

Pennsylvania Fiduciary Best Practices

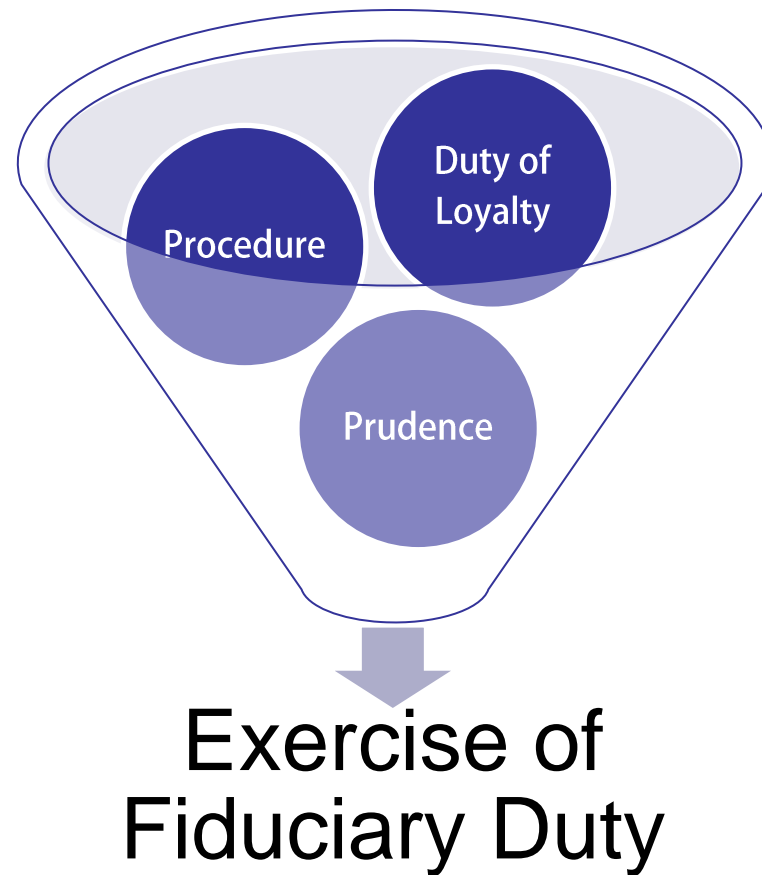
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PAPERS Forum

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Standard of Conduct – Principles



Pennsylvania Fiduciary Law – 20 Pa. Cons. Stat. § 7202(a)

“Except as otherwise provided by the governing instrument, a fiduciary shall invest and manage property held in a trust in accordance with the provisions of this chapter.”

What is my Fiduciary Duty? TO DECIDE

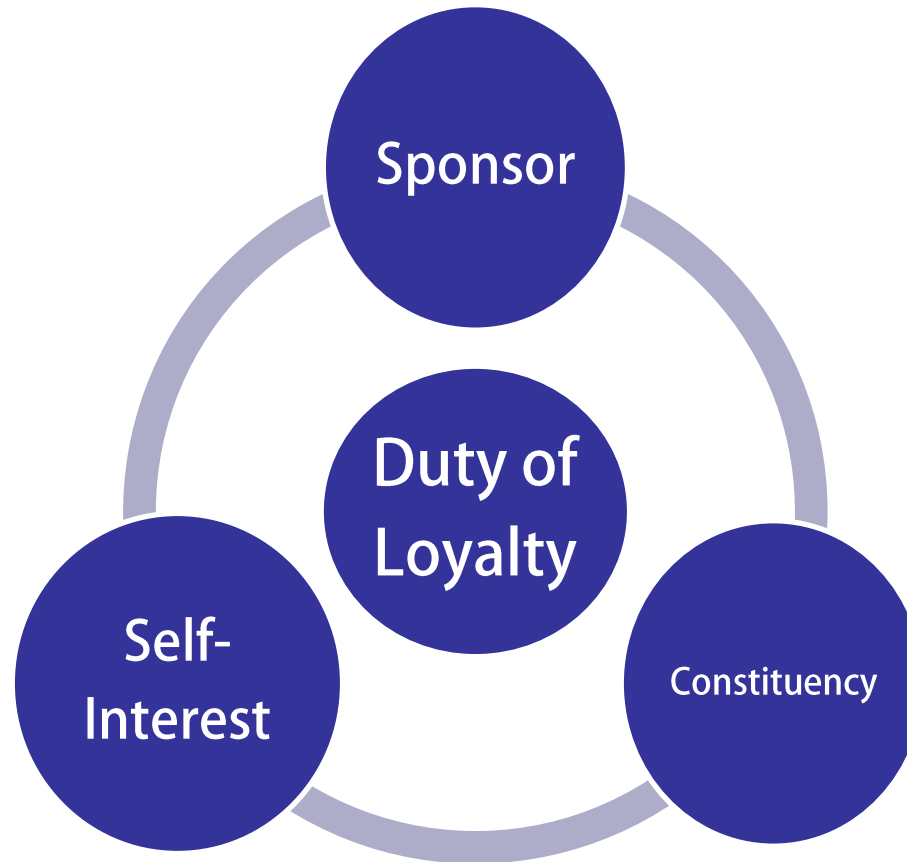
- Duty of Loyalty – Can I be objective in reaching a decision?
- Procedure – Is there a clear procedure or process to follow in making my decision?
- Prudence – Am I armed with the necessary information and/or expertise to make the decision?

