A Discussion of the Intersecting and Complex Fiduciary Responsibilities of California Public Retirement System Trustees

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CalPERS

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Your Presenter

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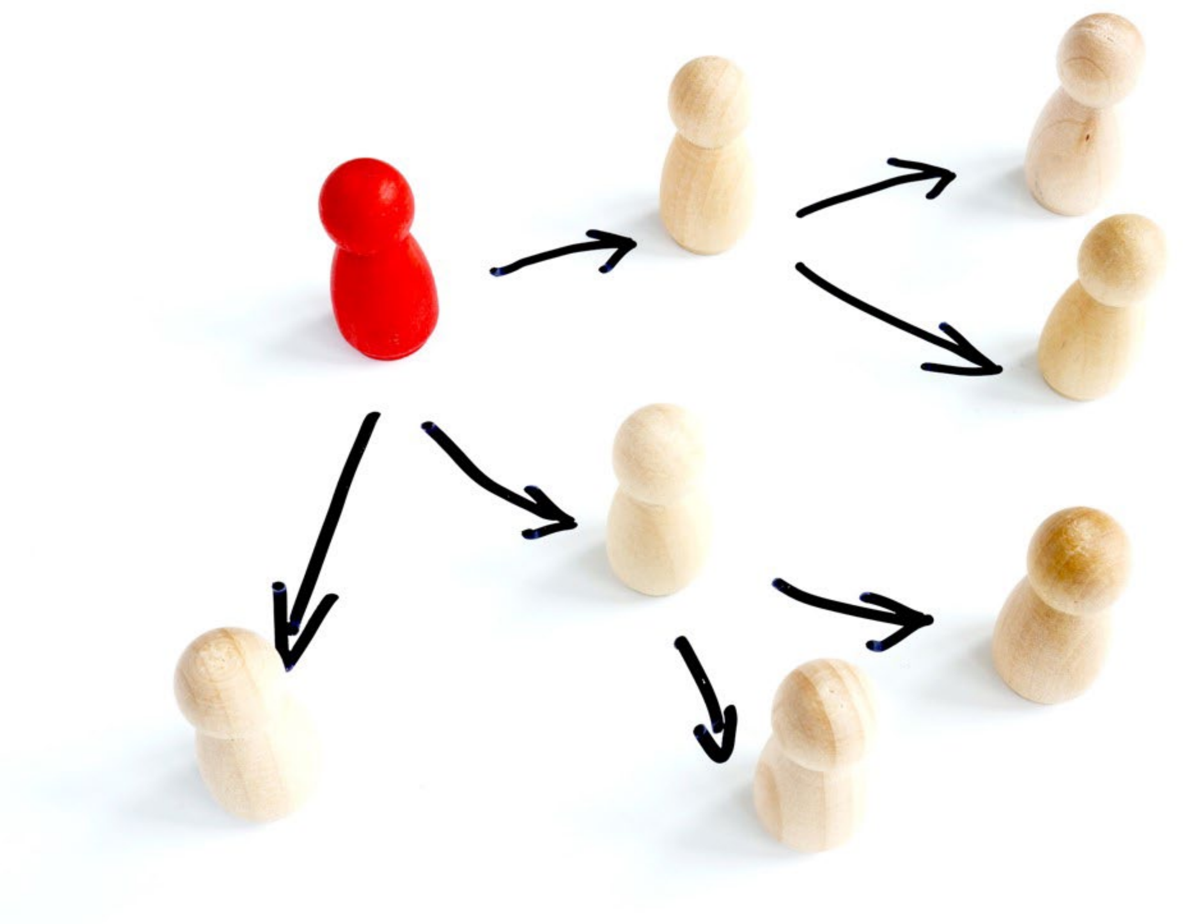
Overview

- What is a Fiduciary
- Five Basic Fiduciary Duties
- Discussion of Hypotheticals



What is a Fiduciary?

