Fiduciary Fundamentals for Public Pension Fund Trustees

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MAKING IT HAPPEN.

First: A Comment & Two Caveats

- This is my first visit to Oklahoma, and I'm delighted to be here!
- I am not licensed to practice law in Oklahoma, nor am I providing legal advice at this conference.
- This is a general training session, and I hope that it is helpful. Please consult your local counsel on specifics.

A Threshold Question for Public Retirement Board Members

- What is the legal source of your authority and responsibilities?

Oklahoma Constitution

- **Teachers**: "The Legislature may enact laws to provide for the retirement for meritorious service of teachers and other employees in the public schools…" Okla. Const. art. V, § 62.
- **Firefighters**: "The Legislature may enact laws authorizing cities to pension meritorious and disabled firemen." Okla. Const. art. V, § 41.
- **Police Officers**: "The Legislature may enact laws authorizing cities to pension meritorious and disabled police officers." Okla. Const. art. V, § 61.

Oklahoma Statutes

- "The governing body of any municipality may provide by ordinance for *a retirement fund and system for any or all of its employees* and the employees of a duly constituted authority of the municipality which are not otherwise provided for by a pension or retirement system." 11 O.S. § 48-101 (emphasis added).

Fiduciary Duties of Trustees

- A Public Pension Fund is a Trust – Whether by Statute or Case Law:
  - "All assets of the System shall be held in trust for the exclusive purpose of providing benefits for the members and beneficiaries of the System . . . ."

See, e.g., 11 O.S. § § 49-100.2, § 50-102.1.

Who is a Fiduciary?

- "A person or financial institution is a fiduciary . . .
  - *Exercises any discretionary authority or discretionary control respecting management* of the . . . System or *exercises any authority or control respecting management or disposition of the assets* of the System.
  - Renders investment advice for a fee . ..
  - Has any discretionary authority or discretionary responsibility in the administration of the System."

See, e.g., 11 O.S. § 49-100.10(D); 70 O.S. § 17-106.1; 74 O.S. § 909.2 (D) (emphasis added).

Two prongs of Fiduciary Duties

- Duty of Care
- Duty of Loyalty

"*Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.*"

Chief Justice Cardozo, *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928).

Fiduciary Duty of Care

- Duty of Care

  "The . . . Board of Trustees shall discharge their duties with respect to the system interest of the participants and beneficiaries . . . with the *care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims*."

  See, e.g., 74 O.S. § 909.1(A)(2)(emphasis added).

Fiduciary Duty of Care— the "Prudent Expert"

- Skill required of trustees
  - The Prudent Investor Rule standards

    "require fiduciaries possessing special facilities and skills to make those advantages available to the trust and its beneficiaries." Restatement 3d Trusts, sec. 227, Cmt. *d*.
  - Standard is *objective,* not subjective to the trustee.
    - Private pension trustees may not escape the "reasonable person" standard of prudence in making investments by having a "pure heart and an empty head". *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).
    - "[I]n the event a trustee commits the assets of a plan to an investment he does not fully understand, he will nonetheless be judged according to the objective prudent person standard. Okla. Op. Att'y Gen. 91-11(1992); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F.Supp. 378 (D.Haw.1980).

Fiduciary Duty of Care— General Investment Authority

- Trustees have a general authority to invest the monies of the System.

Okla. Op. Att'y Gen. 91-11(1992); *see also* 74 O.S. § 909.1.

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Fiduciary Duty of Care – Diversify Investments

- Duty to Diversify Retirement System Assets

> "By diversifying the investments of the System so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."

See, e.g., 11 O.S. § 49-100.9(A)(3); 74 O.S. § 909.1 (A)(3).

Fiduciary Duty of Care— Prohibition of Trust Transactions

- A fiduciary ***shall not*** cause the System to engage in a transaction if the fiduciary knows or should know that such transaction is for less than adequate consideration or adequate security.

  See, e.g., 11 O.S. § 49-100.10(A); 74 O.S. § 909.2(A) (emphasis added).

Fiduciary Duty of Care – Prudent Delegation

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

Fiduciary Duty of Care -- 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."

Restatement 3d Trusts (Prudent Investor Rule, sec. 171, adopted in 1992) (emphasis added).

Fiduciary Duty of Care – Prudent Delegation (cont.)

- Uniform Prudent Investors Act:
  – A trustee may delegate investment and management function that a prudent trustee of comparable skills could properly delegate under the circumstances . . ." 7B Unif. Laws Ann. (2000) at 303.

Fiduciary Duty of Care – Retain Investment Managers

- "The Board of Trustees shall retain qualified investment managers to provide for the investment of the monies of the System."

See, e.g., 74 O.S. § 909.1(D); 11 O.S. § 49-100.9(D).

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Fiduciary Duty of Care – Consult with Experts

– "To the extent necessary or appropriate to the making of informed investment judgments by the particular trustee, care also involves securing and considering the advice of others [such as legal, actuarial and investment counsel] on a reasonable basis."
Rest. 3d Trusts, supra, § 227, p. 15, Cmt. *d*.

