

PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 7th Meeting of the 2018 Interim

October 22, 2018

Call to Order and Roll Call

The 7th meeting of the Public Pension Oversight Board was held on Monday, October 22, 2018, at 1:00 PM, in Room 171 of the Capitol Annex. Senator Joe Bowen, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Joe Bowen, Co-Chair; Representative Jerry T. Miller, Co-Chair; Senators Jimmy Higdon, Christian McDaniel, Gerald A. Neal, Dennis Parrett, and Wil Schroder; Representatives Ken Fleming, DJ Johnson, James Kay, Arnold Simpson, and Russell Webber; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Chris Sears, Ice Miller, LLP (Via Video Conference); Jennifer Black Hans, LRC Staff; David Eager, Executive Director, Kentucky Retirement Systems; and Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; Stephanie Winkler, Kentucky Education Association; and Barbara Sterrett, Former Trustee of Teachers' Retirement System.

LRC Staff: Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Representative Kay moved that the minutes of the September 24, 2018 meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Fiduciary Responsibility of Pension Trustees/Advisors

Chris Sears, Ice Miller LLP (Via Video Conference) provided an educational presentation on fiduciary responsibility, which included who is a fiduciary, sources and standards of fiduciary duties, liability of fiduciaries, and information specifically related to the Kentucky Retirement Systems (KRS) and Teachers' Retirement System (TRS).

Mr. Sears defined how someone becomes a fiduciary, which can result from a person's function or designation. Any person or entity who is specifically named in a retirement plan or trust document as a fiduciary, such as an investment committee or investment officers, would be fiduciary based on designation. In addition, any person or

entity who makes, or has the authority to make, discretionary administrative or investment decisions related to the retirement plan is a fiduciary based on their function. These individuals may not be specifically designated, but job function and authority to exercise discretion would make them fiduciary. Given these definitions, Mr. Sears reviewed several state statutes, which identified the boards of trustees as fiduciaries, and he noted the executive director, investment staff, other administrative executive staff were likely fiduciaries for both KRS and TRS based on function.

Mr. Sears discussed the sources of fiduciary duties and reviewed the standards of conduct fiduciaries are held to under federal, state, and common law. The primary source at the federal level is the Internal Revenue Code, but Mr. Sears also addressed the Employee Retirement Income Security Act (ERISA), which, while not applicable to governmental plans, also serves as an excellent resource with regards to fiduciary duties. At a state and common law level, sources include state statutes, the Executive Branch Code of Ethics, and the Uniform Management of Public Employee Retirement Systems Act (UMPERSA). In addition to applicable law, plan specific documents, policies, statutes, and administrative regulations are sources that must be considered. Mr. Sears emphasized that fiduciaries are held to extremely high standards of conduct under the law, if not one of the highest.

Mr. Sears outlined the three major duties of every fiduciary: loyalty, prudence, and adherence to plan documents. He referenced statutory language for each and walked through underlying responsibilities tied to each. Regarding the duty of loyalty, he noted all fiduciaries have a duty to act: (1) solely in the interest of participants and beneficiaries, (2) for the exclusive purpose of providing benefits or paying reasonable plan expenses, (3) independently and without conflicts of interest, and (4) impartially among differing interests. Under the duty of prudence, he explained four underlying tasks, which included a duty to: (1) act with care, skill, prudence, and diligence of a prudent person familiar with like matters, (2) be informed, (3) delegate responsibilities outside of expertise, and (4) diversify and monitor investments. Lastly, under the duty to follow plan documents, a fiduciary has duty to administer a plan in good faith in accordance with its written terms, which includes consistent administration, a timely update of legal changes, and a timely correction of any plan errors.

Mr. Sears discussed the liability of fiduciaries for both KRS and TRS, emphasizing that a fiduciary can be personally liable for a breach of fiduciary duty. The fiduciary would be liable to restore any losses resulting from a breach, any profits made by the fiduciary of misused plan assets, and other equitable relief. The fiduciary may be liable for a co-fiduciary's breach of fiduciary duty if a fiduciary enables another to commit the breach, knowingly participates in or conceals the breach, or discovers the breach but does not take steps to remedy it.