- **Definition:**
  - Restatement 3d Trusts: A fiduciary is any person who exercises discretionary authority or control over management or disposition of retirement plan assets, renders investment advice for a fee or other compensation or has discretionary authority or responsibility for plan administration.
  - Key Concept—if a person exercises any discretion over the administration or investments of a pension plan, the person is likely a fiduciary and fiduciaries must act with a very high standard of care and loyalty.

What is a Fiduciary? (cont.)

- **By definition, therefore:**
  - All CalPERS Board members and executive officers:
    - are **fiduciaries**
    - who thus owe **duties of care and loyalty**
    - to CalPERS **members and their qualified beneficiaries**
    - with respect to the **benefits due to them**
    - by **the retirement system**.

Five Basic Duties of a Public Retirement Board Fiduciary in California*

1. Duty of loyalty
2. Duty of prudence
3. Duty to diversify investments
4. Duty to assure competency of retirement system assets to pay promised benefits
5. Duty to administer plan in accordance with plan terms and applicable law

*See “cautionary note” in next slide

Cautionary Note*

- Federal, as opposed to State, case law referenced in this presentation applies fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), which govern *private sector retirement and healthcare plans.*
- CalPERS, and other governmental plans, are *exempt from* ERISA (though such plans are subject to certain tax qualification rules applicable under Internal Revenue Code section 401(a)).
- Some guidance may, however, be drawn from fiduciary analyses in cases decided under ERISA, subject to distinctions as between defined benefit and defined contribution plans, and with respect to different plan terms and other laws that may apply to California public retirement systems and not to ERISA plans.

Fiduciary Duty of Loyalty: Exclusive Benefit and Primary Duty Rules

- Under the California Constitution (Article XVI, Section 17) and the Public Employees' Retirement Law (Gov. Code sec. 20150), a fiduciary must discharge its duties:
  - Solely in the interest of, and for the exclusive purposes of providing benefits to, members (including retired members), and their qualified survivors and any other qualified beneficiaries
- Under both constitutional and statutory law, the Board's duty to its participants and beneficiaries "**shall take precedence over any other duty**." In trust law, this is referred to as the "primary duty" rule.
- Constitutional and statutory obligations of "minimizing employer contributions" and "defraying reasonable expenses" of administering the system are secondary to the primary duty.
- Note that duty to employer is not a "fiduciary" duty.

Fiduciary Duty of Loyalty

- Basically a conflict-of-interest rule—fiduciaries cannot have conflicting loyalties. A fiduciary has a duty not to use or deal with trust assets for the fiduciary's profit, the benefit of a third person, including that of the plan sponsor/settlor, or for any other purpose unconnected with the trust. (*O'Neal v Stanislaus County Employees' Retirement Association*, 8 Cal.App.5th 1184, 1209, 1218 (2017) ("*O'Neal*").)
- Putting the plan sponsor's, union's, etc. interests ahead of the overall best interests of plan participants and beneficiaries in the security of their vested retirement benefits is a **breach of a fiduciary's duty of loyalty**.

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 in the security of their CalPERS benefits.
- 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

- 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; *Estate of Bissinger*, 212 Cal.App.2d 831, 833 (no liability where trustee bank “acted reasonably, prudently, in good faith and in the exercise of its best judgment…and with the intention of being fair to both the income and remainder beneficiaries”); 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: 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.
  - For example, trustees elected by retirees/safety/general members are not an “agent” for that group of CalPERS members.

Fiduciary Duty of Loyalty: Not an "agent" for another (cont.)

- On the contrary, the California Constitution, Art. XVI, Sec. 17 (Prop. 162) seeks to prevent such political "meddling" or "interference" by others and mandates loyalty to the overall best interest of members and beneficiaries.
  - See generally *NLRB v. Amax Coal Co*., 453 U.S. 322 (1981) (no "dual loyalties"); *Hittle v. Santa Barbara CERA*, 39 Cal. 3d 374 (1985) (traditional fiduciary duties apply to public retirement system trustees); *Claypool v. Wilson*, 4 Cal.App.4th 646, 676-7 (1992) (Cal. Const., art. XVI, sec. 17 imports the existing law of trusts).