Duty of Loyalty

- *“A trustee shall administer the trust solely in the interests of the beneficiaries.”*

20 Pa. Cons. Stat. § 7772(a)

**“ . . .solely in the interest of the members” –
Duty of Loyalty**



Duty of Loyalty – Members vs. Sponsor

- While a trustee may wear “two hats,” the paramount duty is to all members of the fund, not merely the entity responsible for appointment or election.
- *“In the retirement plan setting, it is important to note that this duty includes the obligation to set aside the interests of the party that appoints a trustee or fiduciary. A trustee, for example, must act solely in the interests of participants and beneficiaries and set aside any interests of a party responsible for the trustees appointment such as an employer or union.”*
- Comment to Sec. 7 Uniform Management of Public Employees Retirement Systems (“UMPERS”)

Duty of Loyalty – Members vs. Sponsor

- Duty of Loyalty encompasses a “Duty of Impartiality.” A trustee is obligated to act in the best interest of all members not merely those responsible for a Trustee’s appointment.
- Typical conflicts: Retirees vs. actives; Bargained vs non-represented; Public safety vs. non-uniformed.
- Duty of impartiality would not prohibit a designated trustee from voicing the concerns of the Sponsor; however, trustee’s exercise of fiduciary power must be on behalf of all members.

Duty of Loyalty – Members vs. Sponsor

- The Duty of Loyalty is particularly significant when a decision involves the governmental sponsor. The Duty of Loyalty would prohibit a transaction in which the primary objective is the financial need of the sponsor rather than the benefit requirements of the participants.
- Duty may arise in connection with decisions regarding manager selection or investments. (e.g. investing in bond paper; loan of operating funds).

Duty of Loyalty – Members vs. Sponsor

- Internal Revenue Code Section 503(a) provides that a governmental plan may lose its tax qualified status if it is deemed to have engaged in a “prohibited transaction” as defined in IRC Section 503(b).

Any such transaction could provide a basis for the IRS to revoke the tax qualified status.

Duty of Loyalty – Members vs. Sponsor

- Generally, a prohibited transaction is a transaction between the plan and the governmental sponsor which involves:
 - Loan of assets to sponsor.
 - Purchase of securities or other property for more than adequate consideration.
 - Selling substantial securities or other property for less than adequate consideration.
 - Any other transaction which results in a diversion of trust assets.

