

# ***ONE OF A KIND!***

## ***A Practical Guide for 21<sup>st</sup> Century Public Pension Trustees***

### **CHAPTER 5: THE PRUDENT FIDUCIARY**

#### **Fiduciary and Co-Fiduciary Duties**

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*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 market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. Justice Benjamin Cardozo, Meinhard v. Salmon (1928) 249 NY 458.*

#### ***Introduction***

The first part of this chapter provides an overview of fiduciary duties, describes who is a fiduciary, the stricter standards applied to pension trustees, the fundamental fiduciary duties of a pension trustee - including the duties of loyalty, impartiality, to manage costs and comply with governing law and co-fiduciary liability.

The second part describes how trustees can position themselves to be able to fulfill effectively their fiduciary duties and discusses a number of issues fiduciaries face, including potential conflicts of interest and the prevention/disclosure of ex parte communications.

As stewards of other people's money, pension fund trustees are held to high legal standards. Those fiduciary duty standards are intended to protect pension fund beneficiaries from being exploited by the agents who have control or discretionary authority over management of their life savings.

#### ***Fiduciary Duty Overview***

Familiarity with a fiduciary's legal obligations is essential for trustees and other pension fund fiduciaries. Fiduciary duty provides the foundation for sound board decision-making and fund governance structures, policies and practices.

#### ***Who is a Fiduciary?***

Investment fiduciary relationships arise when someone assumes control or responsibility for management of assets (such as a pension fund) that are being held for the benefit of one or more third parties. Such relationships involve an inherent potential conflict of interest between the fiduciary (who could squander, steal or misuse the assets) and the intended fund beneficiaries, so the legal standards that govern the conduct of pension fiduciaries are among the strictest imposed by law.

Pension fiduciaries typically include pension fund trustees (board members), investment managers, investment advisors, senior pension fund staff and service providers, who either have or exercise discretionary power over management of the plan, determination of eligibility for benefits, investment of assets or who otherwise have agreed to be held to a fiduciary standard.

It makes no difference whether a trustee is elected, appointed, serves as an ex-officio board member (because of another position held) or is a non-voting trustee. One becomes a fiduciary by taking a position that is designated by statute as involving a fiduciary or trustee role; by exercising discretionary authority over pension assets; or by otherwise agreeing to serve as a fiduciary.

However, other consultants and staff who provide non-discretionary or purely advisory services, such as outside lawyers, accountants and auditors, are typically not considered fiduciaries. In addition, fiduciary duties do not cover plan design, ministerial or general back office administrative functions, even when performed by a person or entity that otherwise acts as a system fiduciary, as long as such duties are performed in a non-fiduciary capacity.

Determining who is a fiduciary and when can sometimes be difficult and often requires consultation with legal counsel. Nevertheless, it is best for trustees to assume that any significant decisions or actions they take involve fiduciary duties.

### ***Fiduciary Duties are Strict***

Though fiduciary duties of corporate board members are similar, they are not as stringent as the legal standards imposed on pension fund trustees. This is because pension beneficiaries do not have the same rights as corporate shareholders to approve or influence the actions of their fiduciary agents

Furthermore, pension beneficiaries are likely to rely more heavily upon their fiduciaries for future financial well-being and are generally not capable of effectively evaluating system fiduciaries' decisions until after any damage has been done. This makes it especially important for trustees who have served in seemingly similar roles, such as corporate fiduciaries, elected officials or members of non-fiduciary boards, to understand how being a pension fund fiduciary is different.

The decision-making process is more tightly circumscribed and standards of conduct are more conservative than what is commonly allowed for similar positions elsewhere in business, finance or government.

### ***Fiduciary Duty Fundamentals***

Public pension fund fiduciary duties are governed by state law, but are influenced by the common law of trusts, provisions in model legislative acts that codify common law (such as the Uniform Prudent Investor Act) and interpretations of private pension fund law under the Employee Retirement Income and Security Act (ERISA). While there can be some variations between states, the main principles of fiduciary duty are relatively consistent.

In short, fiduciary duties are intended to protect beneficiaries against theft, misappropriation, self-dealing, incompetence, negligence, waste and abuse of position by the agents who exercise control or management authority over assets held or controlled by the fiduciary as an agent for beneficiaries. They are process oriented and define the approach, issues and procedures to be considered by fiduciaries.