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).

Fiduciary Duty of Loyalty: Hypothetical No. 1

- Sam is a member of the Board of Administration. Sam also has been active for many years with various organizations focused on addressing homelessness challenges.
- A CalPERS active member presents to the Board in public comment, urging the Board to invest in local companies that build affordable housing.
- CalPERS' CIO previously recommended a higher allocation to real estate, with a component that includes affordable housing.
- What are, and are not, fiduciarily appropriate considerations for Sam, and other CalPERS Board members, with respect to this topic?

Fiduciary Duty of Care

- Under Article XVI, Section 17, a fiduciary must discharge its duties:
  - "With the care, skill, prudence, and diligence 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"
- Courts have interpreted the duty of prudence to be a "prudent fiduciary with experience" standard.
  - The question is whether the fiduciary, at the time it made the decision, employed the appropriate methods. (*California Ironworkers Field Pension Trust v. Loomis Sayles & Company*, 259 F.3d 1036, 1043 (9th Cir. 2001).)

Fiduciary Duty of Care: the "Prudent Fiduciary with Experience"

- Good faith is not enough.
  - An "abuse of discretion occurs when a trustee acts from an improper even though not dishonest motive, such as when the act is undertaken in good faith but for a purpose other than to further the purposes of the trust, or more specifically, the purpose for which the power was granted." (*O'Neal, supra*, 8 Cal. App.5th at p. 1209 (quoting Rest. 3d Trusts §87, com. c, p. 244).)
- Example:
  - A Board member, sympathetic to an ailing member whom the Board member knows personally and has spoken with about the situation, but whom the competent medical evidence demonstrates is not eligible for a disability retirement benefit, votes to grant the benefit.

Fiduciary Duty of Care: the "Prudent Fiduciary with Experience"

- Skill required of trustees
  - The "prudence standard is 'not that of a prudent lay person, but rather that of a prudent fiduciary with experience dealing with a similar enterprise'." *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1998) (quoting *Marshall v. Snyder*, 1 Empl.Ben. Cases (BNA) 1878, 1886 (E.D.N.Y. 1979)).
  - A fiduciary need not be the expert, but may need to consult an expert. When using experts, the fiduciary may take into consideration the advice of experts; however, the fiduciary retains ultimate liability for those responsibilities (including the selection and monitoring of the expert). (*Donovan v. Mazzola*, 716 F.2d 1226, 1235 (9th Cir. 1983).)

Fiduciary Duty of Care: Procedural Prudence

- Duty of prudence does not require a fiduciary to guarantee specific outcomes, but does requires use of a prudent process
- Sometimes referred to as "procedural prudence"—the ability to demonstrate that the fiduciary followed a prudent process in making a fiduciary decision
- Highlights the importance of documenting fiduciary considerations and decision-making
- Note, however, that substantively, a prudent decision may be neither "arbitrary" nor "capricious," and deliberations by fiduciaries should illustrate the relationship between the information presented and the action taken, if any

Fiduciary Duty of Care: Procedural Prudence

- What does procedural prudence look like?
  - Acting consistently with laws and plan governance documents, which include Board policies and procedures (and making sure the plan governance documents match each other).
  - To the extent fiduciary duty is delegated, periodic and systematic monitoring.
  - Documented decision-making
    - What did you consider?
    - Where did you get information?
    - Who did you talk to?
    - What did you conclude?
  - Agendas, staff/consultant supporting materials, minutes, and resolutions detailing facts, findings and conclusions are all ways to document procedural prudence.