Duty of Loyalty – Member vs. Self

Conflict of Interest Transactions

- A sale, purchase, exchange, encumbrance or other disposition of property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with:
 - (1) the trustee's spouse;
 - (2) the trustee's parent or a spouse of the parent;
 - (3) a descendant of the trustee's parent or a spouse of the descendant;
 - (4) an agent of the trustee unless the trustee is a corporation and the agent is an affiliate of the corporation or the transaction is authorized by section 7209 (relating to mutual funds);
 - (5) a corporation or other person or enterprise in which the trustee or a person that owns a significant interest in the trustee has an interest that might affect the trustee's judgment, but this paragraph does not apply to an affiliate of a corporate trustee or to a transaction authorized by section 7209; or
 - (6) the trustee personally.
- 20 Pa. Cons. Stat. § 7772(c)

Duty of Loyalty – Member vs. Self

“A transaction concerning trust property in which the trustee engages in the trustee’s individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.”

20 Pa. Cons. Stat. § 7772(e)

Procedure

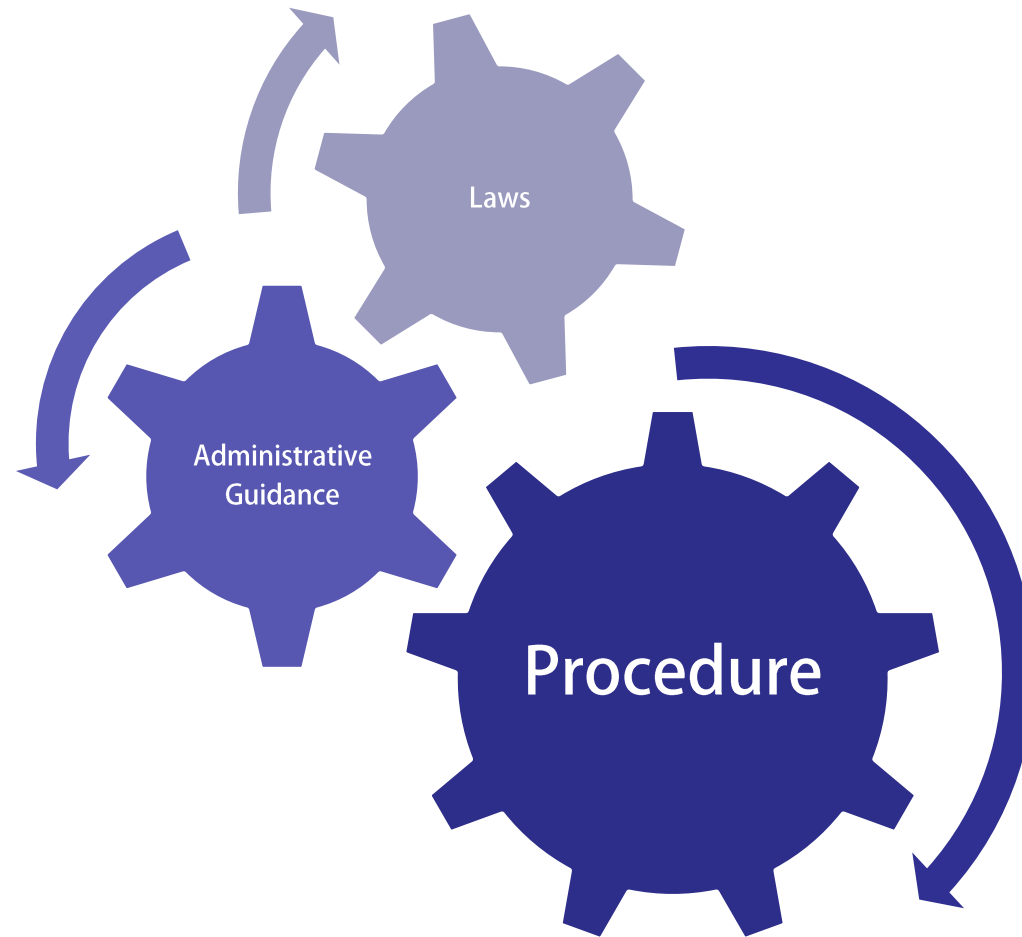
- *“Except as otherwise provided by the governing instrument, a fiduciary shall invest and manage property held in a trust in accordance with the provisions of this chapter.”*

