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Public Fund Fiduciary Standards Principles and Practice

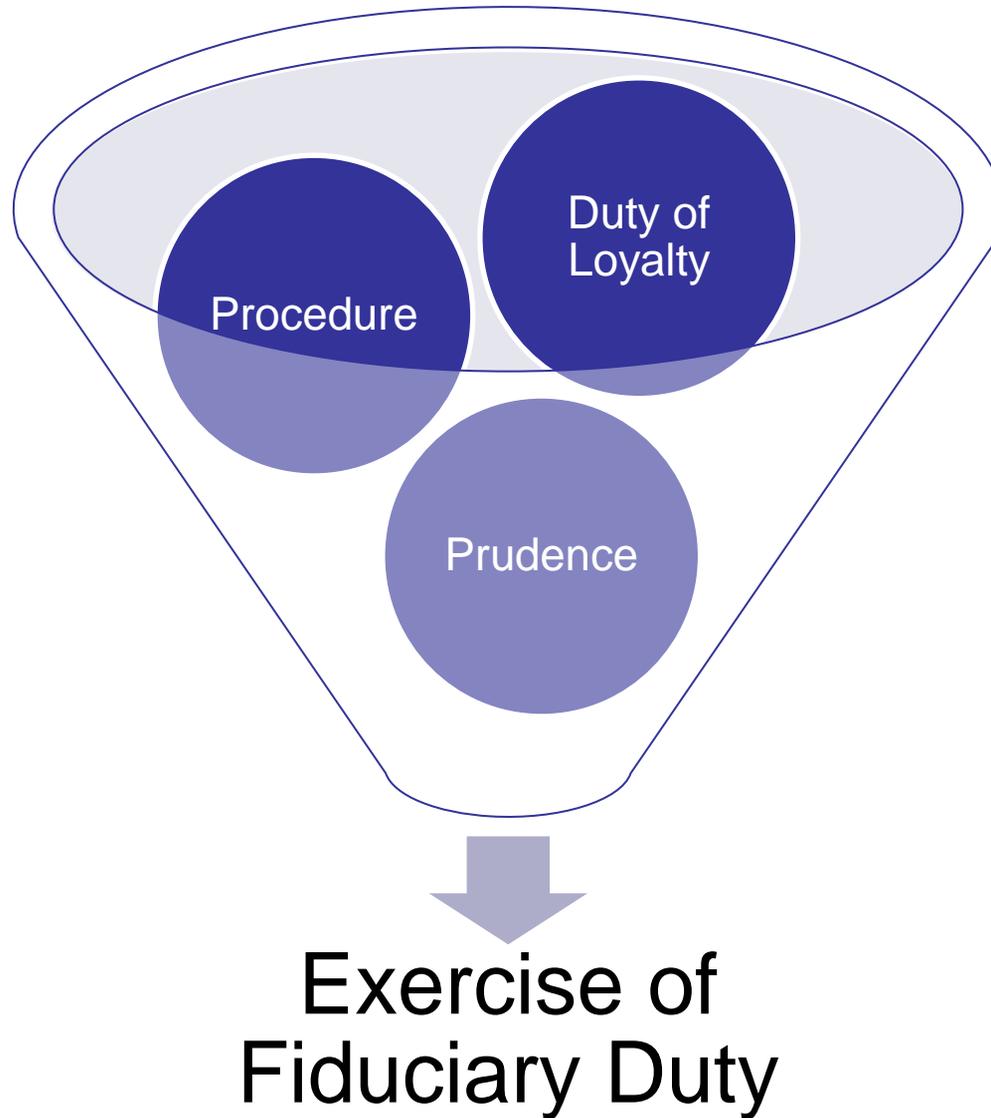
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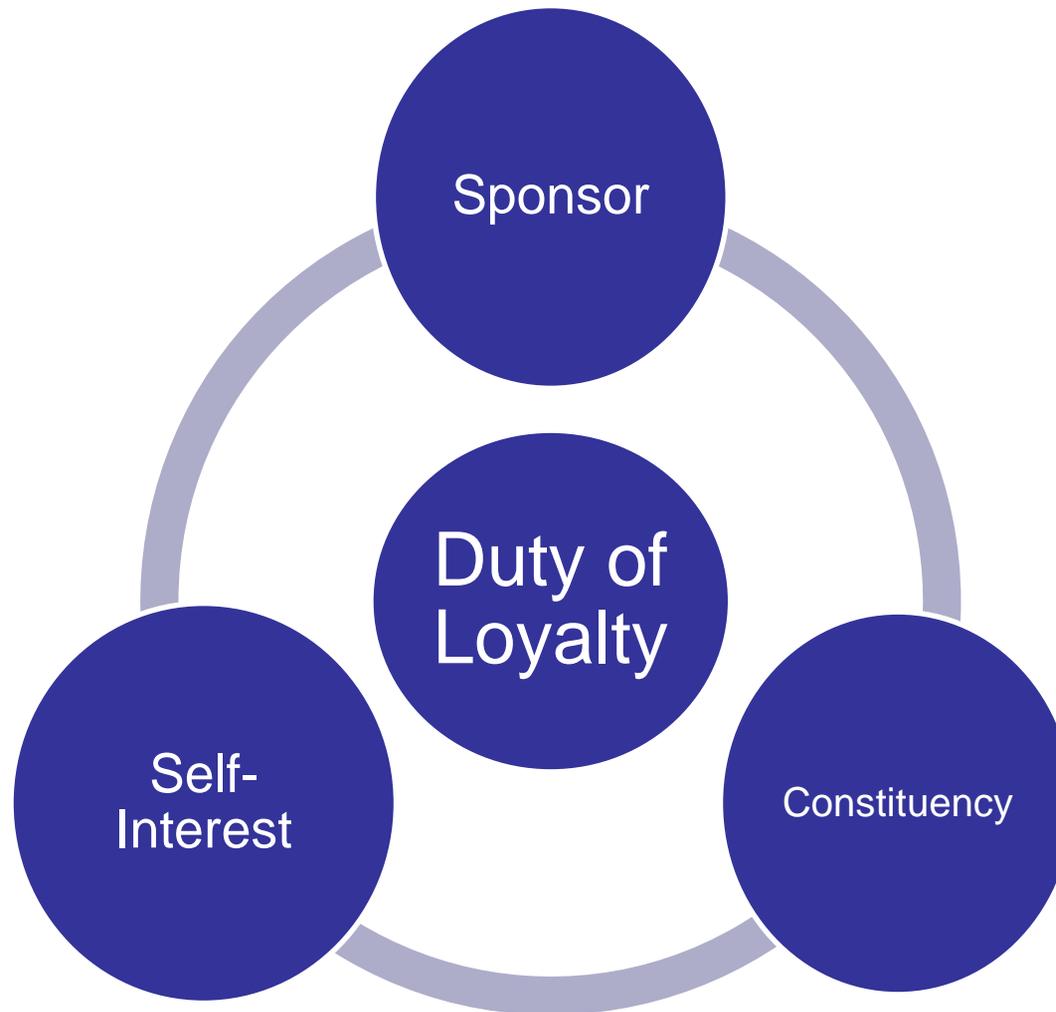
Standard of Conduct - Principles