Fiduciary Duty of Care: Substantive Prudence

- Skill required of trustees
  - Courts may probe the thoroughness of a fiduciary's analysis and basis for its decisions, rather than simply deferring to a determination that a fiduciary may make. See *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996), cert. denied, 520 U.S. 1237.
  - "In fulfilling his duties, a trustee is held to 'the prudent investor rule," which requires that the trustee 'invest and manage trust assets as a prudent investor would"; that is, by 'exercis[ing] reasonable care, skill, and caution," and by "reevaluat[ing] the trust's investments periodically as conditions change." *Tibble v. Edison Int'l*, 843 F.3d 1187, 1197 (9th Circ. 2016) [quoting A. Hess, G. Bogert & G. Bogert, Law of Trusts and Trustees § 684, 145-46 (3d ed. 2009) [hereinafter Bogert 3d]) Bogert 3d § 684.]

Fiduciary Duty of Care: Maintenance of Retirement System Confidential Information

- As a Board member, trustees will received confidential information of CalPERS:
  - Confidential investment information;
  - Confidential attorney-client privileged information; and
  - Confidential member, including health, information.
- Imperative that Board members not disclose that confidential information of the Board, CalPERS or a third party, and the privilege is not that of a single Board member's to waive.

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, comment d.
- 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).

Delegation of Fiduciary Duty

- "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."
  - Rest. 3d Trusts, supra (Prudent Investor Rule, § 171, adopted in 1992) (emphasis added).

Delegations by Board of Administration, Committees and Staff

- When the Board or Committees delegate their fiduciaries duties to Staff, Staff generally become fiduciaries to the extent of those delegated duties and the same standards of care set forth in Article XVI, Section 17 of the California Constitution apply to Staff when carrying out delegated fiduciary functions.
- When the duty of loyalty is delegated to third parties (e.g., investment consultant, outside counsel, etc.), each delegate has a fiduciary duty of loyalty to CalPERS but not to CalPERS members and beneficiaries.

Delegations by Board of Administration, Committees and Staff

- Effective delegation is a key component of fiduciary risk management.
  - For example, competent benefits staff do benefit calculations, not Board members.
- Appointing a fiduciary is itself a fiduciary function, thus when doing so:
  - Act solely in the overall best interest of participants and beneficiaries
  - Apply the required standard of care, skill, prudence and diligence required by the fiduciary standard 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
  - How to supervise
  - Ensure delegate has adequate information and resources
  - Ensure same standards of care and loyalty apply to delegate

Prudent Delegation

- Fiduciary responsibilities do not end with the selection of the delegate; ongoing monitoring is required as well. (See Rest. 3d Trusts §80 com. d2.)
- Ongoing monitoring of staff to whom authority is delegated, as well as service providers, is important fiduciary function
- Tools for monitoring performance of both staff and service providers:
  - Setting of objectives or benchmarks
  - Periodic reports
  - Periodic meetings
  - Addressing red flags, if any

Fiduciary Duty of Care: Examples of Pitfalls for Fiduciaries

- How have fiduciaries gotten in trouble?
  - Not doing what the laws and governance documents say
    - Governance documents should be both frequently reviewed and updated.
  - Having no record of what was considered/who was consulted
    - Fiduciaries may have consulted with experts, but if it is not in the agenda, minutes, resolutions, etc., generally does not help.