20 Pa. Cons. Stat. § 7202(a)

- *“[A] fiduciary shall discharge his duties with respect to the plan . . . in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions [of ERISA or the Internal Revenue Code].”*

ERISA Section 404(a)(1)(D)

“...as required by law” – Procedure



Procedure – Adherence to Process

- *“A fiduciary who discharges her duties prudently and with a good-faith belief that her actions are in compliance with the law does not violate this paragraph, even if a court later determines that the course of conduct was not in compliance with the law.”*

Comment to Sec. 6 UMPERS

- Procedure focuses on the process of making fiduciary decisions, not necessarily the results. Establishing that **the process of the decisions** was in accord with stated guidelines can overcome an adverse outcome stemming from such decision.

Procedure – Adherence to Process

20 Pa. Cons. Stat. § 7213

- “The rules of this chapter are standards of conduct and not of outcome or performance. Compliance with the rules of this chapter shall be determined in light of the facts and circumstances prevailing at the time of the fiduciary’s decision or action and not by hindsight. **A fiduciary is not liable to the extent the fiduciary acted in substantial compliance with the rules of this chapter or in reasonable reliance on the terms and provisions of the governing instrument.** A fiduciary’s investment and management decisions respecting individual assets shall be considered in the context of the trust portfolio as a whole and as part of an overall investment strategy, and not in isolation. No specific investment or course of action, taken alone, shall be considered inherently prudent or imprudent.”

Procedure – Laws

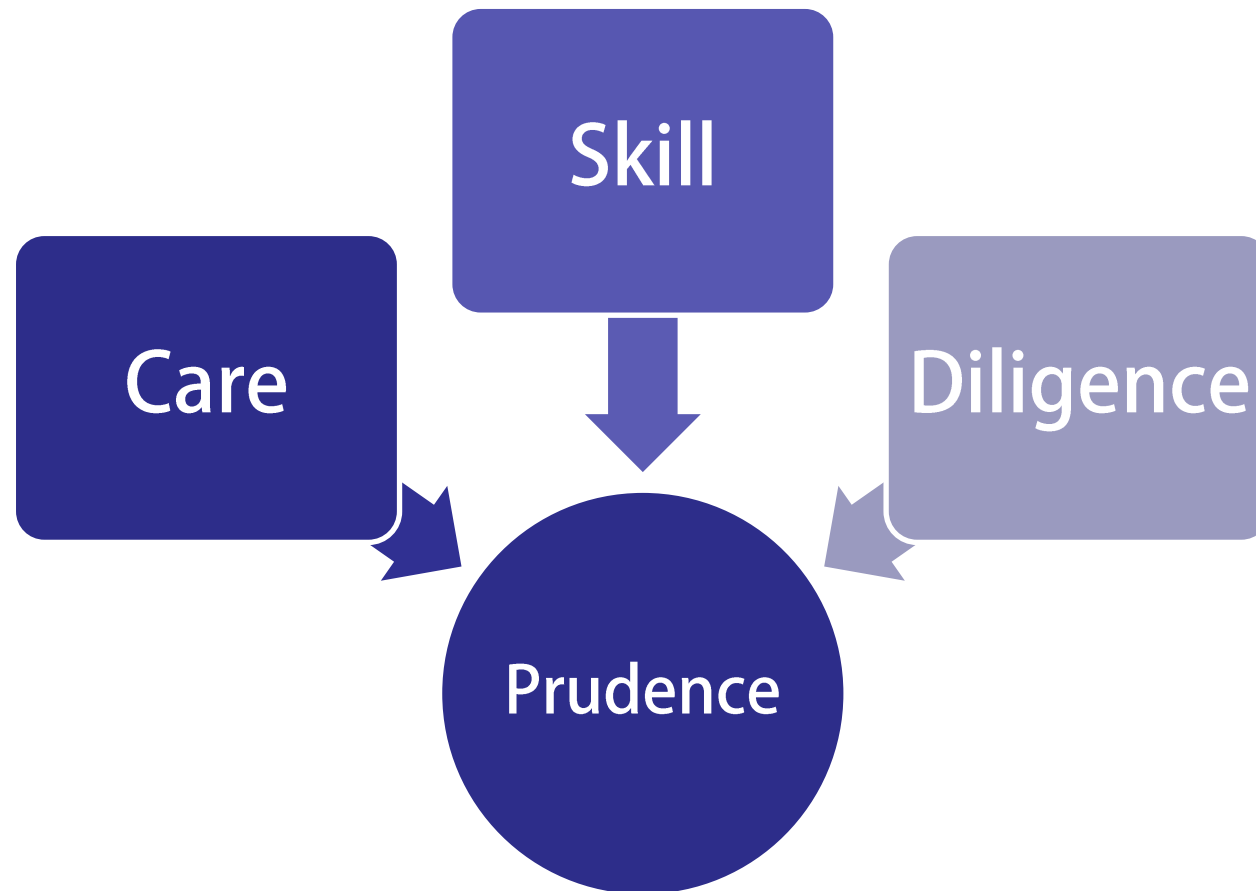
- The “plan document” is effectively a collection of laws and rules that together form the plan guidelines:
 - The Pennsylvania State Constitution
 - Pennsylvania Code Title 20
 - Right to Know & Sunshine Laws - 65 Pa.C.S. § 67.101, 701 et seq.
 - Public Employees Pension Forfeiture Act (“Act 140”)
 - The Internal Revenue Code of 1986
 - “Plan Document” (either standalone or by the statute)