Standard of Conduct Principles

- 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?

“...solely in the interest of the members” – Duty of Loyalty



Duty of Loyalty

- *“As fiduciaries, such trustees shall carry out their functions solely in the interest of the members and benefit recipients and for the exclusive purpose of providing benefits and defraying reasonable expenses incurred in performing such duties. . . .”*

24-51-207(2)(a), C.R.S.

- *“[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan. . . .”*

ERISA Section 404(a)(1)(A)

Duty of Loyalty – Members vs. Constituency

- While a trustee may wear “two hats,” the paramount duty is to all members of the fund, not the entity responsible for appointment or election.
- *“In the retirement plan setting, it is important to note that this duty includes the obligation to set aside the interests of the party that appoints a trustee or fiduciary. A trustee, for example, must act solely in the interests of participants and beneficiaries and set aside any interests of a party responsible for the trustees’ appointment, such as an employer or union.”*

Comment to Sec. 7 Uniform Management of Public Employees Retirement Systems (“UMPERS”)

Duty of Loyalty – Members vs. Constituency

- Duty of Loyalty encompasses a “Duty of Impartiality.” A trustee is obligated to act in the best interest of all members not merely those responsible for a Trustee’s appointment.
- Typical conflicts: Retirees vs. actives; Bargained vs non-represented; Public safety vs. non-uniformed.
- Duty of impartiality would not prohibit a designated trustee from voicing the concerns of the represented members; however, trustee’s exercise of fiduciary power must be on behalf of all members.

Duty of Loyalty – Members vs. Constituency

- *“A trustee or other fiduciary shall discharge duties with respect to a retirement system. . . impartially, taking into account any differing interests of participants and beneficiaries.”*

Sec. 7(4) of UMPERS

- This duty of impartiality *“[R]equires the trustee to take account of the interest of all beneficiaries for whom the trustee is acting. . .”*

Comment to Sec. 6 Uniform Prudent Investor Act (“UPIA”)

Duty of Loyalty – Members vs. Sponsor

- The Duty of Loyalty is particularly significant when a decision involves the governmental sponsor. The Duty of Loyalty would prohibit a transaction in which the primary objective is the financial need of the sponsor rather than the benefit requirements of the participants.
- Duty may arise in connection with decisions regarding manager selection or investments (e.g., investing in bond paper; loan of operating funds).
- Duty may also arise in circumstances where settlements of *employment related* actions are accompanied by requests to increase pension entitlement.

Duty of Loyalty – Members vs. Sponsor

- 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.

Duty of Loyalty – Members vs. Sponsor

- Generally, a prohibited transaction is a transaction between the plan and the governmental sponsor which involves:
 - Loan of assets to 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.

Duty of Loyalty – Member vs. Self-Interest Conflict of Interest Transactions

The Trustees of the Board shall “[N]ot engage in any activities which might result in a conflict of interest with their functions as fiduciaries for the association...” 24-51-207(3), C.R.S.

“A transaction concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.”