Fiduciary duties guide how to approach decisions, but they rarely dictate a specific result. Compliance is not judged with hindsight based on the outcome of a decision but rather is evaluated on the process which was used to reach the decision, based on facts reasonably determined at the time and focused on whether the fiduciary's conduct was in the best interests of system members, retirees and beneficiaries as a whole.

Investments are evaluated in the context of portfolio design and fit within that structure, not on a stand-alone basis. Thus, documentation of the decision processes used by fiduciaries is important.

### ***Duty of Loyalty***

The duty of loyalty establishes a clear perspective that must be adopted and applied. It requires that pension fiduciaries discharge their responsibilities:

1. Solely in the interest of fund beneficiaries and
2. Solely for the exclusive purpose of providing the authorized benefits.

This obliges pension fund trustees first and foremost to make decisions that are in the interests of system members, retirees and beneficiaries as whole even if the decision may be contrary to the interests of other parties (including appointing authorities, employee organizations, electoral constituencies, political parties or an individual's personal interests).

Fiduciary law is clear. While a trustee may wear "two hats"; i.e., be both a trustee and have a "day job" such as being an officer of a plan sponsor or employee organization, when making system decisions as a trustee he or she must only wear their fiduciary "trustee" hat. Of course, theft or misappropriation of funds is also prohibited. The duty of loyalty also contemplates that trustees deal fairly and honestly with beneficiaries and keep them reasonably informed on fund status and material management activities.

The duty of loyalty can be a trap for trustees with conflicts or who have difficulty separating their own interests from those of the people they are legally obligated to serve. Misunderstanding of the strict limits on self-dealing and transfer of trust funds for other uses can also be a problem for trustees with experience in apparently similar but fundamentally different roles. When elected officials serve as trustees, their ability to solicit donations from fund providers of services is significantly limited.

### ***Duty of Impartiality***

The duty of impartiality is often described as part of the duty of loyalty. It imposes an obligation to identify and take reasonable efforts to fairly balance conflicting interests of different beneficiary groups. For example, trustees must attempt to balance the interests of

younger and older participant generations, as well as those of retirees and active employees. See also Chapter 2: Pension Fundamentals.

This makes the generation of short-term earnings, allocation of investment capital to long-term wealth creation and consideration of risk exposures over both time frames equally important. It also precludes trustees from knowingly or negligently failing to act (within the bounds of their authority) when confronted with contribution levels or benefit payments that are not sustainable.

### *Duty of Prudence*

The duty of prudence in most states requires that fiduciaries adhere to the standard of “care, skill, prudence and diligence” and to act in the same way that someone “familiar with such matters” would act at a comparable entity under similar circumstances. The “familiar with such matters” language has been interpreted to mean “expert”.

This language creates an important difference from the earlier prudent person definition, by holding fiduciaries to a stricter standard. This standard of care is based on the legal standard applied to private pension funds under the Federal Employee Retirement Income Security Act (“ERISA”).<sup>1</sup> It contemplates comparison to prudent trustees at other similar institutional funds.

Although ERISA was adopted in 1974, a few states still apply the “prudent person” standard of care that was the prevailing pre-ERISA standard under trust law. The prudent person standard is generally viewed as setting a lower bar than the prudent expert standard. Where it applies, it requires that trustees exercise the same level of care that a prudent person (rather than a prudent expert) would apply in managing their own affairs.

The manner must be consistent with the scope and purpose of a public retirement system. This includes, but is not limited to, the investment of funds with a long-term view and the provision of accurate information to system members regarding benefits. Nevertheless, even trustees who are subject to the prudent person standard are well advised to be familiar with practices used at similar funds, as this could assist them in performing effectively.

Prudence also requires that assets be sufficiently diversified to minimize exposure to large losses, unless it is prudent under the circumstances to not be diversified. Authority should be delegated to experts who are prudently selected, instructed and monitored, consistent with delegation practices employed by similar investors.

A board may prudently delegate authorities to their Chief Executive and, thereby the staff, if it establishes robust processes for selection, instruction, reporting, monitoring, questioning and evaluation of their qualifications, goals and results. This requires trust and trust requires verification. Verification is obtained through independent reassurance that staff assurances and reports are reliable, e.g., due diligence, risk exposure, service quality, succession planning and cyber-security.

