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Public Pension Oversight Board

Fiduciary Education Session

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By Ice Miller LLP

Overview

- Fiduciary training helps fiduciaries understand:
  - Fiduciary responsibilities
  - Statutory requirements
  - Strategies to manage the associated liabilities from a legal and compliance perspective
- Today's review:
  - Who is a Fiduciary
  - Sources and Standards of Fiduciary Duties
  - Fiduciary liability
  - Information as to Kentucky Retirement System (“KRS”)
  - Information as to Teachers’ Retirement System of the State of Kentucky (“TRS”).

Who is a Fiduciary?

Who is a Fiduciary? (KRS)

- The KRS Board is administrator and trustee of KRS' respective trusts: County Employees Retirement System ("CERS"), Kentucky Employees Retirement System ("KERS"), State Police Retirement System ("SPRS"). KRS 61.645(1), 61.650(1).
- The KRS Board also is administrator and trustee of other trust assets: 401(h) account and 115 trust (both are retiree medical funds).
- Executive Director
- Investment Staff
- Executive Staff
- Investment Committee, KRS 61.650
- Other fiduciaries may, depending on circumstances, include:
  - Attorney General (or designee)? KRS 61.645(11).

Who is a Fiduciary? (TRS)

- The TRS Board is administrator and trustee of the TRS trust. KRS 161.250, 161.430.
- The TRS Board also is administrator and trustee of other trust assets, including a health insurance account, a 403(b) Plan, a qualified government excess benefit plan ("QEBA"), and a life insurance benefit fund. KRS 161.420.
- Executive Secretary
- Investment Staff
- Executive Staff
- Other fiduciaries may, depending on circumstances, include:
  - Investment Counselor, KRS 161.430(2).
  - Board Committees – "The board creates committees to assist the board in effectively fulfilling its fiduciary responsibilities." TRS Board of Trustees Governance Manual, § 6.

Fiduciary Defined: Function or Designation

Function: A fiduciary is any person or entity who makes, or has the authority to make, discretionary administrative or investment decisions related to the retirement plan.

- Trustees
- Anyone who chooses, evaluates or monitors service providers
- Anyone who can bind the plan through contracts

Designation: A fiduciary is any person or entity who is named in a retirement plan or trust document as a fiduciary, *e.g.*, Advisory Committee, Investment Committee, Investment Officers.

- Example: Advisory Committee
- Example: Investment Committee
- Example: Investment Officers

Fiduciary Defined *(cont'd)*

- KRS:
  - The funds "shall be administered by the board of trustees of the Kentucky Retirement System, composed of seventeen (17) members. …" KRS 61.645.
  - "The board shall be the trustee of the several funds …, and shall have exclusive power to invest and reinvest such funds in accordance with federal law." KRS 61.650(1)(a).
  - "A trustee, officer, employee, or other fiduciary shall discharge duties with respect to the retirement system: 1. Solely in the interest of the members and beneficiaries; …" KRS 61.650(1)(c).

Fiduciary Defined *(cont'd)*

- TRS
  - "The general administration and management of the retirement system, and the responsibility for its proper operation … are vested in a board of trustees to be known as the "Board of Trustees of the Teachers' Retirement System of the State of Kentucky." KRS 161.250(1)(a).
  - "The board of trustees shall be the trustee of the funds of the retirement system and shall have full power and responsibility for the purchase, sale, exchange, transfer, or other disposition of the investments and moneys of the retirement system." KRS 161.430(1).
  - "The board members and investment counselor shall discharge their duties with respect to the assets of the system solely in the interests of the active contributing members and annuitants and:…." KRS 161.430(2).

Who is Not a Fiduciary?

Settlor

- Establishes, amends, or terminates the plan
- Determines scope of fiduciary duty

Administrative Entities

- Entities or individuals that solely perform administrative functions:
  - Receives contributions and applies to account,
  - Distribution of educational materials,
  - Implements rules, and/or
  - Processes forms

Sources and Standards of Fiduciary Duties

Sources of Fiduciary Duties

Fiduciaries are held to extremely high standards of conduct under the law.