In response to questions from Senator Bowen with regards to full disclosure of investment fees, including fund of funds, Mr. Sears stated that there is a trend for more disclosure, but the risk of higher fees is one of the push backs from managers. In regards to a follow up question regarding the CFA Institute's Code of Conduct and whether it is a common standard, Mr. Sears was not aware of other states who had formally adopted, but stated he believed the code was a common standard and believed it is an appropriate standard for Kentucky. Regarding the definition of investment experience in Kentucky, Mr. Sears believed 10 years' experience was appropriate. In addition to a follow up question regarding the appropriate amount of board meetings, Mr. Sears indicated he did not know of an industry standard, but depending on the size of the plan and other factors, he believes that quarterly meetings would be the minimum requirement. In regards to the question of legal exposure and the recent decision in the City of Fort Wright case, Mr. Sears indicated he was not familiar with the case and could not answer. Lastly, in response to a question regarding Ice Miller's scope of service to KRS and TRS, Mr. Sears stated that Ice Miller, LLP provides federal tax and fiduciary counsel to the systems.

In response to the question from Senator Bowen regarding the City of Fort Wright case, Mr. Mark Blackwell, Executive Director, Office of Legal Services, KRS, stated the court essentially held the Fort Wright plaintiffs had misapplied the law by relying on a statute that refers to general trustees and not to the statutes that relate to the fiduciaries of qualified pension plans. In response to whether there is a likelihood of future employers or employees filing suit regarding the fiduciary responsibilities of the board, Mr. Blackwell stated he believes potential plaintiffs would need to read the decision of the court before proceeding. The court's opinion was not decided on the basis of what assets to invest in, but on the legality of investing in assets other than certificates of deposit (CDs) and other types of assets.

In response to a question from Ms. Mattingly regarding how many states have adopted the model act, UMPERSA, neither Mr. Sears nor Mr. Blackwell were able to respond.

In response to a question from Mr. Chilton with regards to having boards who are able to meet the unique needs of public plans, Mr. Sears stated frequent education is critical for board members who do not have a fiduciary background.

Senator Bowen said that the Public Pension Oversight Board (PPOB) has oversight, but does not have the authority or capacity to pass legislation or vote for change. The PPOB's role is to simply gather information and suggest legislation.

Representative Miller asked whether current statutory language permits a fiduciary to consider both members and the taxpayer and how would that language create conflicts. Mr. Sears stated that there are times when a fiduciary can make a decision in the best interest of both members and taxpayers. Other considerations, such as environmental,

social, or taxation can be incorporated into the decision-making process, but cannot come before or be the driving force in a final decision of a board. Members and beneficiaries should be a fiduciary's first consideration. Only after members and beneficiaries are considered may a fiduciary take up these additional topics.

Kentucky Retirement Systems Administrative Subcommittee Update

Jennifer Black Hans, LRC Staff, provided an update on the activities of the KRS Administrative Subcommittee and outlined the topics covered during August, September, and October meetings. In August, the subcommittee was provided a historical review of local government pension plans in the Commonwealth dating back to 1942, and how other states handle pooled, multiple employer, and local government plans and the trends regarding consolidation or separation. She also discussed the industry relative to local government plans, and stated there were three general models of administration and governance: consolidated, consolidated administration and separate governance, and separated plans. In September, the subcommittee heard testimony from various outside interest groups regarding the administration of the County Employees Retirement System (CERS) and proposed CERS separation or KRS restructuring. Lastly, in October, the subcommittee heard testimony from KRS staff regarding administrative issues, concerns, hurdles, and cost issues of CERS separation or restructuring, while also projecting any financial impact that such changes could have on KRS.

Senator Schroder commented on the subcommittee's activities. First, with regards to the three general models, he pointed out that a lot of times separation is thought of in terms of SB 226 and what it proposed. However, he commented that SB 226 is not the only option and that a hybrid approach that incorporates separate boards under a single administrative agency is also being analyzed. In addition, Senator Schroder referenced a discussion that occurred during the subcommittee earlier in the day regarding the topic of commingling of funds with Kentucky Employees Retirement System (KERS) and CERS. He noted that KRS staff had verified that commingling funds is prohibited under federal law, but explained how staff will pool assets together for the purpose of block investment purchases to get a better price with no commingling of the funds.

In response to a question from Senator Bowen in regards to the weighted representation on the board, Senator Schroder replied the question of representation has been a consistent point of conversation and a topic that the subcommittee plans to explore in more detail as they move forward.

Trustee Election Overview – KRS

David Eager, Executive Director, KRS, presented a review of the KRS board of trustees, which included an overview of the current KRS board of trustees, the process by which they are elected, along with a recommended change staff would like to propose for the upcoming Regular Session.