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<sup>1</sup> Section 404(a)(1)(B) of the Employee Retirement Income Security Act (ERISA)

By prudently delegating, instructing and monitoring delegates that have more time and access to expertise, a board can improve its effectiveness. In the absence of full-time, expert attention, it is generally considered more prudent for trustees to delegate regardless of their individual level of expertise. Trustees put an additional legal burden on themselves if they delegate but do not do so prudently.

However, the legal burden to prudently select, instruct and monitor delegated agents remains and trustees must still exercise effective oversight.

The duty of prudence serves to protect beneficiaries from incompetence and negligence. Compliance requires fiduciaries to keep their relevant skills up to date, as well as be familiar with current pension fund issues and practices. It also contemplates that fiduciaries take general economic conditions into account and make a reasonable effort to verify facts relevant to fund management and investment.

Documentation of the fiduciary decision-making process is especially important. The Duty of Prudence focuses on the process used to make decisions under the circumstances at the time. Having a clear record that demonstrates use of a reasonable process can help to protect trustees from fiduciary liabilities, as compliance is not determined in hindsight on the basis of whether a decision turned out to be right.

A caution is in order. Although the duty of prudence references practices of similar funds, it is not intended to imply that mindless adoption of copycat investment practices is appropriate. Again, each fund is one of a kind!

Decisions must be tailored to the unique liability and benefit structure of each fund and its capabilities. It should also reflect an understanding of how the evolution of investment practices and changes in the economy and society influence the risk and return profile of investment practices over both the short- and long-term. Nor does the diversification mandate require that a fund be invested in any specific index or number of securities, so long as it is reasonably diversified under the circumstances.

### ***Duty to Manage Costs***

Fiduciaries have a duty to incur only costs that are appropriate and reasonable. Trust funds cannot be made to bear unrelated costs and trustees are obligated to keep costs reasonable.

However, “reasonable and appropriate” does not mean that the lowest cost providers and investment strategies must be used. Trustees are expected to focus on net results and weigh expected returns, risk exposures and compliance with all of their fiduciary obligations when making decisions.

For example, selection of the lowest cost provider or least costly investment strategy without consideration of qualitative issues such as track record, staff resources and capability, et cetera, could compromise returns, leave risk exposures unaddressed or create an unsuitable portfolio that breaches other fiduciary duties.

While costs must be identified, measured and managed, this fiduciary standard gives a wide berth where procedures are in place to ensure that costs are both appropriate and reasonable

in the context of a well-designed investment approach and not out of line with cost structures of similar investors. See also Chapter 22: What Every Trustee Needs to Know About Investment Management Fees.

### ***Duty to Comply with Governing Law***

Public pension funds are primarily creations of state and/or local law. While some federal tax and securities laws may also apply, typically public pension fund governance, benefit structure, funding, authority and other legal requirements are found in state or local laws. Trustees are required to follow these laws and any additional restrictions contained in governing policies, rules, contracts or other documents.

While this duty seems obvious, there can be occasions when fiduciaries believe certain statutory enactments or funding practices violate constitutional protections or conflict with other legal requirements. Trustees should seek the advice of legal counsel when such situations arise. There are occasions where fiduciaries and beneficiaries are best served by bringing an issue to the attention of courts, Attorneys General or other regulatory authorities.

Turning a blind eye to constitutional or other legal violations can lead to allegations of breach of fiduciary liability and ensuing litigation. It is usually better for trustees to be proactive in bringing improprieties to the attention of higher authorities for resolution.

### ***Co-Fiduciary Liability – No blind eye***

Trustees have an obligation to exercise independent judgment when they are part of a public pension fund's governing body. Even though the ultimate decision on an issue is made collectively by the governing body (i.e., board, committee or commission), each trustee is obligated to observe his or her fiduciary duties.

While trustees do not have an obligation to monitor each other's conduct, they also cannot turn a blind eye toward a breach of legal duty by a fellow fiduciary. For example, co-fiduciary liability may be a concern when a fiduciary discovers, and fails to act to stop or remedy, self-dealing or an ethics code violation by another trustee.