20 Pa. Cons. Stat. § 7772(e)

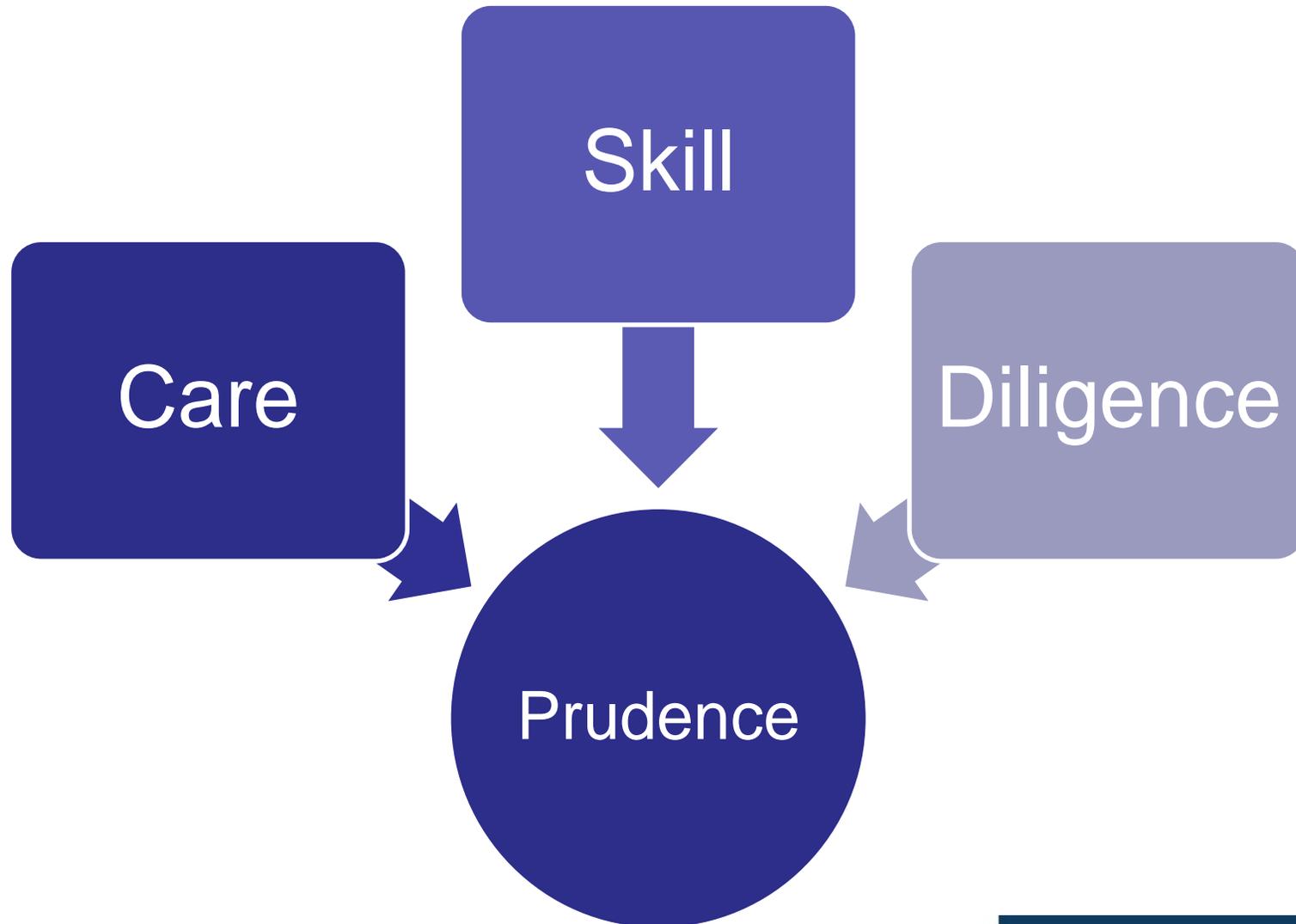
Duty of Loyalty – Member vs. Self

A “Conflict of Interest” encompasses any situation in which a Trustee has, or which a reasonably well-informed and knowledgeable person could properly perceive a Trustee to have, an incentive to decide a matter or provide a recommendation for any reason that would be inconsistent with acting solely in the interest of PERA Participants, or that would provide a private benefit to the Trustee.

COPERA Standards of Professional and Ethical conduct for the Board of Trustees, Sec. 3(a).

“

“ . . .with the care, skill, prudence, and diligence . . .that a prudent person acting in like capacity and familiar with such matters would use”



Prudence Standard

- *“[A] fiduciary shall discharge his duties. . .with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”*

ERISA Section 404(a)(1)(B)

“A pure heart and empty head are not enough. . .”

