

MONTANA

BOARD OF INVESTMENTS

SPECIAL BOARD MEETING

Zoom Conference

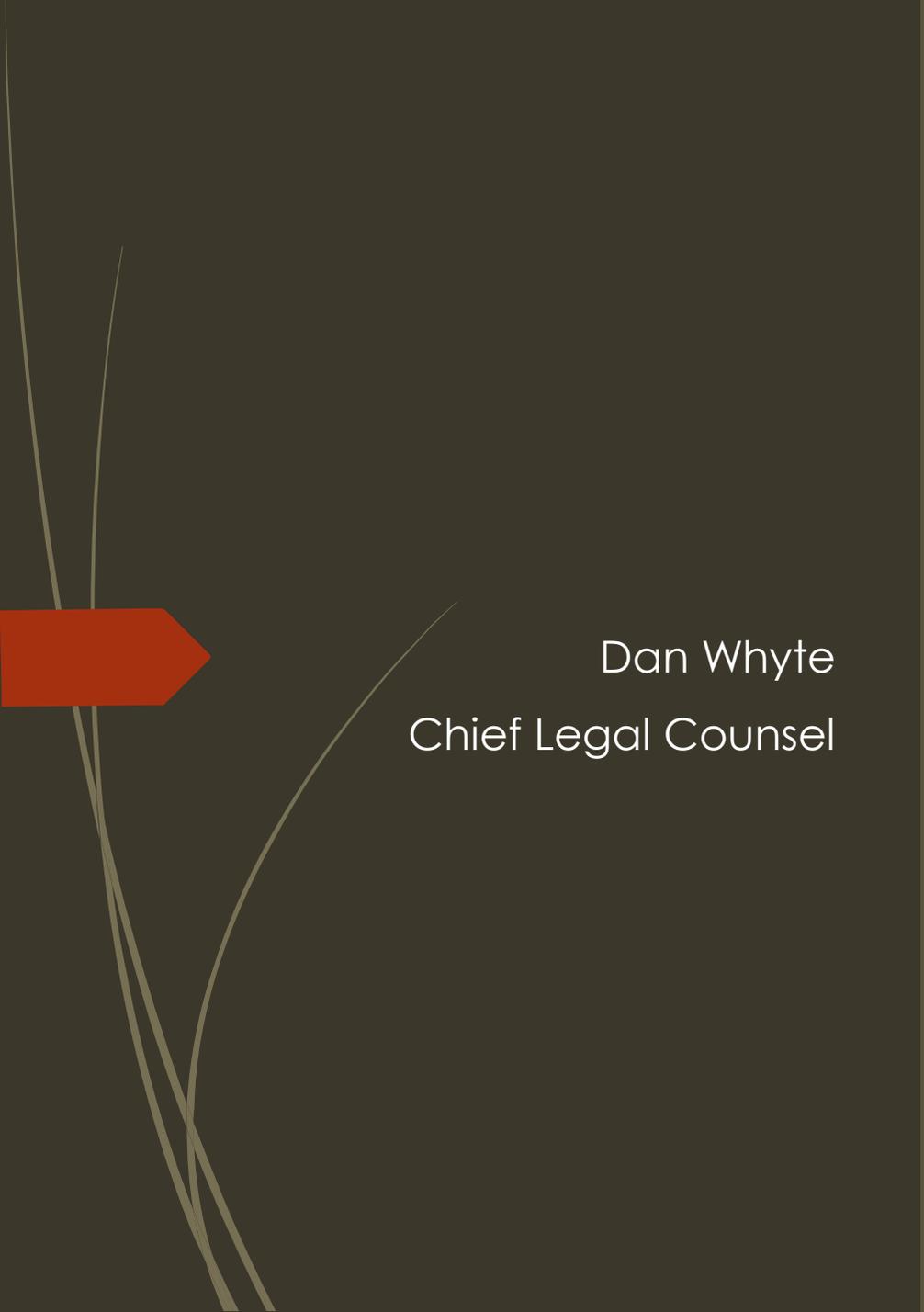
March 23, 2021

10:00 am – 12:00 pm

AGENDA

CALL TO ORDER – Karl Englund, Board Chairman

1. Notice of Video/Audio Recording
2. Roll Call
3. Public Comment – *Public Comment on issues with Board Jurisdiction*
4. Administrative Rule Hearing RE: MAR Notice 8-97-100
5. Request for Proposals – Custodial Bank - **Decision**
6. Fiduciary Duty Training – Dan Whyte, Esq
7. Adjournment



