, adopted in 1992) (emphasis added).



Duty of Prudence – Delegation

- **Prudence** is the key to all aspects of delegation:
 - Whether to delegate;
 - How to delegate;
 - To whom a task is delegated; and
 - How to supervise.

Mandatory Delegations – although expressed as duties of the Board, these responsibilities must be performed by a certified professional and therefore must be delegated (Annual Actuarial Valuations). Board’s duty is effectively limited to consideration and approval of delegate’s recommendation or securing a second opinion.

External/Discretionary Delegation – functions that need not be performed by a certified professional. (Investment of Plan Assets or 3rd Party Recordkeeper). Strong procedures in the selection process will insulate the board even if the delegate performs poorly. i.e., RFP, In-Person interviews, Post-interview deliberation by the Board and any advisor assisting the Board, Documentation of basis for decision.

Internal Delegation – “The board may . . . delegate to the board’s executive director or any other staff member any of the powers or duties conferred by law upon the board except as otherwise provided . . . (19-2-403(15), MCA). Process is a matching of issue expertise and personnel.



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 can often be 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

- 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

- “[A fiduciary shall discharge his [or her] duties with respect to the plan . . . in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions [of ERISA or the Internal Revenue Code].”

ERISA Section 404(a)(1)(D)

- 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 our state statutes



Legal Interpretations of Plan Documents

- The statutes covering benefit eligibility (including the eligible person, age, service credit, etc.) are usually clear, but sometimes exclude 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 can be confusing 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 statute which is not the same as treating everyone equally
- Boards must be reasonable and cannot be arbitrary and capricious (unpredictable)
- You must act as neutral decision-makers when exercising your quasi-judicial responsibilities



Final Points about the Duty to Follow Plan Documents

- The plan documents are created by our legislature 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;
- 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 or sister’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 speak up”**



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.)



Closing Comments

Always ask yourself these three questions:

- **Duty of Loyalty** – Can I be objective in reaching a decision?
- **Prudence** – Am I armed with the necessary information and/or expertise to make the decision?
- **Procedure** – Is there a clear procedure or process to follow in making my decision?
- The MPERB must use informed judgment and act in the overall best interest of system members/beneficiaries in a manner that is consistent with applicable laws when exercising its authority over administration of its systems, and its actions *must be rationally related to the information* presented to the Board.