Co-fiduciary liability alarms should sound when a trustee:

- Knowingly participates in, or helps to conceal, a co-fiduciary's breach;
- Fails to exercise reasonable care and prudence which enables another fiduciary's breach; or
- Fails to undertake reasonable efforts to remedy a known breach by a co-fiduciary.

### ***Defined Contribution Plans***

When plan sponsors establish Defined Contribution Plans (also sometimes called Deferred Compensation) which transfer investment risks to participants, trustees of those funds often assume that their fiduciary obligations are correspondingly reduced. This is not the case. While Defined Contribution Plans present some different issues for trustees, the same fundamental fiduciary obligations apply.

For instance, transfer of investment risk to participants under Defined Contribution Plans does not eliminate the duty of prudence for fiduciaries in selection and monitoring of investment options. The duty to manage fees and costs still requires selection of Investment Managers with competitive fees. Additional obligations to monitor accuracy and effectiveness of participant educational materials, success in achieving participant retirement readiness and appropriateness of default investment options present new challenges.

In their role as fiduciaries for a deferred compensation (DC) plan, in addition to the duties of loyalty, prudence, impartiality, diversification, cost management and adherence to laws, trustees also must ensure that the plans are sound, investment options and default strategies are appropriate, and that participants are well informed and prepared for their responsibilities and the related risks.

Furthermore, the relatively new status of Defined Contribution Plans (they did not exist when ERISA was enacted in 1974) makes prediction of court decisions more difficult. Trustees should approach oversight of Defined Contribution Plans with the same attention to prudence, loyalty, impartiality, cost management and compliance with plan governing laws as they do with defined benefit plans.

### ***Common Public Pension Fund Trustee Fiduciary Duty Issues:***

#### ***Fulfilment of Fiduciary Duties from “Day 1”: Board Skill Building and Training***

Most state and local public retirement systems in the United States are managed by lay boards numbering from 7 to 13 trustees that come into their positions either through election (by active and/or retired plan membership), appointment (by a plan sponsor elected executive or governing body) or as an “ex officio” (through service as an elected or appointed office with the plan sponsor, such as state or local Treasurer). While some system’s governing laws specify requisite expertise for some or all trustees, this is the exception rather than the rule, and there is no “grace period” from the imposition of the exacting fiduciary responsibilities outlined above once a trustee assumes office.

How, then, can a new trustee with little or no expertise in the subject areas germane to the administration of a public retirement system fulfill their fiduciary duties from “Day 1”? Most public retirement systems provide an orientation for new trustees that provides an overview of key operational and policy areas of the system, covering areas such as governance, plan administration, investments and actuarial assumptions.

However, it sometimes happens that the timing of the trustee’s assumption of office and the board meeting calendar do not allow even for this before a trustee attends his or her first meeting and yet are expected to cast votes on important and sensitive issues that may implicate their fiduciary duties.

## ***The CalPERS “Eight Questions”***

Given this, there is a clear need for a “self-check” that both new as well as experienced trustees can employ to have some assurance that they are casting their vote in a manner that complies with their fiduciary duties. In response to this need for both new and experienced trustees, the California Public Employees’ Retirement System (CalPERS) developed eight questions for their trustees to ask themselves prior to casting a vote to help ensure that their vote is consistent with their fiduciary duties.

1. Do the agenda materials and presentation/discussion at the meeting provide all the information necessary for a proper understanding of the issue so that we can make a sound, informed decision?
2. Have all the potential benefits and risks resulting from this decision been appropriately identified and analyzed?
3. Have all viable alternatives to this proposal been appropriately identified and analyzed?
4. Are staff and the outside expert (where applicable) in agreement on the recommended course of action?
  - a. If not, are the bases for disagreement adequately explained?
  - b. Are both recommendations reasonable (so that I can reasonably choose/decide between them), or do we need to seek another opinion?
5. Were any questions that we had before and during the discussion of the item sufficiently addressed?
6. Do I have any actual or potential conflicts of interest that prevent me from participating in this decision or make it advisable for me not to do so?
7. Does my intended vote reflect what I feel to be in the best interests of the system’s members, beneficiaries and retirees as a whole, without regard to the interests of any constituency or appointing power responsible for my position as a board member?
8. Will the results of the board’s decision favor the interests of one group of the system’s members, beneficiaries or retirees over those of another group?