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Fiduciary Duty of Care: Consult with Experts

– The implicit corollary to the duty to consult with experts is that if a fiduciary fails to follow the advice of its professional consultants, it must demonstrate an informed, reasonable, and prudent rationale for failing to do so.

– Another implicit corollary is that expert advice from a reasonable source should provide the basis for a Board's decision to take an alternative course of action on a topic within that area of expertise (e.g., investment, actuarial, legal).

Fiduciary Duty of Care— Investigative Responsibility

- Duty to employ appropriate methods to investigate the merits of an investment.
  - "It requires a trustee who is unfamiliar with an unusual or difficult investment decision to make an independent inquiry into the particular investment rather than relying wholly upon the advice of others."
  - "A trustee who lacks the education, experience and skill required to make a decision regarding a particular investment has an affirmative duty to seek independent counsel in making the decision; failure to do so is imprudent and constitutes a violation of the trustee's fiduciary duty."

Okla. Op. Att'y Gen. 91-11(1992).

Fiduciary Duty of Care— Duty to Investigate (cont.)

- "Because the market position of the [seller of options] affects the risk entailed in various . . . transactions, it is essential that the trustees understand this factor and know the level of risk associated with the particular transactions or types of transactions that they authorize."

Okla. Op. Att'y Gen. 91-11(1992).

Fiduciary Duty of Care – Monitoring Responsibility

- Duty to Monitor
  - The duty to monitor and to take corrective action when reasonably appropriate is fundamental to a trustee's exercise of the duty of care. Rest. 3d Trusts, § 227, p. 14 (1992), Cmt. *d* ("The duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives").

Fiduciary Duty of Care: Duty to Monitor (cont.)

- Last year, the United States Supreme Court weighed in on this topic in *Tibble v. Edison International*, 575 U.S. ___, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (May 18, 2015):
  - Petitioners contended that fiduciaries of an ERISA defined-contribution plan acted imprudently in offering higher priced retail-class mutual funds to them, when the fiduciaries allegedly could have offered effectively the same mutual funds to them at the lower price available to institutional investors such as the plan.
  - The lower price reportedly reflected the lower administrative costs afforded to institutional investors.

Fiduciary Duty of Care: Duty to Monitor, *Tibble*

- The *Tibble* Court observed:
  - Under the common law of trusts, a fiduciary is required to conduct a regular review of its investments with the nature and timing of the review contingent on the circumstances.
  - Under trust law, a trustee also has a “continuing duty to monitor trust investments and remove imprudent ones.”
  - A fiduciary’s alleged “imprudent retention of an investment” could provide the basis of an action that would trigger the running of a limitations period, not simply the original investment date.

Fiduciary Duty of Care: Duty to Monitor, *Tibble* (cont.)

- The *Tibble* Court remanded for consideration by the 9th Circuit, and did not decide in this instance:
  - Whether the challenged mutual funds' investments fee structure as compared to analogous investment opportunities constituted a breach of fiduciary duty by the trustees who failed to remove the more expensive, but otherwise equivalent, investment options from the mutual funds proposed to members of the plan.
- In April 2016, the U.S. court of appeals nevertheless dismissed the lawsuit.

Retirement System Take-Aways from *Tibble* and Attorney General Opinion?

- Retirement systems should ensure that:
  - Some process is adopted and implemented to ensure reasonable investigation and oversight on a periodic basis of the investments made on behalf of the trust beyond the due diligence undertaken when the investment decision was originally made.
  - "Primary focus of consideration should be on the particular investment decision; nevertheless, the Board of Trustees may take into consideration the overall objectives of the System's portfolio as a whole." Okla. Op. Att'y Gen. 91-11(1992).

Retirement System Take-Aways (cont.)

- Investigative process should:
  - Employ appropriate methods to investigate the merits of the transactions to determine whether the particular transactions are prudent.
  - Independent inquiry into the transaction—cannot rely wholly upon the advice of others.
  - Affirmatively seek independent counsel if lacks the education, experience, and skill necessary to make decision.
  - Ascertain the market position of the System and consider its impact on the risk of the transactions.
  - Exclusive reliance on self-reporting by investment managers is insufficient.

Retirement System Take-Aways (cont.)

- Monitoring process should:
  - Analyze compliance with systems' existing investment policies and contractual terms
    - Including, among other terms, diversification and leverage limits, and fee and expense allocation provisions.
  - Include a process to trigger a more focused review in some circumstances

Summary re Fiduciary Duty of Care

- Duty of care = Duty of prudence
  - Prudence requires *asking questions* and *understanding the rationale* for actions before taking them
  - Prudence requires *analyzing advice* and *recommendations* received from experts, not acting as a "rubber stamp," but also, if not adopting the experts' recommendation(s), having a reasonable basis for doing so that is *informed by the applicable expertise* implicated by the decision and that is consistent with fiduciary duties
  - Prudence requires *following the Plan Document and other applicable law*, as well as the Board regulations, policies, resolutions and other rules governing the retirement system

Fiduciary Duty of Loyalty – Exclusive Benefit Rule

"All the proceeds, assets and income of any public retirement system administered by an agency of the State of Oklahoma shall be held, invested, or disbursed as provided for by law as in trust for the exclusive purpose of providing for benefits, refunds, investment management, and administrative expenses of the individual public retirement system, and shall not be encumbered for or diverted to any other purposes."