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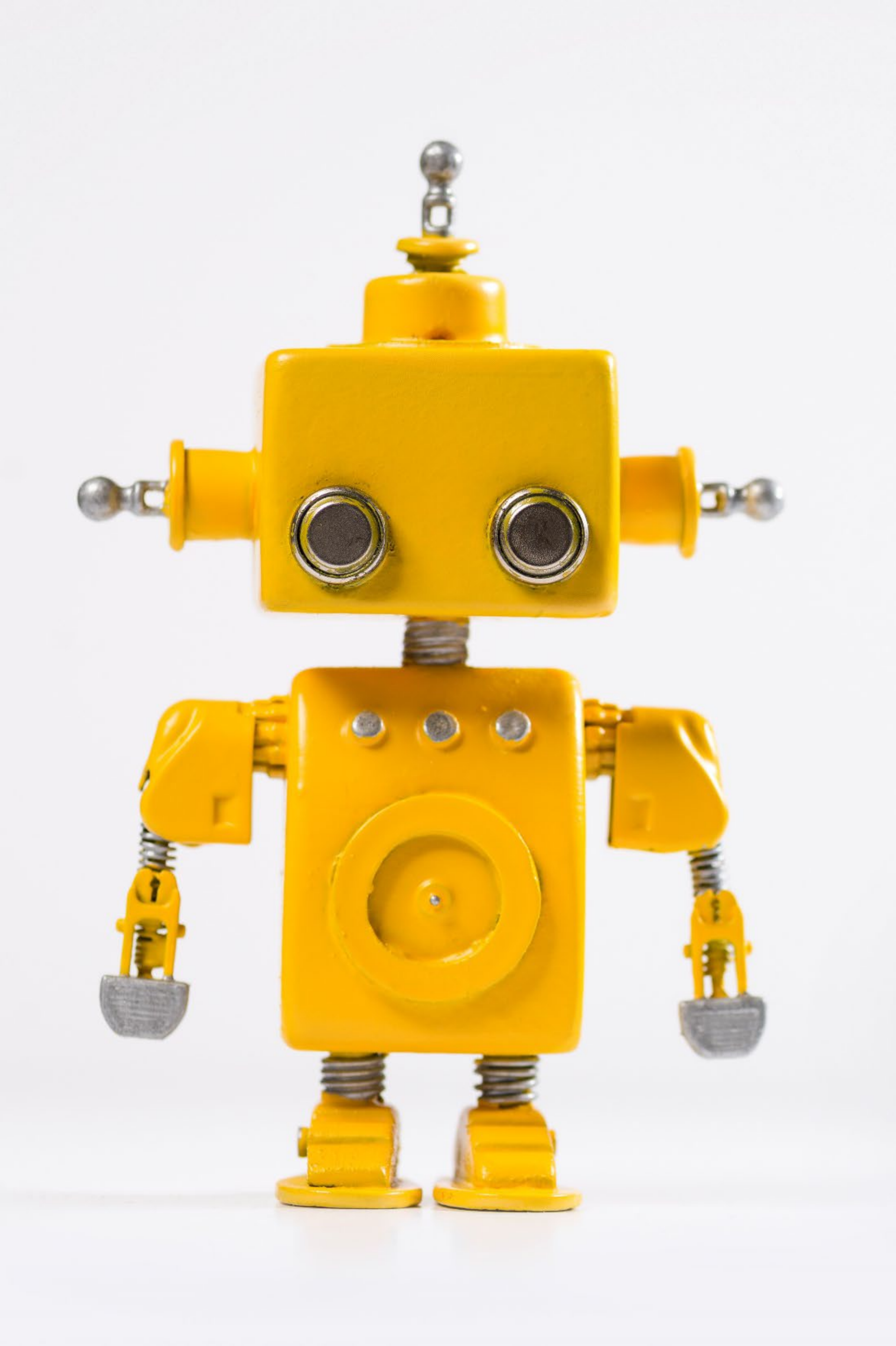