A cursory review of these questions reveals that the first five cover various aspects of the Duty of Prudence (also referred to as the Duty of Care) while the remaining three address the Duty of Loyalty. While the importance of these questions likely will be intuitive to an experienced trustee, the challenge is in providing new trustees with the knowledge to enable them not only to ask themselves these questions but to feel confident with the answers.

## ***Trustee Responsibilities, Core Competencies and Education***

In determining how best to meet this challenge, it is first helpful to understand that trustees do not and should not conduct the day-to-day business of running a public retirement system. Instead, a trustee’s principal function is to work with his or her fellow trustees to establish the strategic direction of the system, hire the necessary staff and consultants that have the



requisite expertise to carry out that direction, and then oversee the work being done to ensure that the direction is being carried out appropriately and effectively.

In other words, while trustees are not expected to personally calculate the required employer and employee contributions, collect them, invest them, and calculate and pay benefits owed, they are ultimately responsible for seeing that appropriate functions are in place for all of these activities.

The process of preparing a trustee for his or her role and responsibilities is a shared obligation of the board, system staff, and the trustee. As a part of its governance policies, the board should have a policy that defines the core competencies and knowledge base required of trustees and an educational program that is aligned with the development of the core competencies and acquisition of the requisite knowledge.

System staff, in turn, does the work to provide or make available the specified elements of the education program, and most importantly, trustees must put in the work necessary to successfully complete the program.

The Clapman 2.0 Report, developed by the Stanford Institutional Investor Forum to describe institutional investor governance leading practices, identifies the following responsibilities and core competencies required of trustees:<sup>2</sup>

- Attendance at all board and applicable committee meetings;
- Committee service;
- Preparation;
- Inquisitiveness;
- Integrity;
- Knowledge in the following areas:
  - Public pension plan governance;
  - Asset allocation and investment management;
  - Actuarial principles and funding policies;
  - Financial reporting, controls and audits;
  - Benefits administration;
  - Disability (where applicable);
  - Vendor selection process;
  - Open meeting and public records laws;
  - Fiduciary responsibility; and

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<sup>2</sup> Available at: [http://law.stanford.edu/wp-content/uploads/sites/default/files/event/392911/media/slspublic/ClapmanReport\\_6-6-13.pdf](http://law.stanford.edu/wp-content/uploads/sites/default/files/event/392911/media/slspublic/ClapmanReport_6-6-13.pdf).

- Ethics, conflicts of interest and disclosures
- Fulfillment of educational requirements;
- Collegiality; and
- Independence.

To assist trustees with acquiring the needed knowledge, the Clapman 2.0 report recommends the adoption of an Education Policy that contains the following elements:

- A new trustee orientation conducted in advance of the trustee’s first board meeting that covers the knowledge areas outlined above, as well as the role and expectations of trustees, a history and overview of the system (including its mission and purpose), the committees and their purposes, the organizational structure (including the roles of staff and key service providers), the system’s Strategic Plan (where applicable) and its planning process, and other elements designed to provide a broad overview of the system and its operations;
- A mentoring program that matches an experienced trustee with the new trustee for a one-year period to assist the new trustee with becoming familiar with his or her board responsibilities;
- Ongoing education, including attendance at in-house and external educational sessions and conferences that are provided and selected with an eye towards obtaining knowledge in specific areas of need. To help trustees identify their needs, they must complete annually a “Trustee Knowledge Self-Assessment” and then discuss the results with the system’s Chief Executive;
- Annual fiduciary education;
- Ethics training; and
- Subscriptions to pension and investment-related periodicals.

### ***Trustee Meeting Preparation***

Fulfilling the rigorous educational process outlined above provides the foundation for ensuring compliance with trustee fiduciary duties. However, this is only the first step. Most public retirement system governing boards meet on an at-least monthly basis for several hours to consider and vote upon matters that often are critical to the system’s successful operation. Typically, approximately 7 to 10 days in advance of the meeting, trustees receive, either in hard copy or electronically, an agenda package that often comprises hundreds of pages of materials.