Mr. Eager began by outlining the composition of the board and providing statutory references for the elected and appointed members of the board. There are six elected trustees, including three CERS members, one State Police Retirement System (SPRS) member, and two KERS members each elected by their respective membership. There are 10 total trustees who are appointed by the Governor, and Mr. Eager outlined the statutory requirements. First, one of the appointees must have knowledge about the impact of pensions on local government. Secondly, three of the appointees are chosen from a list of three candidates that are submitted to the Governor by the Kentucky League of Cities, Kentucky Association of Counties, and the Kentucky School Board Association, respectively. Lastly, six of the gubernatorial appointees must have the statutorily-required investment experience. In addition to the elected and appointed trustees, the Secretary of the Personnel Cabinet serves as an ex-officio member to make the full board a total of 17 members.

Regarding the gubernatorial appointees, Mr. Eager walked through the statutory definition of investment experience. He noted that statute requires trustees to meet any one of the following five requirements: (1) be a portfolio manager acting as fiduciary; (2) be a professional securities analyst or investment consultant; (3) be a current or retired employee or principal of a trust institution; (4) be a CFA in good standing; or (5) be a university professor, teaching investments or related studies.

Mr. Eager provide a profile of the current board of trustees and discussed the employment or financial background of several members. In addition, he noted a few of the responsibilities of a board member, stating that most are serving on at least two committees in addition to the full board and most attend 14 or more meetings during the year. Compensation for trustees, who are not employed by the state, is just \$190 per meeting and some have to use personal time to attend meetings. Lastly, all trustees serve as fiduciaries and are subject to personal liability.

Mr. Eager walked through the trustee election process and provided a summary of recent elections. The process begins in February, when the executive director notifies the board in writing of the election procedures. KRS staff then distribute a notice to the membership seeking applications, which must be received prior to July 31. In August, an information meeting is held with candidates and their personal information is forwarded to the Attorney General to determine constitutional compatibility. The board then nominates up to three eligible candidates for each vacancy before September 30, but any member not nominated by the board has until November 30 to file a petition and be added to the ballot. Ballots are prepared by December 31 and mailed to the membership on January 20. Returned ballots are mailed to an external auditor, who tabulates the results, and must be postmarked by March 1. The external auditor certifies the votes by March 15, winners are announced and begin serving their term April 1.

Mr. Eager reviewed a summary of recent elections for each plan. In 2018, KERS mailed 132,551 ballots with 9 percent voter response. In 2017, CERS mailed 223,764 ballots for a special election with 5 percent voter response and, in the same year, CERS mailed 227,829 ballots for the regular election with 11 percent voter response. In 2011, SPRS mailed 2,521 ballots with 23 percent voter response.

In closing, Mr. Eager discussed two recommended changes to reduce cost and improve participation. First, KRS is recommending to synchronize two separate CERS elections so they may occur simultaneously. Making this change would eliminate one election, which in 2017 cost \$97,271, most of which was postage. Secondly, KRS would like authorization to allow electronic balloting for trustee elections. He stated that KRS currently has email coverage for about 50 percent of their membership and that percentage is growing. Making this change would initially save an estimated \$25,000 and, as more members began using it, could save up to \$40,000 per election.

In response to a question from Senator Bowen, Mr. Eager stated the Attorney General determines whether or not a member meets the qualifications of a trustee, plus Senate Bill 2 requires anyone appointed by the Governor to be confirmed by the Senate.

In response to a question from Representative Miller regarding past KRS housekeeping bills, Mr. Eager stated there was a housekeeping bill passed in 2017 and a prior one in 2011. Representative Miller added that, in 2017, KRS had two housekeeping bills, one with a financial impact and one without. The financial impact bill, which did not pass, included language to enable electronic voting. Representative Miller expressed his intent to introduce a similar bill again and include the proposal as a PPOB recommendation. In response to a follow up question, Mr. Eager confirmed that anyone still wanting to vote by paper ballot would be able to do so and the integrity of both the paper and electronic vote would be ensured.

In response to questions from Representative Simpson with regards to liability insurance, Mr. Eager confirmed that KRS has a \$5 million insurance policy with a \$500,000 deductible. The policy premium costs approximately \$365,000 per year. In response to a follow up question regarding if personal assets of trustees might be at risk, Mr. Eager asked Mr. Blackwell to assist with response. Mr. Blackwell stated KRS is liable for trustees' proper expenses, which would include attorney fees. However, he noted that in many cases the standard rate approved by the state contract review committee is materially less than most attorneys will accept, which has become an issue for some lawsuits. In a follow up question from Representative Simpson seeking a reason why state employees are not compensated for serving on the board, Mr. Eager stated he believes it is a bit unfair. Representative Simpson recommended KRS bring forth a recommendation to address issues like this to ensure quality individuals are serving on the board.