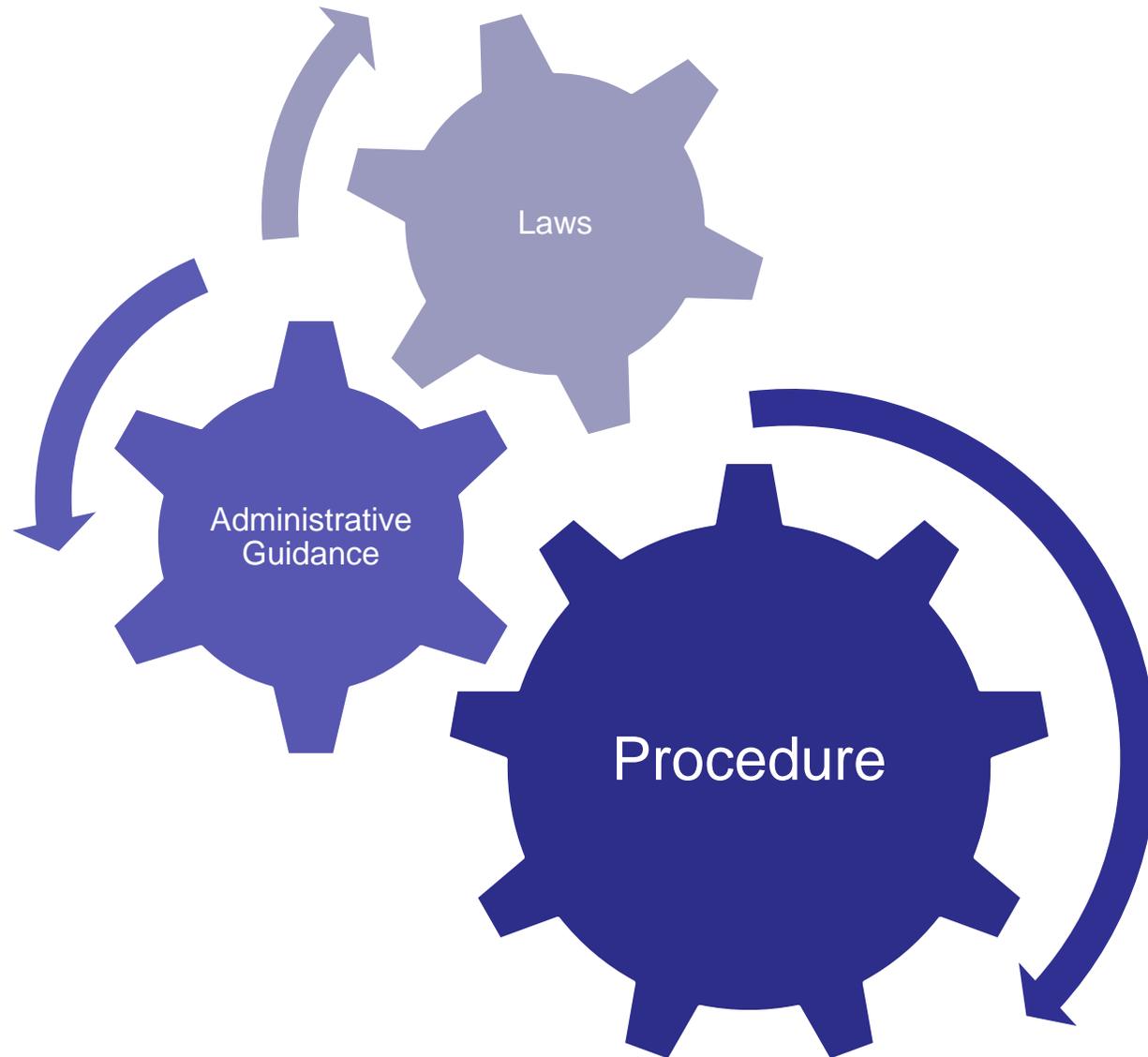
Prudence Standard

- “... *familiar with such matters...*” PERA law imposes a “prudent fiduciary” standard, which presumes that the trustee would act in a manner consistent with that of a prudent person performing the same function. In effect, the trustee must be personally informed or have access to the advice of informed experts.

“Fiduciaries should be evaluated, not against a single prudent expert, but in terms of the actions of prudent fiduciaries for other similar systems facing similar circumstances.”

Comment to Sec. 7(3) UMPERS

“...as required by law” – Procedure



Procedure

- “[A] fiduciary shall discharge his 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)

- *A trustee or other fiduciary shall discharge duties with respect to a retirement system. . . in accordance with a good-faith interpretation of the law governing the retirement program and system.*

UMPERS Section 7(6)

Procedure – Adherence to Process

- *“A fiduciary who discharges her duties prudently and with a good-faith belief that her actions are in compliance with the law does not violate this paragraph, even if a court later determines that the course of conduct was not in compliance with the law.”*

Comment to Sec. 7(6) UMPERS

- Procedure focuses on the process of making fiduciary decisions, not necessarily the results. Establishing that the **process of the decisions** was in accord with stated guidelines can overcome an adverse outcome stemming from such decision.

Procedure – Plan Document

The “plan document” is effectively a collection of laws and Board rules that together form the elements of PERA. According to IRS guidance:

“The Service recognizes that governmental plans may have no single cohesive plan document available. The Service is willing to work with a plan sponsor whose plan document consists of documents from various sources and who is unable to submit a restated plan, provided that the sponsor can submit selected material in an organized manner so that Service reviewers can readily determine the applicable plan language.”