As noted above, the Clapman 2.0 Report identifies preparation as a key responsibility of trustees, and they are expected not only to read these materials in advance of the board meeting but to ask questions and/or seek assistance when necessary to gain understanding of the issue to be discussed. This is not a one-way street.

All agenda materials, whether prepared by system staff or outside consultants, should be as concise as possible, insightful and informative, and focused on the “big picture” as opposed to minutiae. See also Chapter 8: The Role of the Board - especially Insight for Oversight.

If they are not getting such insights, trustees should provide direction to system staff and consultants as necessary so that the meeting materials meet these criteria.

### ***Conduct of Board Meetings***

Broadly speaking, there are two primary purposes for board meetings. The first is to vote on high level issues involving the administration of the plan, such as asset allocation, actuarial assumptions, policies regarding plan governance and administration and the hiring of executives, consultants and investment managers.

The second is to provide information to the board on system operations in key areas. These issues are discussed and debated in a meeting that is open to the public (except for those issues that applicable law allows to be considered in closed session) and attended by system staff, stakeholder representatives (including union and retiree organization representatives) and other interested persons.

Trustees often consider sensitive and sometimes controversial issues and must do so in a manner that serves the best interests of system members, retirees and beneficiaries as a whole and is compliant with trustees’ Duty of Prudence. This requires preparation, patience, effective time management, maintenance of a strategic focus and the willingness not only to ask questions but to be respectfully open to other viewpoints.

### ***Maintaining a Proper Board Role***

It is critical, not just during these meetings but always, for trustees to keep to their oversight role and to avoid micromanaging. The proper role for trustees has been characterized as “noses in, fingers out”. Trustees are responsible for oversight of system staff, consultants and operations.

However, this does not equate to substituting trustee judgment for that of the staff or consultant expert who has been delegated the authority to carry out day-to-day operations pursuant to the board’s policy direction. To do so without a compelling and well-documented reason in an exceptional situation would carry significant risk of contravening the “prudent expert” aspect of the Duty of Prudence.

### ***Conflicts of Interest***

Unfortunately, a recurring theme where breaches of trustees’ fiduciary duty have been alleged and/or proven is the existence of a conflict of interest on the part of one or more trustees that influenced a board decision to ignore the recommendations of an expert. In one such recent case, the U.S. Department of Labor sued several trustees of the International Association of Machinists (IAM) Pension Fund and the Fund itself, alleging that:

“The trustees, among other things, failed to loyally and prudently select the Fund’s service providers, routinely ignored required procedures written in the Fund’s governing documents, created conflicts of interest, unlawfully solicited and accepted gratuities from service providers,

spent and permitted others to spend Fund assets lavishly on unnecessary trips, parties, and inordinately expensive food and wine, failed to prudently, and loyally monitor and control Fund costs, and generally engaged in a pattern of conduct in which they disregarded their fiduciary duties.”<sup>3</sup>

Significant to the DOL’s theory of breach of fiduciary duty was that most the Fund’s trustees voted to hire a general investment consultant that their search consultant had rated as “inferior” to the other candidates and the costliest of the candidates under consideration. The investment consultant was hired by the board against the recommendations of both the Fund’s Chief Investment Officer and outside search consultant.

The record in the case showed that the father of the lead individual for the investment consultant had a personal relationship with the IAM President, and that the Fund subsequently paid the investment consultant for the due diligence the investment consultant was required to perform as a part of the selection process. The DOL’s complaint also alleged numerous other violations, including the solicitation and receipt by trustees of gratuities from the Fund’s service providers.

In a consent judgment, the Fund and the trustees who were named in the DOL’s action were required to adopt a new manager search and selection policy, engage in a new general investment consultant search to be led by an independent search consultant, and amend the Fund’s code of conduct/ethics and records retention policies. Significantly, the trustees named in the action were required to repay \$200,000 to the Fund and an additional \$40,000 in civil penalties to the DOL.