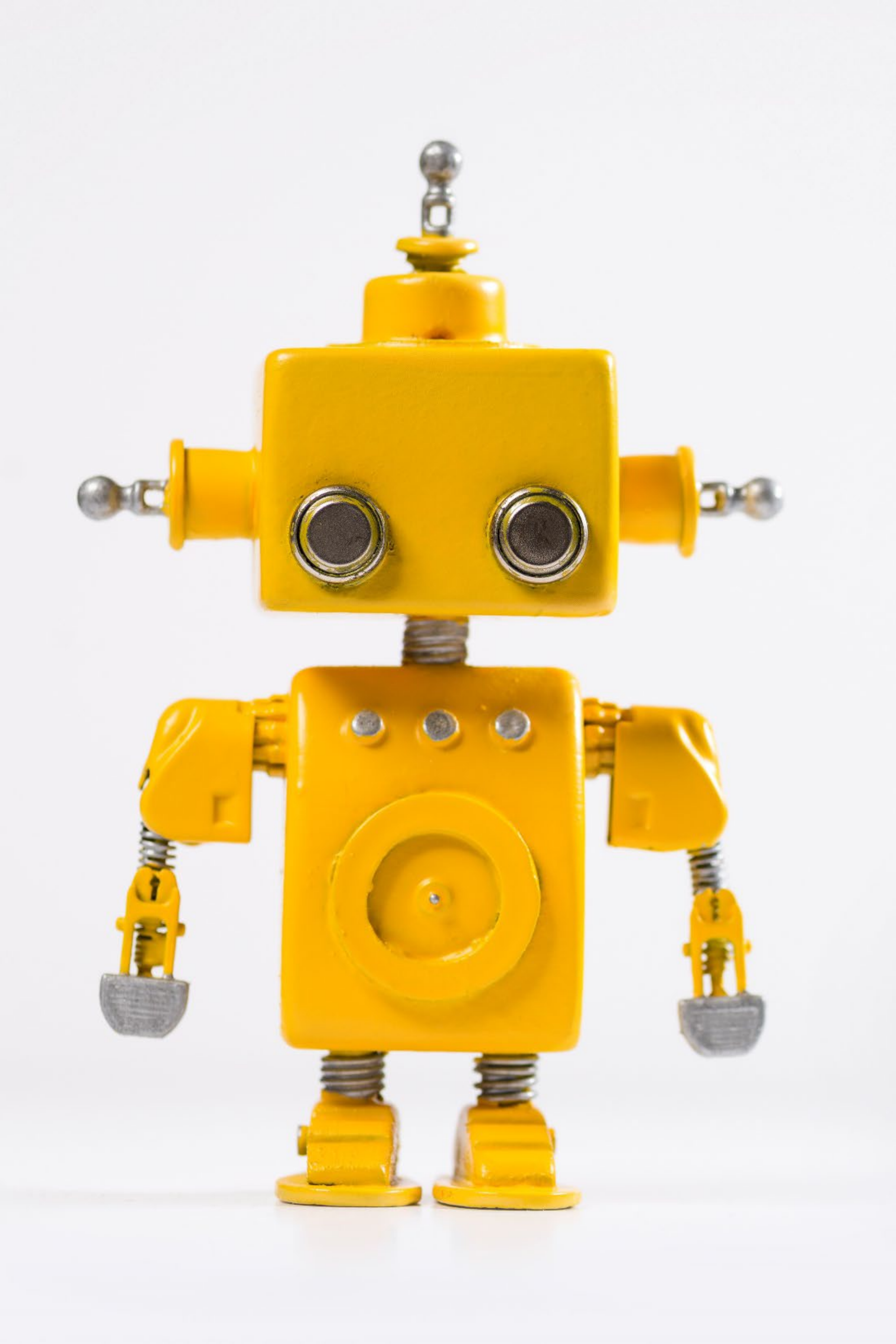
Fiduciary Duty of Care: Examples of Pitfalls for Fiduciaries