Federal Law	State Law	Common Law	Plan and Plan-Related Documents
• **Internal Revenue Code** • **ERISA** (*not applicable, but excellent resource*)	• **Commonwealth of Kentucky statutory fiduciary duties/rules** • **Kentucky Executive Branch Code of Ethics**	• **Restatement (Third) of Trusts** (*collection of common law*) • **Uniform Management of Public Employee Retirement Systems Act (UMPERSA)** (*not adopted by Kentucky but excellent resource*)	• **Kentucky Revised Statutes ("KRS")** • **Kentucky Administrative Regulations ("KAR")** • **Trust Documents** • **Board Policies**

ERISA

- Employee Retirement Income Security Act (ERISA) requires fiduciaries of ***private sector*** plans to discharge their duties with respect to a plan:
  - solely in the interest of plan participants,
  - for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan,
  - with the care, skill, prudence, and diligence under the circumstances then prevailing,
  - that a prudent man acting in like capacity and familiar with such matters would use.
- Adopts a “prudent expert” rule

Affirmative Fiduciary Duties

Duty of Loyalty	Duty to act solely in the interest of participants and beneficiaries.
	Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses.
	Duty to act independently and without conflicts of interest.
	Duty to act impartially among differing interests.
Duty of Prudence	Duty to act with care, skill, prudence, and diligence of prudent person familiar with like matters.
	Duty to be informed.
	Duty to delegate responsibilities outside of expertise.
	Duty to diversify investments.

Duty to Follow Plan Document

Duty of Loyalty

- Internal Revenue Code's **Exclusive Benefit Rule**:
  - "Under the trust instrument it [must be] impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the ***exclusive benefit of his employees or their beneficiaries***."

    - Internal Revenue Code § 401(a)(2)
- This is a <u>qualification requirement</u> under the Internal Revenue Code.

Duty of Loyalty *(cont'd)*

- KRS
  - KRS 61.650(1)(c) incorporates **duty of loyalty**:

    a trustee, officer, employee, or other fiduciary shall discharge duties with respect to the retirement system:

    (1) solely in the interest of the members and beneficiaries;

    (2) for the exclusive purpose of providing benefits to members and beneficiaries and paying reasonable expenses of administrating the system;

    * * *

Duty of Loyalty *(cont'd)*

- TRS
  - KRS 161.430(2) incorporates **duty of loyalty**:

    The board members and investment counselor shall discharge their duties with respect to the assets of the system solely in the interests of the active contributing members and annuitants and:

    (1) For the exclusive purpose of providing benefits to members and annuitants and defraying reasonable expenses of administrating the system;

    * * *

Duty of Loyalty: Practical Impact

- A fiduciary has a duty to act in the interest of the trust **as if it had no other competing interests to protect**.
  - Cannot act for fiduciary's own interest.
  - Cannot be influenced by the interest of any third party.
  - **Must set aside the interests of the party that appoints/elects the fiduciary**.
- Requires **undivided loyalty** to members and beneficiaries.

Duty of Loyalty: Costs (Investments)

- A fiduciary shall discharge duties with respect to a plan incurring only costs that are **appropriate and reasonable to administer the plan**.
  - Fee transparency.
  - Understand what and how fees are paid.
- Only plan expenses can be paid from trusts.

- Internal Revenue Code § 401(a)(2); ERISA § 404(a)(1)(A);UMPERSA § 7(5)

Duty of Loyalty: Costs (Investments) *(cont'd)*

- KRS
  - KRS 61.650(1)(c)2 (exclusive benefit) and 61.650(1)(c)5 ("Incurring any costs that are appropriate and reasonable". . .).

Duty of Loyalty: Costs (Investments) *(cont'd)*

- TRS
  - "All of the assets of the retirement system are for the exclusive purpose of providing benefits to members and annuitants and defraying reasonable expenses of administering the system." KRS 161.420
  - "In discharging his or her administrative duties under this section, a trustee shall strive to administer the retirement system in an efficient and cost-effective manner for the taxpayers of the Commonwealth of Kentucky." KRS 161.430(5).

Duty of Loyalty: Independence

- One challenge of "independence" for a trustee is to be independent of preconceived notions.
- "Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations."

  - UMPRSA Comments on § 5
- The Kentucky Executive Branch Code of Ethics establishes standards of ethical conduct to "determine those conflicts of interest which are substantial and material or which, by the nature of the conflict of interest, tend to bring public servants into disrepute." KRS 11A.005.
- KRS has Conflict of Interest and Confidentiality policies/requirements.
- TRS has a Conflict of Interest statute (KRS 161.460), policies addressing conflicts (trustees, employees, and managers), and standard contract language with managers. All sign statements of adherence to the law and policies.

Duty of Loyalty: Impartiality

- UMPERSA Commentary: "**<u>Differing interests are inevitable in the retirement system setting. Differences can arise between retirees and working members, young members and old, long and short-term employees, and other groupings of those with interest in the retirement system</u>**. The duty of impartiality does not mean that fiduciaries must accommodate such interests according to some notion of absolute equality. **<u>The duty of impartiality … requires that such decisions be made carefully and after weighing the differing interests</u>**."