One of the underlying premises of the Clapman 2.0 report is that leading practice governance policies regarding conflicts of interest and disclosure can help to ensure sound decisions made by the boards of public retirement systems that are compliant with trustee fiduciary duties. The report recommends adoption of a policy in this area containing the following elements:

- Summary of fiduciary duties;
- Statement of ethical conduct;
- Prohibition on insider trading;
- Summary of applicable state or local conflict of interest laws;
- Avoidance of nepotism;
- Limitation on receipt of gifts;
- Prohibition of contacts between prospective bidders and trustees during a RFP process;
- Disclosure of communications between trustees and persons seeking to do business with the system and avoidance of undue influence on trustees and staff;

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<sup>3</sup> See <https://www.dol.gov/ebsa/newsroom/2016/16-217-PHI.html>.

- Prohibition on campaign contributions to trustees over specified levels in an effort to prevent so-called “pay-to-play”; and
- Disclosure of placement agent relationships and payments coupled with a permanent ban on current or former trustees or staff providing placement agent services about their current or former system.

Taken together, these recommended policies are designed to form a structural and procedural barrier against conflicts of interest affecting decisions by system boards. But, as the report notes, policies alone are not enough. A strong ethical culture in any organization starts with the “tone at the top,” which requires the board and senior management “not just to adopt clear standards but to live by them.” See also Chapter 29: Independent Reassurance.

As just one example, trustees can be faced with a situation where their personal economic interests would be affected by a board decision. While rules vary from state to state, based either on applicable law or the Duty of Loyalty’s prohibition of self-dealing, unless a clear exception applies, trustees are required to recuse themselves from the discussion and vote and follow the appropriate procedure for announcing the recusal and its basis in advance.

This means disclosure is not just required by law—it reinforces that the trustee takes his or her obligation to avoid conflicts of interest seriously and reinforces that obligation throughout the system.

Clear lines of communication ensuring that all trustees have equal access to the same information are also critical. How would your system handle a situation in which a potential system vendor has a conversation with a single trustee, and that trustee then advocates to the system’s Chief Executive for the hiring of that vendor without the rest of the board having knowledge of that contact?

The potential damage to the integrity of the selection process and to the reputation of the system is tremendous even if the potential vendor is the most qualified and cost-effective service provider. Such “ex parte” communications not only create inequalities of information flow between trustees but also create the potential for undue influence in the selection process.

### ***Evolution of Investment and Pension Practices***

The investment industry and understanding of how fiduciary duty principles should be applied to investment decisions involve dynamic processes that evolve in response to changes in knowledge and circumstances. Economic, social, environmental, governance and academic developments since the turn of the twenty-first century have generated a number of challenges which are driving change in the pension and investment industries. This evolutionary process presents new issues for the prudent fiduciary which are discussed in other chapters of this Handbook (See especially Chapter 1: Shift Happens, and Chapter 6, The Law of Rising Expectations and ESG Risks).

The fiduciary duty of prudence is inherently forward looking. At its root, the word "prudent" means to act with care and thought for the future. As investors with long-term liabilities, public pension trustees must be open to evaluating changes in knowledge and circumstances that are

material to their future obligations. One of the primary treatises on legal guidance for trustees advises trustees to pay close attention to this evolution.

*"There are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts. Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments."* [Restatement of Trusts, 1992]

## **Conclusion**

There are a lot of moving pieces involved in the oversight of their systems by public pension fund trustees, and trustees are held to the highest legal standard in doing so. While this can feel like a very daunting process, it can be lessened if trustees view their fiduciary duties of prudence and loyalty, using the "Eight Questions," as guides to effective decision making, reinforced by strong education, conflicts of interest, and the other important governance constructs discussed throughout this Handbook.

## **Self-Assessment**

1. Do all trustees understand their fiduciary duties and act in accordance with them?
2. Does the board receive annual fiduciary training?
3. Does the board have a policy that identifies trustee responsibilities and core competencies?
4. Does the board have an education policy that supports trustee development of required core competencies?
5. Does the education policy properly prepare new trustees for their "Day One" responsibilities?
6. Are our agenda materials clear and concise, and do they provide sufficient information and insight to allow trustees to make prudent, informed decisions?
7. Do trustees come to board meetings fully prepared to discuss and address the issues on the agenda?
8. Do trustees discuss issues in a collegial and open-minded manner?
9. Does the board have a comprehensive conflict of interest policy?
10. Do trustees model ethical behavior to set a positive "tone at the top?"
11. Does the board understand and respect the difference between its oversight role on the one hand and the operational role of system staff and consultants on the other?