

Fiduciary Challenges in an Evolving Legal Landscape

CalPERS Board of Administration Offsite Workshop

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What's “Evolving” About the Public Retirement Legal Landscape?

- For starters
 - Legislative efforts to mandate lower and/or more restrictive retirement benefits
 - Ensuing litigation and court decisions; upholding some of those efforts...

What's “Evolving” About the Public Retirement Legal Landscape?

■ Investments

- Legislative efforts to achieve greater transparency into fees, expenses and returns from alternative investment funds into which public pension plans invest
- Pushback and rejection of public pension plans as investors by certain managers
- Retirement plans seek to balance various interests to ensure successful investment program

What's “Evolving” About the Public Retirement Legal Landscape?

■ Others

- Grand jury and public critiques of retirement system funding, which are described in certain court decisions and used as a rationale to bring more suits
- Retirement boards seek to address funding challenges

What's “Evolving” About the Public Retirement Legal Landscape?

- In addition
 - Continuing pressure to meet investment return assumptions
 - Greater emphasis on private investment market allocations and transactions
 - Investments in asset classes considered to have more risk but greater returns
 - Increased tolerance for less LP-friendly fund terms

Fiduciary Challenges Related to Pension Reform Litigation

- What's happening now?
 - Challenges to plan sponsor's adoption of enhanced benefit formulas and attempts to unwind them
 - *Luke* (Sonoma CERA), *Brown* (Marin CERA)
 - Challenges to constitutionality of PEPRA provisions impacting future benefit accrual rights
 - *Cal Fire* (CalPERS), *MAPE* (Marin CERA), *Coordinated Proceedings* (Alameda, Contra Costa, Merced CERAs)

Fiduciary Challenges Related to Pension Reform Litigation

- More pending litigation
 - Challenges to retirement board's management of reserves (Excess Earnings and/or SRBR)
 - *O'Neal* (Stanislaus CERA), *Miller* (San Joaquin CERA)
 - Challenges to retirement system/board's determinations of compensation earnable and/or pensionable compensation
 - *SJCCOA v. County* (San Joaquin CERA)

Fiduciary Challenges Related to Pension Reform Litigation

- Even more pending litigation
 - Challenges to felony forfeiture implementation
 - *Hipsher* (Los Angeles CERA), *Wilmot* (Contra Costa CERA), *Shafiee* and *Bustamante* (Orange County ERS)
 - Challenges to changed/closed DB plan
 - *Boling v. PERB* (San Diego City ERS)
 - Challenges to retirement board's interpretation of Charter amendment that court of appeal determined was partially unconstitutional
 - *City v. SFERS Board* (San Francisco ERS)

Fiduciary Challenges Related to Pension Reform Litigation

- Litigation in other states
 - Illinois
 - Oregon
 - Colorado

What's a Board to Do in the Context of Pension Reform Litigation?

- Roles of the Board

- Plan sponsor legislation or ordinance
 - Administrator who implements legislation/ordinance
 - Trusted information provider
 - Passive observer
 - Advocate
 - Policy considerations?
 - Fiduciary and exclusive benefit issues

What's a Board to Do in the Context of Pension Reform Litigation?

- Roles of the Board
 - Litigation
 - Necessary party
 - Passive role
 - Advocate
 - Member education
 - Intervenor if not named?
 - Declaratory relief?

What's a Board to Do in the Context of Pension Reform Litigation?

- Roles of the Board
 - Administration in context of dispute
 - Policy determinations
 - Interpretation of ambiguities in law
 - Balance of obligations as between statutory mandate and contractual obligation

What's a Board to Do in the Context of Pension Reform Litigation? (cont.)

- Who decides and/or sets the tone regarding litigation strategy?
 - Board? What if the Board composition changes during the litigation?
 - CEO? In consultation with Board Chair & counsel?
 - Roles of in-house and outside counsel?
 - Are there any required recusals among Board members or its advisors? Why, and why not?

What's a Board to Do in the Context of Pension Reform Litigation? (cont.)