Okla. Const. art. XXIII, § 12 (emphasis added).

Fiduciary Duty of Loyalty: Exclusive Benefits

" The . . . Board of Trustees shall discharge their duties with respect to the System solely in the interest of the participants and beneficiaries and:

- 1. For the *exclusive purpose* of:
  - a. providing benefits to participants and their beneficiaries, and
  - b. defraying reasonable expenses of administering the System"

See, e.g., 74 O.S. § 909.1(A)(1)(emphasis added).

Fiduciary Duty of Loyalty— Prohibited Dealings

"A fiduciary . . . **shall not**:

- a. deal with the assets of the System in the fiduciary's own interest or for the fiduciary's own account;
- b. in the fiduciary's individual or any other capacity act in any transaction involving the System on behalf of a party whose interests are adverse to the interests of the System or the interests of its participants or beneficiaries; or
- c. receive any consideration for the fiduciary's own personal account from any party dealing with the System in connection with a transaction involving the assets of the System.

See, e.g., 74 O.S. § 942 (D)(2); 2016 Okla. Sess. Law Serv. Ch. 45 (H.B. 2258) effective November 1, 2016; 11 O.S. § 49-100.10(B).

Fiduciary Duty of Loyalty: Collateral Interests?

- Collateral interests of Board members?
  - The strict duty of loyalty in trust law ordinarily prohibits the trustee from . . . investing in a manner that is intended to serve interests other than those of the beneficiaries or the purposes of the settlor. *Thus, for example, in managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes.*

    Rest. 3d Trusts, supra, § 227, p. 12, comment c (emphasis added).

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Fiduciary Duty of Loyalty -- Not an "agent" for another

- Trustees are not permitted to administer the retirement system as an "agent" for the party that appointed, or subgroup of members that elected, that individual to the Board.

- Under traditional employee benefit trust law, even though the pre-ERISA statute: "requires an equal balance between trustees appointed by the union and those appointed by the employer, *nothing in the language of [the provision] reveals any congressional intent that a trustee should or may administer a trust fund in the interest of the party that appointed him, or that an employer may direct or supervise the decisions of a trustee he has appointed*." 453 U.S. at 331 (emphasis added).

See generally NLRB v. Amax Coal Co., 453 U.S. 322 (1981) (no "dual loyalties").

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Fiduciary Duty of Loyalty -- Duty of Impartiality

- Trustees are not permitted to show partiality to any interest. The rule of impartiality is applicable whether the beneficiaries are entitled to an interest in the trust "simultaneously or successively."

  (Restatement Trusts 2d § 183.)
- Trustees have a duty to the overall best interest of all members and beneficiaries.

Fiduciary Duty of Loyalty: Conflicting Interests Among Various Members and Beneficiaries

- Can be complex and crosscutting.
- Determinations of priorities among members and beneficiaries must serve the *overall best interest of members and beneficiaries of the retirement system*.
- Appropriate balance may not be obvious when the interests within the member and beneficiary groups are not the same.

Fiduciary Duty of Loyalty: Conflicting Interests Among Various Members and Beneficiaries (cont.)

- Dissimilar interests among beneficiaries are built into most trusts.
- Trust law has evolved to grant trustees a fair measure of discretion to balance those competing beneficiary interests.

See Rest. 3d Trusts, § § 50, 183 comment a, and 232; and IIIA Fratcher, Scott on Trusts, § 232, p. 7 (4th ed. 1988) ("The trustee, however, ordinarily has considerable discretion in preserving the balance between beneficiaries").

Fiduciary Duty of Loyalty (cont'd)

- **Conflicting Interests Among Members and Beneficiaries?**
  - Examine specific provisions, and identified purposes if any, in Plan Document and determine means to implement those provisions and serve those purposes.
  - Consider number of active, deferred and retired members and their beneficiaries affected by Board action.
  - Consider degree of hardship created by potential curtailment or provision of particular benefit.
  - Consider equities as between members/beneficiaries.
  - Consider whether proposed action implicates any vested rights of members/beneficiaries, including, without limitation, actuarial competency of retirement system assets to pay promised benefits.

Processes to Demonstrate Fiduciary Compliance

- Recognize that Boards have general discretion in decision-making, but not absolute discretion
- Avoid "abuse of discretion" in areas as to which Board members have fiduciary responsibility and authority
  - Process important – make sure record reflects that process: minutes reflecting deliberation, written materials provided by expert consultants
  - Education, inquiry, disclosure of reasons for action, reflecting due consideration to overall best interest of members and beneficiaries
  - Evaluate market risks factors
  - Active independent investment inquiry and investigation
  - Active independent oversight
  - Active independent actuarial oversight
  - Legal consultation and compliance with applicable law

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Thank You!

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Ms. Dunning received her J.D. from the University of California, Hastings College of the Law, cum laude; Order of the Coif., and her B.A. from Yale University, cum laude, with Distinction in History. She was selected in 2016 by the California Daily Journal as one of the Top Women Lawyers in California.