Duty of Loyalty: Impartiality *(cont'd)*

- A fiduciary owes a duty of loyalty to **all participants and beneficiaries**, and respecting that duty requires the fiduciary to be **impartial among differing interests**.
  - Balance the interests of retirees and active participants.
  - Balance the interests of different groups of participants.
    - For KRS: state employees, public safety officers (*i.e. hazardous vs. nonhazardous employees*), local employees
    - For TRS: teachers, university faculty
  - **<u>Balance roles with regard to different plans and trusts</u>**.
    - DB plans, retiree health programs, 403(b).
- Prevents application of assets for personal use, self-dealing, competition with trust, or improper benefit.

Duty of Prudence

- KRS
  - KRS 61.650(1)(c), listing the Board's duties, incorporates the **duty of prudence**:

    A trustee, officer, employee, or other fiduciary shall discharge duties with respect to the retirement system:

    * * *

    3. "With the care, skill, and caution under the circumstances then prevailing that a **prudent person** acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose."

    * * *

  - KRS' Conflict of Interest and Confidentiality Policy

    "KRS recognizes the need to maintain the public's confidence and trust and the integrity of KRS and the Commonwealth of Kentucky. Individuals associated with KRS must not engage in activities that have the potential to become a conflict of interest with their association with KRS. Likewise, individuals associated with KRS must not release information about KRS or any of its members that would breach any duty to protect such information. KRS recognizes the need to establish procedures to prevent such conflicts or breaches."

Duty of Prudence *(cont'd)*

- In addition to the standards of conduct found in Kentucky state law, KRS trustees "shall adhere to … the Code of Conduct for Members of a Pension Scheme Governing Body if the individual is a board member." KRS 61.650(1)(d).
  - Code cited is promulgated by the CFA Institute.

Duty of Prudence *(cont'd)*

- TRS also incorporates the duty of prudence: "The board members and investment counselor shall discharge their duties with respect to the assets of the system …: (b) 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;…" KRS 161.430(2)
- TRS' Conflict of Interest and Confidentiality Policy

  "TRS recognizes the need to maintain the public's confidence and trust in the integrity of TRS and the Commonwealth of Kentucky. Individuals associated with TRS must not engage in activities that have the potential to become a conflict of interest in their association with TRS. Likewise, individuals associated with TRS must not release information about TRS or any of its members that would breach any duty to protect such information. TRS recognizes the need to establish procedures to prevent such conflicts or breaches."

Duty of Prudence *(cont'd)*

- In addition to the standards of conduct found in Kentucky state law, TRS trustees "shall adhere to … the Code of Conduct for Members of a Pension Scheme Governing Body if the individual is a board member." KRS 161.430(1).
  - Code cited is promulgated by the CFA Institute.

Duty of Care: Skill and Diligence

- According to the Code of Conduct for Members of a Pension Scheme Governing Body:

  "**Skill and diligence require trustees to be knowledgeable about the matters and duties with which they have been entrusted**. Ignorance of a situation or an improper course of action on matters for which the trustee is responsible or should at least be aware is a violation of this code. Improper or ill-advised decisions can be costly to the pension scheme and detrimental to the scheme's participants and beneficiaries. **Prior to taking action on behalf of the scheme, effective trustees and/or their designees analyze the potential investment opportunities and act only after undertaking due diligence to ensure they have sufficient knowledge about specific investments or strategies**."

Duty of Care: Skill and Diligence

- Skill and diligence require trustees to be knowledgeable about the matters and duties with which they have been entrusted.
- Trustees may seek appropriate expert or professional guidance if they believe themselves lacking the expertise necessary to make an informed decision.
- Effective trustees will have knowledge and an understanding of
  - The strategies in which the scheme is investing;
  - Investment research and will consider the assumptions used – such as risks, inflation, and rates of return – as well as thoroughness of the analysis performed, the timeliness and completeness of the information, and the objectivity and independence of the source;
  - The basic structure and function of the selected investments and securities in which the scheme invests;

Duty of Prudence: Skill and Diligence

- How investments and securities are traded, their liquidity, and any other risks (including counterparty risk).

Duty of Prudence: Skill and Diligence

- KRS
  - Under KRS 61.645(1)(e)5, KRS' Board is required to have at least six members with investment expertise and one member knowledgeable about the impact of pension requirements on local governments.
  - Under KRS 61.650, KRS' Board is required to establish an Investment Committee (under 61.645, the Committee will have extensive experience in investments and/or portfolio decision-making).