- How are fiduciary considerations addressed?
 - Duty of prudence regarding subject matter of litigation
 - Duty of loyalty to members and beneficiaries
 - Role as administrators of plan
 - What is the record, and how well is the retirement system positioned to defend the Board's actions or inactions?
 - See *O'Neal v. Stanislaus CERA*

Fiduciary Challenges Related to Fund Investments

- How are fiduciary considerations assessed?
 - Duty of prudence regarding terms
 - Duty of loyalty to members and beneficiaries
 - Delegation to manager, with or without assumption of fiduciary responsibilities
 - What is your record, and how well is the retirement system positioned to defend the Board's/systems decisions?

Fiduciary Challenges Related to Fund Investments (cont.)

- Role of the Board
- Role of CEO and/or CIO
- Role of in-house and/or outside counsel
- Any conflicts present for any of the above?
 - Form 700 disclosures of all involved re “reportable interests”
 - FPPC Informal Assistance No. I-17-093;
 - FPPC Advice Letter A-17-157
 - Personal financial interest vs. institutional interest?

Fiduciary Challenges Related to Fund Investments (cont.)

- Private fund disclosures of fees, expenses and returns
 - State legislation
 - ILPA Fee Reporting Template
 - Fund documents
 - Negotiations with GPs
 - ILPA Principles
 - Model Subscription Agreement and LPA
 - Annual public disclosures
 - Best practices?

Fiduciary Challenges Related to Setting of the Discount Rate (Assumed Rate of Return)

- Using the assumed rate of return
 - Cost v. value
- Roles of the actuary, investment consultant, and legal office
- Asset allocation
- Measuring investment risk
- Best practices?

Fiduciary Challenges Related to Setting of the Discount Rate (Assumed Rate of Return) (cont.)

- Role of consulting actuary to “recommend” assumed rate of return
- Role of in-house staff: CEO, CIO and/or actuary, if any?
- Role of outside investment consultant?
- Role of in-house and/or outside counsel?
- Role of the Board once information is presented for consideration

Fiduciary Challenges Related to Investment Decisions and Monitoring

- Sufficient diligence pre and post close of investment and duty to monitor portfolio
 - Legal duty
 - Investment consultant's role
 - Potential conflicts of interest
 - Investment staff's role
 - Governance issues & war stories?
 - Board's role
 - Information level
 - Exception reporting

Fiduciary Challenges Related to Investment Decisions and Monitoring (cont.)

- Private fund negotiations
 - Communications with other LPs
 - Economic v. non-economic terms
 - Highly contested provisions
 - Latest GP strategies and LP pushback
 - Market terms (varies by asset class)
 - Emerging trends
 - ILPA efforts
 - Role of LPACs
 - Role of third parties

Sources of Interpretation of Fiduciary Duty

- State Constitution
- Case law
- ERISA
 - Statutory language
 - Agency Interpretation (DOL)
 - Case law

Observations on the Evolving Definition of Fiduciary Duty in the European Union

- European Pensions Directive (Jan. 1, 2017)
 - Directs EU Member states to place consideration of ESG factors at the forefront of investment decisions
 - Article 19, Investment Rules: retirement institutions to invest in accordance with “prudent person” rule, may take ESG factors into account

Observations on the Evolving Definition of Fiduciary Duty in the EU

- Policy push in EU to develop a strategy for sustainable finance
 - High-Level Expert Group on Sustainable Finance, July 2017 report:
 - recommended that EC clarify that the fiduciary duties (duties of loyalty and prudence) of institutional investors and asset managers explicitly integrate material ESG factors and long term sustainability

Observations on the Evolving Definition of Fiduciary Duty in the EU

- EC launched public consultation in November 2017, seeking evidence on institutional investors' duties regarding sustainability:
 - Evidence from leading responsible investors on their strategies for considering ESG issues.
- Comment period open until Jan. 22, 2018
 - https://ec.europa.eu/info/consultations/finance-2017-investors-duties-sustainability_en

Additional Resource & Comment Related to Evolving Definitions of Fiduciary Duty Globally

- *Fiduciary Duty in the 21st Century*, September 2015 report
– <http://www.fiduciaryduty21.org/resources.htm>
- Cautionary note: regardless the evolving definition of fiduciary duty globally, CalPERS remains governed by state law, including common law principles of fiduciary duty, with respect to the Board's administration of the plan and investment of its assets.

Questions?

- THANK YOU