MONTANA BOARD OF INVESTMENTS

Dan Whyte
Chief Legal Counsel

FIDUCIARY DUTY

BASIC TERMINOLOGY

- Plan sponsor
 - State, county, or city that created the pension fund, trust, or other plan
 - Establishes the benefit structure and terms of the plan
- The plan sponsor
 - The Constitution and Legislature
- Plan documents
 - State or local laws governing the plan
- Beneficiary
 - Receives money from the pension or trust
- Trustees
 - Those elected or appointed to oversee the management of assets and payment of benefits in accordance with the plan documents
 - Whenever there is a trust there must be at least one trustee
 - Some trustees may be “ex-officio” members of the board, serving by virtue of the office they hold
 - All trustees are fiduciaries, without exception
 - Others may be fiduciaries as well

FIDUCIARY DUTY HISTORY

- ▶ Fiduciary law stems from the common law of trusts
 - Hundreds of years old, starting in England
 - Developed by the courts over time
 - Applied to family, business, and charitable trusts even before pension funds
- ▶ ERISA (1974), a federal law, clarified trust law as it applied to private sector pension funds
- ▶ Technically, ERISA does not apply to public pension funds, but it is influential in providing guidance about how fiduciaries should act

FIDUCIARY RESPONSIBILITY

A “fiduciary duty” is the highest duty of trust and confidence that one person may owe to another.

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

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

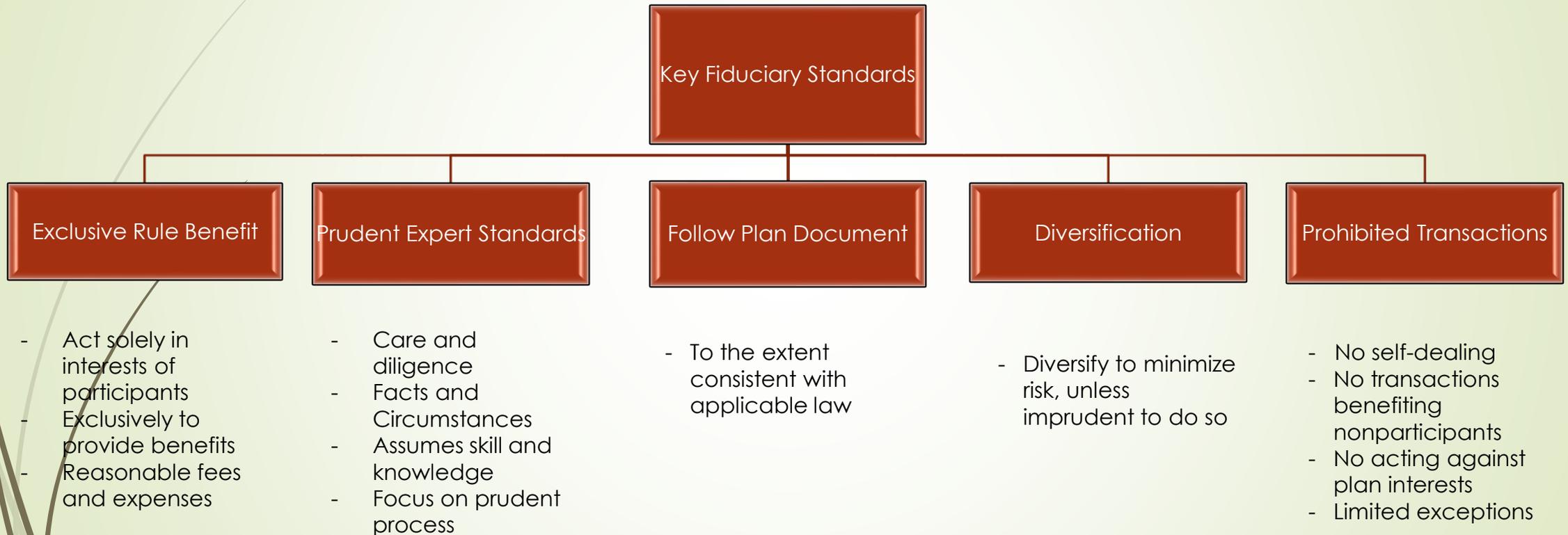
The 9th Circuit has indicated with respect to fiduciary duties that “These duties are the highest known to the law.”

Howard v. Shay, 100 F.3d 1484, 1488 (9thCir. 1996).