Duty of Prudence: Skill and Diligence *(cont'd)*

- TRS:
  - Under KRS 161.250(1)(a), TRS' Board includes two trustees, appointed by the Governor, with at least ten years of investment experiences.
  - Under KRS 161.430(1), TRS' Board shall employ experienced investment counselors to advise it on all matters pertaining to investments.
  - Since 2009, the TRS Investment Committee has included two experts who have significant investment experience.

Duty of Prudence: Be Informed

- Duty to be **informed**.
- The trustee must exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives, including keeping informed of rights and opportunities associated with those investments.
  - Obtain and consider relevant information about trust, beneficiaries and investments.
  - Look at operations and documents, especially high risk areas.
- May require securing and considering the advice of experts on a reasonable basis.

\- Restatement (Third) of Trusts § 77, comment b

Duty of Prudence: Be Informed *(cont'd)*

- KRS
  - "A trustee discharges his duties on an informed basis if, he makes an inquiry into the business and affairs of [KRS] or into a particular action to be taken or decision to be made, he exercises the **care an ordinary prudent person in a like position would exercise under similar circumstances**." KRS 61.645(15)(b) (Emphasis added).
  - "In discharging his duties, a trustee may rely on information, opinions, reports, or statements, including financial statements and other financial data . . ." KRS 61.645(15)(c).

Duty of Prudence: Be Informed *(cont'd)*

- TRS
  - "The board members and investment counselor shall discharge their duties with respect to the assets of the system …: (b) 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**; …" KRS 161.430(2).

Duty of Prudence: Delegation

"If you don't know jewelry, know the jeweler."

- Warren Buffett

- A fiduciary can delegate functions that a prudent fiduciary acting in a like capacity and familiar with those matters could properly delegate.
- A fiduciary has a duty to delegate responsibilities outside of the fiduciary's expertise.
- Delegation should not be overly broad and must be consistent with duty of care and caution, *e.g.* terms of delegation must be prudent.

- ERISA § 405(c)(1); UMPERSA § 6; Restatement (Third) of Trusts, § 80

Duty of Prudence: Delegation *(cont'd)*

- Documentation should be clear and consistent with respect to the process of delegation.
- Specific duties and responsibilities of the delegate should be set out in writing, approved by the fiduciary, and accepted by the delegate.
- Delegation is a fiduciary act –
  - Must delegate prudently and in accordance with the written plan.
  - Must monitor delegate.
  - Fees and costs must be reasonable.

Duty of Prudence: Delegation

- KRS
  - "The board is granted the . . . following powers:

    (d) Except as provided in KRS 61.650(6), to contract for investment counseling, actuarial [also consider KRS 61.670], auditing, medical, and other professional or technical services. . ." KRS 61.645(2)(d).
  - All individuals associated with the investment and management of retirement system assets are required to adhere to the following CFA Institute codes:
    - Code of Ethics and Standards of Professional Conduct
    - Asset Manager Code of Professional Conduct
    - Code of Conduct for Members of a Pension Scheme Governing Body

      KRS 61.650(1)(d)

Duty of Prudence: Delegation

- TRS
  - "Except as provided by KRS § 161.430(7), the board shall contract for actuarial, auditing, legal, medical, investment counseling, and other professional or technical services..." KRS 161.340(3)(a).
  - "The board generally delegates investment authority for the retirement system to the Investment Committee. The statutory authority for the Investment Committee is KRS 161.430. The purpose of the Investment Committee (committee) is to assist the board with its duty to invest the assets of the retirement system." Strategy for Implementation of Investment Policies Established by Administrative Regulations, § 10 Investment Committee Charter.

Duty of Prudence: Diversification

- In investing and managing assets of a retirement system, a fiduciary with authority to invest and manage assets shall diversify the investments unless the trustee reasonably determines that it is not prudent to do so.
- TRS - “The board members and investment counselor shall discharge their duties with respect to the assets of the system…: (c) By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; …” KRS § 161.430(2)(c).
- Fundamental to the prudent management of risk.

  - UMPERSA § 8(2); Restatement (Third) of Trusts, § 90(b); ERISA § 404(a)(1)(C)
- Consider Board's Investment Policy
  - TRS – 102 KAR 1:175 and 102 KAR 1:178

Duty of Prudence - Continuing Duty to Monitor

- Common law of trusts recognizes a **continuing responsibility** to monitor investments after initial selection:

  > *"[A] trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved*." Restatement (Third) of Trusts.