IRS Retirement Plan FAQ regarding Governmental Plan Determination Letters Q & A (1)

Procedure – Plan Document

- State Constitution
- Pension Statute
- Board Rules and Regulations
- Open Records Law
- Open Meetings Law
- Administrative Procedures Statute (Rulemaking Procedures)

Procedure – Plan Document

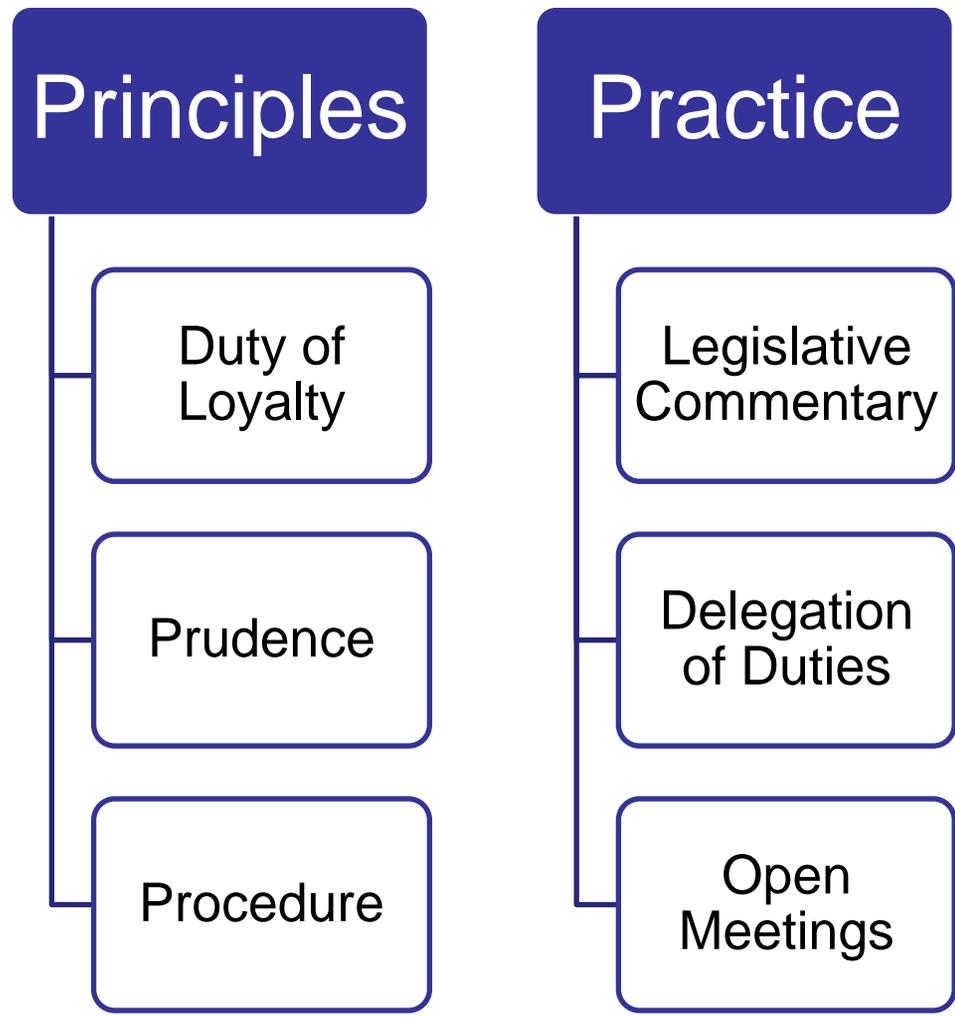
- Governance Manual
 - Trustee, Committee and Executive Director Charters
 - Board Operations Policy
 - Communications Policy
- Adopted Actuarial Assumptions
- Statement of Investment Policy

It is critical that the Board's meeting records reflect fidelity to these policies in both form and spirit. If they can't be followed, they should not be adopted.

Procedure

- The Board must also consider certain Federal laws that directly impact its operation (most significantly the Internal Revenue Code).

From Principles to Practice



Standard of Care – In Practice

The diagram consists of two large, stylized arrows pointing towards each other. The arrow on the left is dark blue and points to the right. The arrow on the right is a lighter, muted blue and points to the left. The text 'Duty of Loyalty' is centered within the dark blue arrow, and 'Legislative Commentary' is centered within the lighter blue arrow.

Duty of
Loyalty

Legislative
Commentary

Legislative Commentary

Legislation is typically a “settlor” function:

*“ . . .the Legislature is interested in protecting its legitimate prerogatives. Subject to the state constitution and other law, the Legislature retains control over settlor functions; the Legislature, for example, **creates retirement programs, establishes benefit levels, and determines funding methods.**”*

Comment to Section 5, UMPERS

However, the Duty of Loyalty implies that the Board should have a role in assuring that legislation isn't harmful to long-term health of the fund.

Legislative Commentary

Sometimes the duty is expressed. . .

“ . . . the board shall submit specific, comprehensive recommendations to the general assembly regarding possible methods to respond to the decrease in the value of the association’s assets. . .and to ensure that each division of the association will become and remain fully funded.”