LEGISLATIVE V. FIDUCIARY ACTIONS

- ▶ Who is a fiduciary is a functional test
- ▶ An individual may have two roles – as a board member and an official or employee of the plan sponsor, such as *ex officio* legislative members
- ▶ The Legislature is the entity that decides to adopt a pension or plan in the first place and determines what benefits will be provided
- ▶ Examples of legislative functions
 - Choosing to create a trust and the options available in that trust
 - Amending a trust, including changing or eliminating trust benefits/options
- ▶ Examples of fiduciary functions
 - Managing the plan
 - Controlling plan assets
 - Administering benefits
- ▶ Awareness of which role you perform is critical
- ▶ Trust assets cannot be used for costs relating to legislative purposes (e.g., accounting requirements imposed on employer, plan design, etc.)
 - Costs of implementing legislative decisions may be payable from the plan

FIDUCIARY STANDARDS



FIDUCIARY STANDARDS (CONT.)

- ▶ Duty of Loyalty – Solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, and defraying reasonable expenses of administering the plan
- ▶ Duty of Prudence – “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.”

Section 17-6-201(1)(a), MCA



DUTY OF LOYALTY

- ▶ A fiduciary shall discharge his duties with respect to the plan solely in the interest of members and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan
- ▶ Trustees are challenged more regarding the duty of loyalty than with anything else – conflicts of interest frequently arise
- ▶ Solely does not mean primarily – no balancing test
- ▶ Exclusive purpose is the “exclusive benefit rule”
- ▶ “Wearing only one hat” is required
 - Complete loyalty
 - Undivided loyalty
 - An eye toward a single purpose
 - Unwavering duty of loyalty to beneficiaries



DUTY OF
LOYALTY --
LOYALTY TO
WHOM

- ▶ No fiduciary duty is owed to the plan sponsor or participating employers
 - They are “customers,” not beneficiaries
- ▶ No fiduciary duty is owed to a group of union members or “constituents”
 - An association or union may have a duty to a much smaller group of members
 - A statewide elected official may owe a duty to a much larger group, the citizens of the state
- ▶ No fiduciary duty is owed to the Legislature
 - It is the creator (settlor), not the beneficiary of the pension or trust
- ▶ No fiduciary duty is owed to the Governor
 - The Governor administers the state budget but does not oversee or control the plan



DUTY OF
LOYALTY --
LOYALTY TO
WHOM
(CONT.)

- ▶ No fiduciary duty is owed to the County Executive or County Commissioners
 - The Executive's duty is to a much larger group, the entire population of the county
- ▶ No fiduciary duty is owed to taxpayers
 - However, the duty to incur only reasonable costs exists
- ▶ If no fiduciary duty, then what duty is owed to these groups?
 - Duty to employ good governance - transparency and accountability
 - Open meetings
 - Communication

DUTY OF PRUDENCE

- ▶ “The test of prudence is one of conduct and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment and not whether his investment succeeded or failed.”

Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir.1983); *Austin v. Union Bank & Trust Co.*, 2016 U.S. Dist. LEXIS 43454, 22-23

DUTY OF PRUDENCE

- ▶ The duty of prudence requires more than a good faith attempt to do the right thing
- ▶ The duty requires that trustees and other fiduciaries act with the care, skill, and diligence used by others acting in the same capacity
- ▶ It requires pure, thorough, and scrupulous processes in all decision-making
 - Understand the facts
 - Investigate the options
 - Seek expert advice if you are not an expert, and question those experts if their advice is not clear
- ▶ The duty of prudence is an ever-evolving standard that keeps getting higher and higher

DUTY OF PRUDENCE (CONT.)

- ▶ When times are tough, public pension boards are more closely scrutinized by the media, the membership, politicians, and the general public
- ▶ If a board is accused of imprudent behavior, a good process is more important than a good outcome and is the best defense to potential liability; board members are judged by the prudence of their process
- ▶ In order to show that a board member acted prudently, written documentation is critical
- ▶ You are not expected to be perfect; you are expected to be prudent

DUTY TO FOLLOW THE LAW AND PLAN DOCUMENTS

- ▶ In many public pension plans, the “plan documents” are the laws establishing the governance framework, benefits, investments, and administration of the plan
- ▶ Sometimes there are other written materials that are also considered plan documents
- ▶ Fiduciaries cannot be arbitrary and capricious in their application of applicable laws or plan documents
- ▶ Fiduciaries have a duty to comply with the plain meaning of provisions in a fair and impartial manner
- ▶ In doing so, they must consider:
 - Plan or trust provisions
 - Statutes, rules, and ordinances
 - Federal laws
 - Legal opinions
 - Common law concepts

FIDUCIARY LIABILITY

▶ Fiduciary liability and Statutory Immunity

– Section 2-9-305, MCA

- “It is the purpose of this section to provide for the immunization, defense, and indemnification of public officers and employees civilly sued for their actions taken within the course and scope of their employment.”
- If act outside of the course and scope then individual liability may apply
- No claims for exemplary or punitive damages