- Supreme Court in *Tibble v. Edison International* looked to common law in finding that trustee has a **continuing duty under ERISA** to monitor and remove imprudent investment options.

Duty to Follow Plan Documents

- Fiduciary duty to administer a plan in good faith in accordance with its **written terms – "by the book."**
  - Plan includes the statutes, administrative rules, and administrative procedures.
  - Consistent interpretation and administration.
  - Timely update for legally required changes.
  - Timely correct plan errors.
- Burden on fiduciary to understand the governing documents of the plans and the context in which the plans exist.

- Revenue Procedure 2018-52; ERISA § 404(a)(1)(C); Restatement (Third) of Trusts § 76.

Key Takeaways

Highest duty known to law.

Objective standard:

- Prudent "expert" standard.
- Good faith is not sufficient.
- If you don’t know, learn or hire an expert.

If it is not documented, it never happened.

Fiduciary Liability

Fiduciary Liability

- KRS
  - The Board is hereby granted the powers and privileges of a corporation, including but not limited to, the following powers:

    (a) To sue and be sued in its corporate name;

    * * *

    (e) To purchase fiduciary liability insurance;

    * * *

    (g) The Board shall reimburse any trustee, officer, or employee for any legal expense resulting from a civil action arising out of the performance of his official duties.

KRS 61.645(2).

Fiduciary Liability *(cont'd)*

- KRS continued:

  (e) Any action taken as a trustee, or any failure to take any action as a trustee, shall not be the basis for monetary damages or injunctive relief unless:

    1. the trustee has breached or failed to perform the duties of the trustee's office in compliance with this section; and

    2. in the case of an action for monetary damages, the breach of failure to perform constitutes willful misconduct or wanton or reckless disregard for human rights, safety, or property.

  * * *

  (f) a person bringing an action for monetary damages under this section shall have the burden of proving by clear and convincing evidence that provisions of paragraph (e)1. and 2. of this subsection, and the burden of proving that the breach or failure to perform was the legal cause of damages suffered by the Kentucky Retirement Systems.

Fiduciary Liability *(cont'd)*

(g) nothing in this section shall eliminate or limit the liability of any trustee for any act or omission occurring prior to July 15, 1988.

(h) in discharge on his or her administrative duties under this section, a trustee shall strive to administer the retirement system in an efficient and cost-effective manner for the taxpayers of the Commonwealth of Kentucky.

KRS 61.645(15)

Fiduciary Liability *(cont'd)*

- TRS
  - "The Board shall provide for legal counsel and other legal services as may be required in defense of trustees, officers, and employees of the system who may be subjected to civil action arising from the performance of their legally assigned duties if counsel and services are not provided by the Attorney General." KRS 161.340(3)(b).
  - "The board of trustees may expend funds from the expense fund as necessary to insure the trustees, employees, and officials of the Teachers' Retirement System against any liability arising out of an act or omission committed in the scope and course of performing legal duties." KRS 161.340(5).

Fiduciary Liability *(cont'd)*

- **Personal liability** for breach of fiduciary duty.
  - Restore to the plan any losses resulting from a breach of fiduciary duty.
  - Restore to the plan any profits made by the fiduciary though use of plan assets.
  - Other equitable or remedial relief as the court may deem appropriate.
- May be liable for a co-fiduciary's breach of fiduciary duty if a fiduciary enables another fiduciary to commit the breach, knowingly participates in or conceals the breach, or discovers the breach but does not take steps to remedy.

Fiduciary Liability *(cont'd)*

- Governmental trustees are increasingly a target of fiduciary claims. Common allegations include:
  - Self-dealing/dishonesty/pay to play
  - Failure to properly disclose fees
  - Benefit reductions
  - Insufficient funding
  - Imprudent investments (e.g. hedge funds)
  - Failure to diversify
  - False or misleading statements
  - Errors in plan administration

Stating a Claim

- In *White v. Chevron*, N.D. CA (2016), the court dismissed a complaint alleging a breach of fiduciary duty for failure to state a claim finding that plaintiffs failed to cite sufficient facts to support allegations. The Court noted:
  - ERISA does not require plan fiduciaries to include any particular mix of investment vehicles in their plan.
  - Prudent process, not results, is the focus.
  - Fiduciary actions not judged from hindsight.
  - Fiduciaries can value investment features other than price.
  - Prudence of investment is assessed not in isolation but as it relates to the portfolio as a whole.
  - ERISA does not prohibit revenue sharing nor require periodic competitive bidding.

Questions?

Christopher S. Sears
Ice Miller LLP
Indianapolis, IN
(317) 236-5891
christopher.sears@icemiller.com