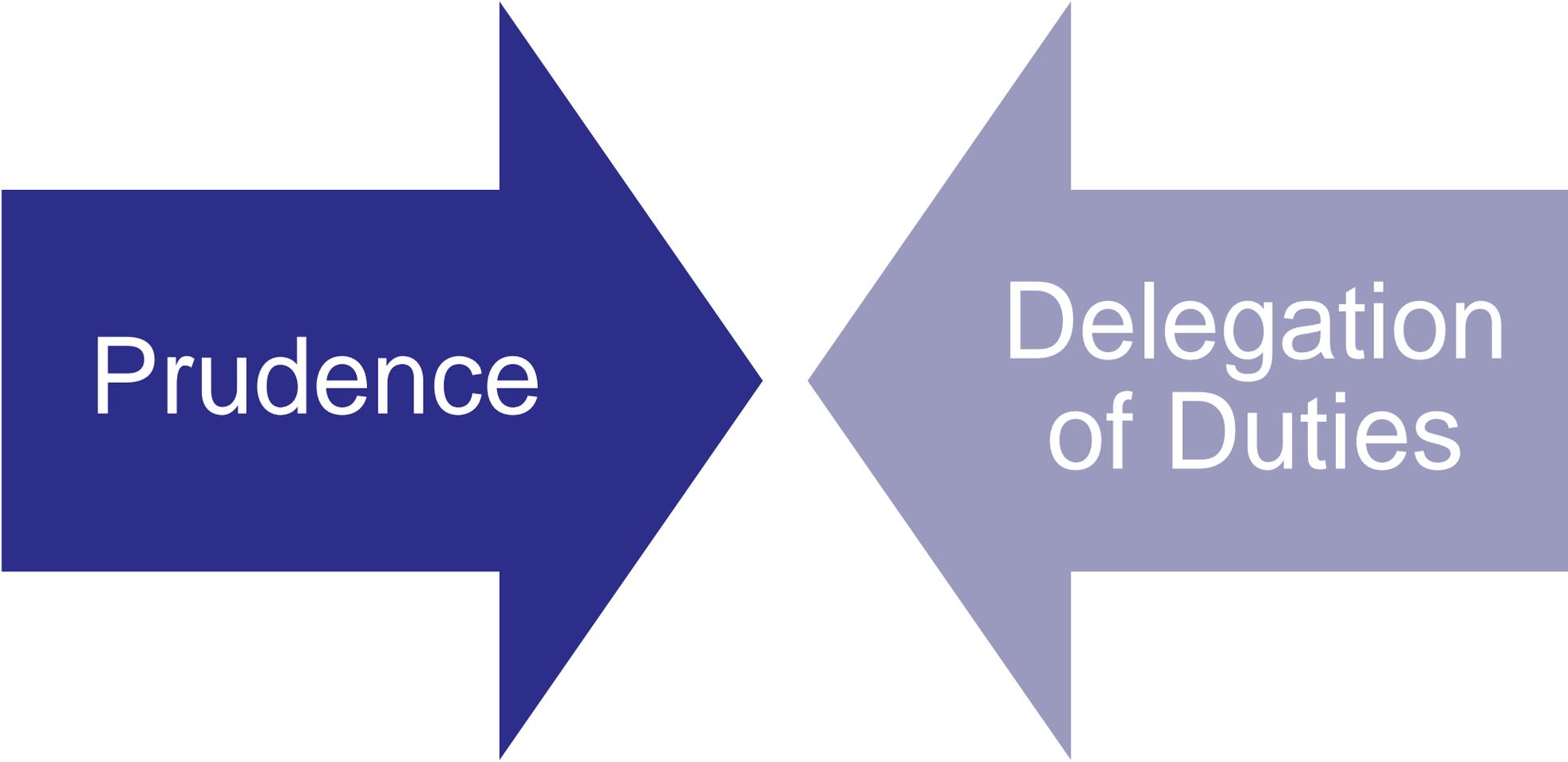
24-51-211(2), C.R.S.

Legislative Commentary

Sometimes the duty is implied. . .

- Legislation required for federal tax compliance
- Adjustments to benefit formula
- Legislation that changes the role of the Board (e.g., POB legislation)

Standard of Care – In Practice



Prudence

Delegation
of Duties

Delegation of Duties

- *“A fiduciary may delegate investment and management functions that a prudent investor of comparable skills might delegate under the circumstances.”*

20 Pa. Cons. Stat. § 7206(a)

- *“The board may delegate any of its responsibilities, duties, and authorities as set forth in this article to the executive director of the association or to designated agents of the association. . . .”*