Procedure – Plan Document

- Governance Manual
 - Trustee, Committee and Executive Director Charters
 - Board Operations Policy
 - Communications Policy
- Adopted Actuarial Assumptions
- Statement of Investment Policy

It is critical that the Board's meeting records reflect fidelity to these policies in both form and spirit. If they can't be followed, they should not be adopted.

“ . . .with the care, skill, prudence, and diligence . . .that a prudent person acting in like capacity and familiar with such matters would use”



Prudence

- *“A fiduciary shall exercise reasonable care, skill and caution in making and implementing investment and management decisions. A fiduciary who represents that he has special investment skills shall exercise those skills.”*

20 Pa. Cons. Stat. § 7212

- *“[A] fiduciary shall discharge his duties. . .with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.”*

ERISA Section 404(a)(1)(B)

“A pure heart and empty head are not enough. . .”

Donovan v. Cunningham, 716 F.2d 1455,1467 (5th Cir. 1983)

Prudence Standard – Pennsylvania Prudent Investor Rule

- *“A fiduciary shall invest and manage property held in a trust as a prudent investor would, by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust.”*

20 Pa. Cons. Stat. § 7203(a)

Prudence Standard

- *“...A fiduciary’s investment and management decisions respecting individual assets shall be considered in the context of the trust portfolio as a whole and as part of an overall investment strategy, and not in isolation. No specific investment or course of action, taken alone, shall be considered inherently prudent or imprudent.”*

20 Pa. Cons. Stat. § 7213

- *“Fiduciaries should be evaluated, not against a single prudent expert, but in terms of the actions of prudent fiduciaries for other similar systems facing similar circumstances.”*

Comment to Sec. 7(3) UMPERA

Prudence – Standard

- “. . .*as a prudent investor would. . .*” The trustee must be prudent and informed. It **does not** require that the trustee act as would an “expert.” However, the standard does require a baseline of knowledge, experience and familiarity.
- Trustees *must* remain informed on investment options and strategies, even if certain investment management functions are delegated to others.

Prudence – Delegation of Duties

- *“A fiduciary may delegate investment and management functions that a prudent investor of comparable skills might delegate under the circumstances.”*

20 Pa. Cons. Stat. § 7206(a)

Prudence – Delegation of Duties

- Delegation is perhaps the most significant fiduciary duty as the selection of investment managers and consultants is effectively the delegation of the Commission’s investment authority.
- In the ERISA context, delegation is required of a fiduciary:
 - *“Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.”*

DOL Reg. Section 2509.95-1(c)(6).