Senator Bowen commented that at the end of the year the Chairs will be requesting the members to bring suggestions forward for legislation that would affect the systems.

Trustee Election Overview – TRS

Beau Barnes, Deputy Executive Secretary and General Counsel, TRS, provided an overview of the TRS board of trustees, the process by which they are elected, as well as a summary of recent elections. He began with a profile of the 11 member board, which is established by KRS 161.250. The board has two ex-officio members, the education commissioner and state treasurer, who serve by virtue of their office. In addition, there are two governor appointed trustees, who, much like KRS, are required to possess statutorily-defined investment expertise. The remaining seven members are elected by TRS membership, of whom four must be active teachers, one a retired teacher, and two from outside the teaching profession. Board members are term limited and can serve up to three consecutive four year terms before an absence is required. After a break, a member can return to the board for one more four year term.

Mr. Barnes discussed the trustee election process, which is also established by KRS 161.260. He noted that the process has been largely unchanged since TRS was created. TRS has a single election each year. Two of the seven elected trustees are subject to election in most years. Every fourth year only one elected trustee is elected. Elections are completed by June 1 of each year and trustee terms begin on July 1 of each year. Two candidates are selected by a 13 member nominating committee, which consists of an active member from each of the 12 Kentucky Education Association districts, along with one retired member. TRS prepares and mails paper ballots to each member in early May, and each mailing includes biographies of each candidate and prepaid return postage. All ballots have a tracking number for security purpose. Returned ballots must be postmarked by May 31 and are mailed to the Kentucky Department of Education, where the Commissioner tabulates and provides results to TRS. Results are announced during the June trustee meeting, and Mr. Barnes stated all election expenses are paid from the TRS general expense fund. Lastly, Mr. Barnes noted the paper ballot process served two purposes. While the primary focus was electing trustees, a secondary purpose was the ability to keep member and retiree addresses current.

Mr. Barnes reviewed the cost and participation of the two most recent trustee elections. For the 2017 election, a total of 114,913 ballots were mailed, the total cost was \$65,040, and participation was 11 percent. The 2018 election included 113,642 ballots mailed, a total cost of \$64,866, and participation was 12 percent.

In response to questions from Senator Bowen regarding how potential candidates are identified, Mr. Barnes responded that, during the nominating process, active and retired teachers often suggest candidates, some may be a self-recommendation, or others may write or suggest someone be considered. In response to a follow up question regarding if TRS had considered electronic ballots, Mr. Barnes stated TRS had not. He referenced the

use of paper ballots to confirm addresses along with some concerns about members not being comfortable with using computers as reasons why electronic ballots had not been considered. Senator Bowen pointed out the low participation rate and encouraged TRS to consider electronic voting as a means to facilitate more participation.

In response to questions from Representative Miller with regards to how TRS reminds members to vote or participate, Mr. Barnes stated that information is included in newsletters, posted on their website, and shared through presentations that are performed by TRS staff throughout the state. In response to a follow up question asking if members have electronic access to their member accounts, Mr. Barnes indicated that all members have electronic access to their account through the member portal, but he was unable to confirm how many members actually use the portal. In response to a follow up question regarding other mailings from TRS, Mr. Barnes stated that TRS has several mailings, which include the annual 1099 tax information, a member annual statement, and newsletters or health insurance updates. As to a follow up question regarding the number of ballots versus total members, Mr. Barnes was unsure and offered to follow up at a later date. He did suggest that second accounts likely accounted for the majority. Representative Miller commented on the representation of retired teacher trustees and suggested that as the TRS membership becomes more mature it might make sense to add more retired trustees.

In response to a question from Ms. Mattingly regarding the election process and number of candidates, Mr. Barnes indicated that two candidates are considered for each vacancy. Members have two candidates to vote from for each vacancy.

In response to a question from Senator Bowen, Mr. Barnes confirmed TRS was not actively considering electronic balloting at this time.

Stephanie Winkler, President, Kentucky Education Association (KEA), noted that KEA not only represents teachers, but also classified school employees that account for a large portion of the CERS nonhazardous plan. She referenced the activity of the KRS Administrative Subcommittee and encouraged the PPOB to consider a board that was more proportional to the underlying membership. Ms. Winkler emphasized that she and the members she represents have a desire to be educated, and understand that, while the PPOB is not a decision making body, it can make recommendations for changes to future legislation. Lastly, Ms. Winkler expressed a belief that the TRS board election process is fair.

Barbara Sterrett, a former TRS trustee, shared her experience as a trustee and stated she believes the election process is fair and she would like for it to stay in place.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, November 26, 2018.