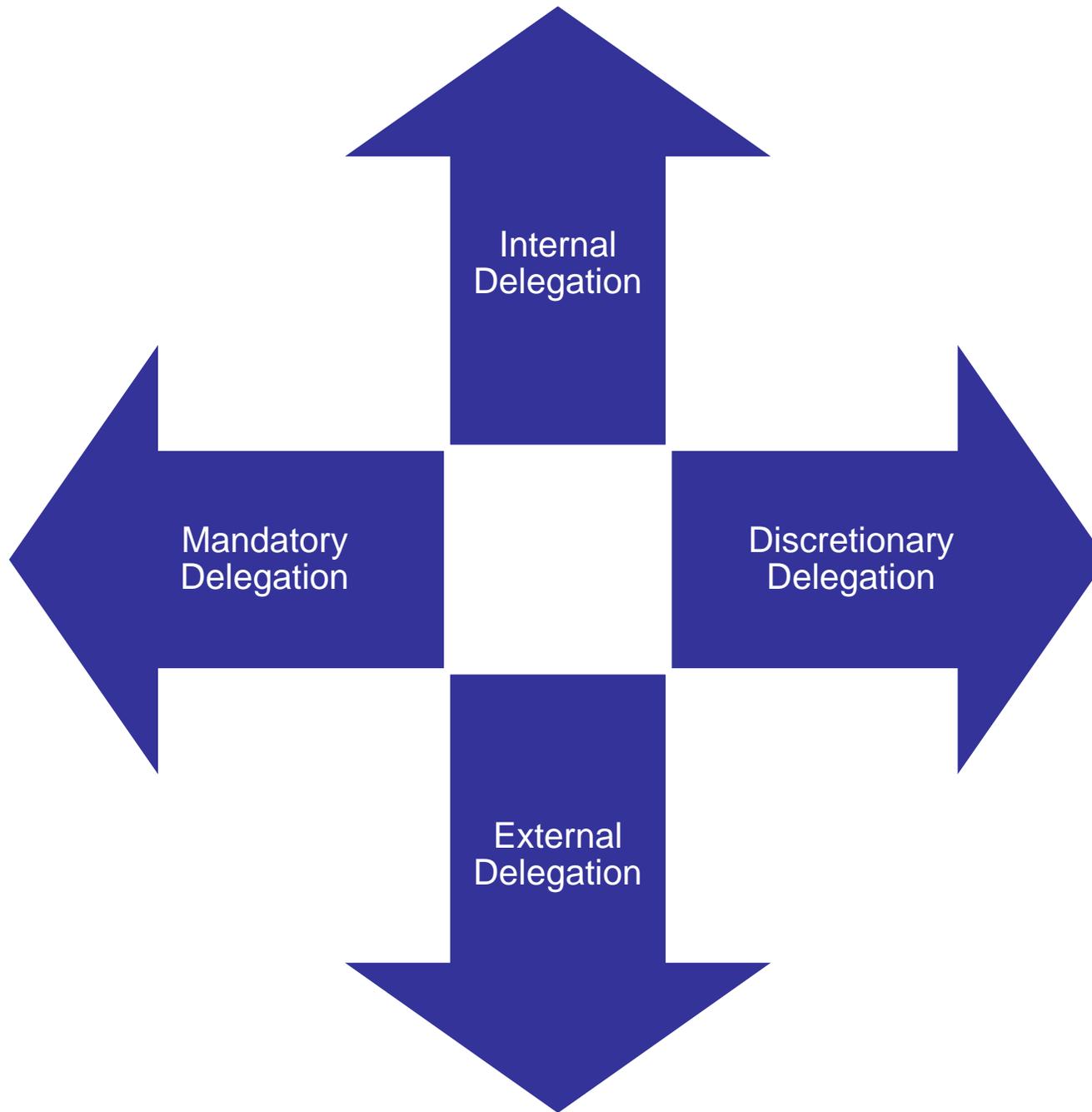
24-51-205(6)(a), C.R.S.

Delegation of Duties

Why is this so important. . .

“A trustee or administrator who complies with [the standard of care] is not liable to the retirement system or to its participants or beneficiaries for the decisions or actions of the agent to whom the function was delegated.”

UMPERS Sec. 6(d)



Delegation of Duties

- Mandatory Delegations – Although expressed as duties of the Board, these responsibilities must be performed by a certified professional and therefore must be delegated:
 - Determination of annual actuarial valuations.
 - Preparation of annual reports such as the CAFR.

Board's duty is effectively limited to consideration and approval of delegate's recommendation or securing a second opinion.

Delegation of Duties

- Discretionary Delegation – Functions that need not be performed by a certified professional. While each could be performed by the Board, the required expertise strongly suggests delegation:
 - Determine membership and benefits
 - Investment of Plan Assets

Board may reject the recommendation proposed by the delegate

Internal Delegation

- Statutory language allows the board discretion to delegate **any** “responsibilities, duties, and authorities” to the Executive Director (and by extension, professional staff).

The delegation process is a matching of issue expertise and personnel.

- The Executive Director assembles professional staff in a manner that (1) is responsive to the varying responsibilities of the Board; and (2) contains the necessary experience and expertise to perform the delegated duties. In effect, the delegation to staff is an appropriate exercise of prudence in that it assures a prompt and reasoned response to the issue.

External Delegation

- Section 6 of the UMPERS divides the delegation process into three discrete obligations:
 - Selection of the Delegate;
 - Establishing the scope and terms of the delegation, consistent with the purposes and terms of the plan; and
 - Periodically reviewing the delegate's performance and compliance with the terms of the delegation.

External Delegation

- The threshold issue in the evaluation of a potential delegate is whether it is sufficiently independent to maintain the duty of loyalty. Key questions:
 - Does compensation vary depending upon advice?
 - Does potential delegate receive ancillary benefits as a result of certain recommendations?
 - Has delegate fully disclosed other relationships that may benefit from its engagement?
 - Can the delegate give unfettered advice?
 - Does the delegate have “clean hands”?

External Delegation

- Strong procedures in the selection process will insulate a fiduciary even if a delegate performs poorly. Beginning with the identification stage, the selection of a delegate must follow an established protocol which should include:
 - RFP or RFQ: A process which will disclose the needed services and identify potential delegates.
 - In-Person interviews.
 - Post-interview deliberation by the Board and any advisor assisting in the selection process.
 - Documentation of basis for the decision.