Prudence – Delegation of Duties

- *“A fiduciary shall not be responsible for the investment decisions or actions of the investment agent to which the investment functions are delegated if the fiduciary exercises reasonable care, skill and caution in selecting the investment agent, in establishing the scope and specific terms of the delegation and in reviewing periodically the investment agent’s actions in order to monitor the investment agent’s performance and compliance with the scope and specific terms of the delegation.”*

20 Pa. Cons. Stat. § 7206(b)

Prudence – Selecting the Delegate

- Section 6 of the UMPERSA divides the delegation process into three discrete obligations:
 - Selection of the delegate;
 - Establishing the scope and terms of the delegation, consistent with the purpose and terms of the plan; and
 - Periodically reviewing the delegate’s performance and compliance with the terms of the delegation.

Prudence – Selection of Delegate Duty of Loyalty

- The threshold issue in the evaluation of a potential delegate is whether it is sufficiently independent to maintain a duty of loyalty. Key questions:
 - Does compensation vary depending upon advice?
 - Does potential delegate receive ancillary benefits as a result of certain recommendations?
 - Has delegate fully disclosed other relationships that may benefit from its engagement?
 - Can the delegate give unfettered advice?
 - Does the delegate have “clean hands”?

Prudence – Selection of Delegates Procedure

- Strong procedures in the selection process will insulate a fiduciary even if a delegate performs poorly. Beginning with the identification stage, the selection of a delegate must follow an established protocol which should include:
 - RFP or RFQ: A process which will disclose the needed services and identify potential delegates.
 - In-Person interviews.
 - Post interview deliberation by the Pension Board and any advisor assisting in the selection process.
 - Documentation of basis for the decision.

Prudence – Selection of Delegates Procedure

- Experience: Length of time in business, and specific experience and educational credentials of the persons who actually will be providing the services.
- Costs: Absolute transparency in the disclosure of costs and fees.
- References: Beginning with the advisor recommendation, but also verification of clients and current status of client relationships.
- Qualifications: Check to ensure the consultants and providers are qualified and maintain appropriate registrations.
- Contracting: Agreements should be unambiguous on “the break-up provisions,” termination, indemnity, liability, dispute resolution.

Prudence – Diversification of Investments

- *“Except as provided in section 7205 (relating to retention of inception assets), a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.”*

20 Pa. Cons. Stat. § 7204(a)

Prudence – Applicability regarding Diversification of Investments

- The Diversification of Investments does not apply to any of the following:
 - (1) A trust which became irrevocable prior to December 25, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.
 - (2) A trust created by a revocable instrument executed prior to December 25, 1999, if such instrument is not amended after December 24, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.

20 Pa. Cons. Stat. § 7204(b)

- The Trustees, with the assistance of its investment advisors must monitor the collective investments to assure compliance with the Investment Policy.

Prudence – Diversification

- Social Investing
 - Long a component in public plans, the debate intensified with US DOL release of Interpretative Bulletin 94-1 addressing “economically targeted investments.”
 - IB 94-1 defined economically targeted investments “*as investments selected for the economic benefits they create apart from their investment return to the employee benefit plan*”.

For ERISA purposes, an ETI is not a prudent investment if it provided the benefit plan with a lower rate of return than other available investments with commensurate or lower degrees of risk.

Prudence – Diversification

- Pennsylvania Law “tips the scale” in permitting “affirmative” and “negative” forms of Social Investing:
 - *“The board may, when possible and consistent with its fiduciary duties imposed by this subsection or other law, including its obligation to invest and manage the fund for the exclusive benefit of the members of the system, consider whether an investment in any project or business enhances and promotes the general welfare of this Commonwealth and its citizens, including, but not limited to, investments that increase and enhance the employment of Commonwealth residents, encourage the construction and retention of adequate housing and stimulate further investment and economic activity in this Commonwealth. The board shall, through the Governor, submit to the General Assembly annually, at the same time the board submits its budget covering administrative expenses, a report identifying the nature and amount of all existing investments made pursuant to this subsection.”*
- 24 Pa. Cons. Stat. § 8521(e)
- By contrast, the Sudan and Iran divestment mandates prohibit investment in “scrutinized companies” regardless of economic worth.