– Loss of reputation

– Criminal actions

▶ Co-Fiduciary Liability

- If you know of another’s fiduciary breach and you do nothing about it, you are breaching your fiduciary duty
- For liability to attach you must have actual knowledge of an action you know to be a breach
- The courts have said that fiduciaries have a duty to speak up and try to prevent or remedy the breach
- Resignation from the board is not sufficient

PROTECTIONS FROM LIABILITY

External Protections

- Sovereign or governmental immunity, where available
- Indemnification
- Fiduciary liability insurance – tort claims protection

Prudence Processes as Protections

- Have sound written policies
- Demonstrate that a prudent process was followed
 - Preparation for meetings
 - Good advice from true experts
 - Thorough documentation
- Verify compliance
- Require ongoing education
- Establish a culture of adherence to the highest ethical standards
- Avoid conflicts of interest



CHECKLIST OF COMMON AND BEST PRACTICES TO MITIGATE FIDUCIARY RISK



CHECKLIST OF COMMON AND BEST PRACTICES TO MITIGATE FIDUCIARY RISK

- ✓ Establish and document prudent processes
- ✓ Maintain a good governance structure
 - A thorough decision-making processes
 - Rigorous risk identification and management
 - Ensure roles and responsibilities are clearly defined and understood
- ✓ Perform on-going oversight
- ✓ Establish appropriate reporting and disclosure
- ✓ Follow established processes
- ✓ Periodically review procedures and processes, and, if needed, revise
- ✓ Offer orientation and continuing education
- ✓ Obtain independent expert advice – law, actuarial, benefits, investments, audits



CHECKLIST OF COMMON AND BEST PRACTICES TO MITIGATE FIDUCIARY RISK (CONT.)

- ✓ Understand the investment options offered
- ✓ Monitor investments once made
- ✓ Become familiar with the qualifications and reputation of the key service providers
- ✓ Monitor transaction costs
- ✓ Make sure your service provider contracts provide for indemnification
- ✓ Read and be familiar with the law, rules, regulations and key policy documents governing the plan
- ✓ Require transparency and accountability
 - Increase communications to stakeholders
 - Benchmark operations to best practices
 - Conduct board self-evaluations
 - Adopt a culture of good governance
- ✓ Diligently attend all board and committee meetings



CHECKLIST OF COMMON AND BEST PRACTICES TO MITIGATE FIDUCIARY RISK (CONT.)

- ✓ Prepare for meetings
- ✓ Seek indemnification
- ✓ Require ongoing education
- ✓ Avoid conflicts of interest
 - If avoidance is impossible, disclose the conflict promptly and manage it to the best of your ability
- ✓ Adopt a culture that promotes the highest ethical standards
 - Adopt a Code of Conduct
 - Institute an Ethics Officer function
- ✓ Establish an internal control framework
 - Audit Committee
 - Internal Audit function
- ✓ Review on a regular basis the efficiency and effectiveness of the system's success in meeting its goals, including assessing the performance and actions of service providers, such as investment managers, consultants, and actuaries
- ✓ Conduct an annual Board self-assessment

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FUNCTIONING AS A FIDUCIARY IN THE FACE OF POLITICAL PRESSURES

WHAT IS THE APPROPRIATE ROLE OF A BOARD IN THE POLITICAL PROCESS?

Neutral Administrator

Follow the statutory parameters as established

Advisor or Educator

Give costs and implications of benefit changes, but offer no recommendations

Protector

Oppose legislation when the actuarial stability of the system is threatened

Innovator

Design and recommend changes to benefits and funding sources

Advocate or Activist

Lobby for changes in state laws to sustain the system; lobby against illegal or ill-advised proposed changes



HOW TO ADDRESS POLITICAL SITUATIONS





WHAT TO EXPECT IN HARD POLITICAL TIMES?

- ▶ Being blamed because the general public thinks the Board sets the benefits
- ▶ Being ridiculed for not making more money for the Funds
- ▶ Being portrayed in the media as an organization you would never want to be associated with
- ▶ You should also expect . . .
 - Longer board meetings
 - Increased preparation time
 - Some angst among usually collegial board members
 - Tension among board, staff, and others

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Remember	Remember the difference between legislative and fiduciary functions
Act in	Act in good faith and in the best interest of the system participants and beneficiaries
Act with	Act with prudence and reasonable care
Seek	When in doubt, seek the advice of experts – investments, legal, etc.
Maintain	Maintain independence and objectivity by, among other actions, avoiding conflicts of interest, refraining from self-dealing, and refusing any gift that could reasonably be expected to affect your duty of loyalty
Abide by	Abide by all applicable laws, rules, and regulations, including the terms of the system's plan documents



SUMMARY OF KEY POINTS