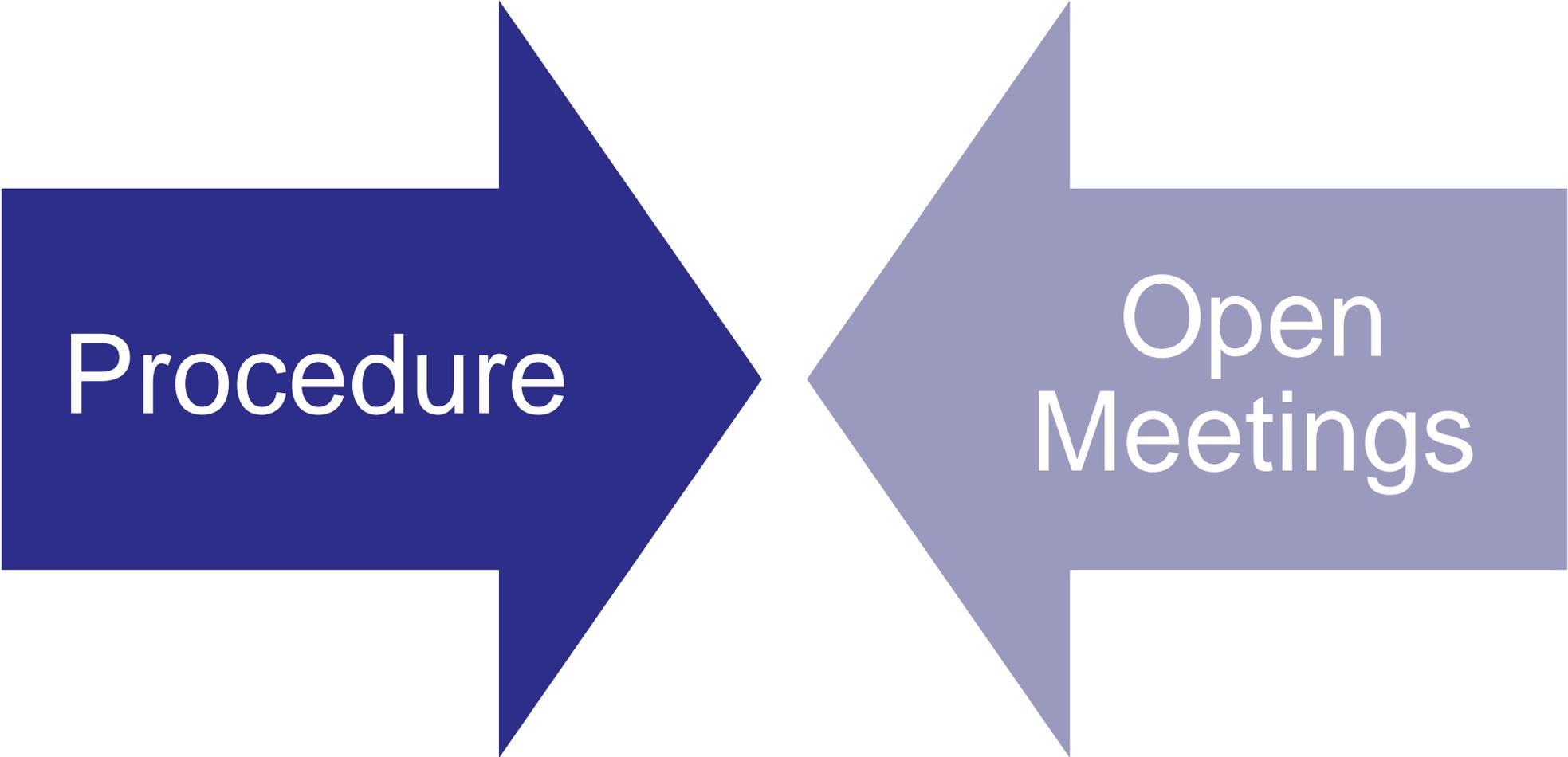
External Delegation

- Experience: Length of time in business and specific experience and educational credentials of the people who actually will be providing the services.
- Costs: Absolute transparency in the disclosure of costs and fees.
- References: Beginning with the advisor recommendation, but also verification of clients and current status of client relationships.
- Qualifications: Check to ensure the consultants and providers are qualified and maintain appropriate registrations.
- Contracting: Agreements should be unambiguous on “the break-up provisions” (termination, indemnity, liability, dispute resolution).

External Delegation

- Confirm that the services/strategy solicited in the RFP/RFQ are actually being provided consistent with the Investment Policy and the fees are consistent with the response.
- Post-selection evaluation: Aside from pure results, be aware of conduct in the marketplace (i.e., government investigations, bad media).
- Monitor, monitor, monitor... The results will/should speak for themselves. Understand the scope of the relationship and watch for “service deflation.”

Standard of Conduct – In Practice



Procedure

Open
Meetings

Open Meetings Law – Executive Sessions

- Executive Sessions are the key exemption from Open Meetings law. The statute gives specific examples of matters that are appropriate for executive session:
 - Conferences with counsel.
 - Confidential matters under state or federal law. Confidentiality must be legally mandated with authority referenced before Executive Session is called.

Open Meetings Law – Executive Sessions

- Personnel matters, provided, however that the individual involved may request an open meeting.
- Documents protected by the mandatory non-disclosure provisions.

Further Information

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