- How have fiduciaries gotten in trouble? (cont.)
  - Having no record of what decision was made
    - Even maintaining the status quo can be a fiduciary decision to be documented.
  - Having a record of the decision but the decision itself was deemed, by a court, to be unreasonable.
    - Example: Paying for retail-class fund shares when less expensive institutional-class fund share were available to the investor with no difference other than cost. (e.g., *Tibble*)
    - Example: Applying retirement plan terms in a manner that court determines breaches fiduciary duties because members were not “fully and fairly” informed of rights. (e.g., *Hittle)*), or where court disagrees with retirement system’s interpretation of law (e.g., *Nowicki*)



Fiduciary Duty of Care: Hypothetical No. 2

- Board Member Barbara became fascinated with artificial intelligence (AI) products and asked the Chief Executive Officer to speak with the Board about the potential use of AI products to interface with CalPERS members and beneficiaries.
- The CEO presented on the topic and discouraged the Board from replacing any CalPERS staff with AI products.
- The CEO explained the manner in which staff assists members and beneficiaries, as well as CalPERS management, in exercising judgment pertaining to the provision of CalPERS benefits and related services and urged the Board to weigh that benefit against the potential short-term and/or long-term expense savings of use AI products in lieu of staff.



Fiduciary Duty of Care: Hypothetical No. 2

- The Board hires an AI Consultant who advises that CalPERS could save substantial expense by replacing staff with AI products, but also noted certain risks inherent in those AI products.
- What considerations should Board members take into account with respect to this topic?

Duty to Diversify Investments

- Under Article XVI, Section 17, of the California Constitution a fiduciary must “diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.”
- Under ERISA*, the “duty to diversify is not measured by hard and fast rules or formulas. Congress has instructed that ‘[t]he degree of investment concentration that would violate this requirement to diversify cannot be stated as a true percentage, because a prudent fiduciary must consider the facts and circumstances of each case.’” (*In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 438 (3d Cir. 1996) (citing 1974 U.S. Code Cong. & Admin News 5038, 5085).)

Duty to Diversify Investments

- Diversification is generally considered based on the plan's entire portfolio.
  - Give appropriate consideration to diversification within an individual manager's mandate. (See *California Ironworkers*, 259 F.3d at 1044; In re: Unisys Sav. Plan Litig., 74 F.3d at 438.)
- Factors to be considered in ERISA* cases include "'(1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographic location; (6) distribution as to industries; [and] (7) the dates of maturity.'" (*In re Unisys Sav. Plan Litig.,* 74 F.3d at 438 quoting 1974 U.S. Code Cong. & Admin. News 5038, 5085.)

Divestment mandates?

- Statutorily-provided divestment
  - “The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.”
    - Cal. Const., art. XVI, § 17(g) (emphasis added).

Duty to Control Actuarial Services and Assure "Competency" of Assets

- Under Article XVI, Section 17 of the California Constitution, the Board:
  - "consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system."

Duty to Control Actuarial Services and Assure "Competency" of Assets

- In *O'Neal*, petitioners challenged various board of retirement decisions relating to the actuarial methodologies and transfers of funds among reserves authorized by the board of retirement.
- *O'Neal* concluded that the retirement board had not violated its fiduciary duty of care by making certain actuarial decisions that resulted in lowering the employer contribution rate (such as permitting negative amortization), though it deferred a final decision on that topic with respect to the alleged breach of the duty of loyalty (discussed further below).
  - *O'Neal, supra,* 8 Cal. App. 5th at pp. 1209, 1221, n. 10.

Duty to Act in Accordance with Plan Documents and Other Applicable Law

- Fiduciaries have a duty to administer plans in accordance with plan terms and applicable law. (See *San Diego City Firefighters, Local 145 v. Board of Administration of the San Diego City Employees' Retirement System*, 206 Cal.App.4th 594, 629 (2012).)
- "As an initial guideline, a trustee 'has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law.'" (*O'Neal, supra*, at p. 1209, quoting Rest. 3d Trusts, §76, accord, Prob. Code, §16000]")

Processes to Demonstrate Fiduciary Compliance

- Recognize that although Courts afford Board's broad discretion in decision-making, "exclusive authority" is not absolute discretion
- Avoid "abuse of discretion"
  - 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
  - Active independent actuarial oversight
  - Active independent investment oversight
  - Legal consultation and compliance with applicable law

Fiduciary Goal

- The Board and its delegees must use informed judgment and act in the overall best interest of system members/beneficiaries in a manner that is consistent with applicable laws when exercising its plenary authority over administration and investments, and its actions in that regard may not be "arbitrary" or "capricious" and must be rationally related to the information presented to the Board.

Thank you for your time

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