

Doing Well by Doing Good

*Emerging Manager and
Directed Investment Programs*

National Association of Public Pension Attorneys
Legal Education Conference

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Fiduciary Considerations

- What Makes a Prudent Investor?
- Responsible Investing: Doing Well by Doing Good
- What Do Suits Against Fiduciaries Look Like?

What Makes A Prudent Investor?

Modern Portfolio Theory: the difference between the Prudent Person, the Prudent Investor, and the Prudent Expert

- In the literature discussing the duties of pension trustees in the area of investment responsibility, terms like “prudent person,” prudent investor,” and “prudent expert are used. While the terms are sometimes used interchangeably, their histories and meanings are distinct.

What Makes A Prudent Investor?

- In *The New Prudent Investor Rule and Modern Portfolio Theory: A New Direction for Fiduciaries*, Alberts and Poon, 34 AMBJ 39 (1996), the history of fiduciary duty is explored at length from its biblical origins in Luke 16:1-8, 10 (the parable of the stewards) and St. Thomas Aquinas' *Treatise on Prudence and Justice* through the creation of the prudent expert rule under ERISA. American jurisprudence is said to begin with the decision in *Harvard College v. Amory*, 26 Mass. (9 Pick) 446 (1830) in which the Court held:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

What Makes A Prudent Investor?

- The adoption of the Employee Retirement Income Security Act of 1974, further extended this rule to a new, higher standard. The operative provisions of Section 404(a), codified as 29 U.S.C. 1104 (a)(1)(B), require a fiduciary to discharge his or her 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 and with like aims.”
- While ERISA Section 404 (a) has its foundations in the prudent person and prudent investor rules, legal scholars have concluded that the statute created a new “prudent expert rule.”

What Makes A Prudent Investor?

- While the ERISA standard is obviously based on the common law prudent investor rule, in many respects ERISA goes well beyond traditional requirements. For example, ERISA requires the care that a “man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This has been termed the “prudent expert” rule (as opposed to the prudent investor rule's “managing his own property” standard) and is perceived as imposing a higher standard. The legislative history indicates that the “enterprise of like character” language was intended to form a standard that would consider the attributes and diversity of employee benefit plans in federalizing the common law of trusts. Another major change wrought by ERISA is that it permits a fiduciary to emphasize the performance of the overall portfolio as compared with the performance of each individual investment. At common law, the fiduciary was required to defend the performance of each individual investment in the portfolio. Bobo, *Nontraditional Investments of Fiduciaries : Re-Examining the Prudent Investor Rule*, 33 Emory L J 1067, 1078 (1984). See also, Hughes, *Hot Topics and Important Considerations for Retirement Plan Fiduciaries*, 57 - Jul Advoc 38 (June/July 2014), Note 7.

What Makes A Prudent Investor?

- The key, according to the prudent expert standard is whether the trustees, at the time they engaged in an investment, employed appropriate methods to investigate the merits of the investment and its structure. *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983). Perhaps more importantly, the prudent expert standard (found in the Restatement (Third) of Trusts) greatly expands a trustee's ability to delegate to investment professionals. See, Langbein, *Reversing the Non-Delegation Rule of Trust - Investment Law*, 59 MCLR 105 (1994).

Responsible Investing: Doing Well by Doing Good

- Environmental, Social and Governance (ESG) - Incorporates these issues into the investment decision making process as a means to enhance returns and reduce risk. Additionally, these approaches may involve active proxy voting, company engagement, and public policy work.
- Mission Related Investing is a more focused type of ESG and is closely aligned with the mission of the organization. For example, one large church pension plan will not invest in stocks relating to gambling, firearms, alcohol, or private prisons. Church plans have even greater flexibility as they are unregulated by either state law or ERISA. The decision to invest or refrain from investing in certain industries is deemed a matter of faith and is exempt from judicial or legislative interference under the First Amendment of the U.S. Constitution and comparable state constitutional provisions respecting freedom of religion.

Responsible Investing: Doing Well by Doing Good

- Sustainable investing is generally focused on investments in companies addressing issues relating to conservation of natural resources, such as energy, air, and water.
- Currently billions of dollars of public and private pension money have been placed into economically targeted investments (ETI's) which are designed to create jobs, boost local economies or create affordable housing.

Responsible Investing: Doing Well by Doing Good

- The Labor Department began issuing responsible investing guidance for ERISA plans as early as 1998. Fund trustees were reminded that loyalty to the plan, diversification, and prudence were the primary investment determinants. Responsible investing was criticized for failure to provide a solid economic return to the pension fund.
- Later research has not shown a compelling economic difference. Focus has shifted from negative screening (limiting the opportunity set) to positive screening, yielding a more balanced approach of integrating the ESG principles into the over-all investment decision making process.

Responsible Investing: Doing Well by Doing Good

- Social investing has been approved in the context of a political decision rather than a highest and best rate of return investment. *See, Board of Trustees v. City of Baltimore*, 562 A.2d 720 (Md. 1989). The Maryland high court held that requiring South African divestment did not impair the pension contract or subvert the purposes of the System when the plan sponsor adopting the requirement was willing to bear any economic consequences of the political decision.

Responsible Investing: Doing Well by Doing Good

Directed Investment In Prisons Held Not To Impair Constitutional Rights of Members

The West Virginia Legislature passed a bill directing the state pension board to invest \$150 million of the state retirement fund assets in the jail authority for ongoing construction and renovation projects. The pension board refused to transfer the \$150 million based on its belief that it impaired the rights of members to their constitutionally-guaranteed pension benefit. The appeals court disagreed holding that as long as the state continued to pay the benefits of members that the contractual right to a pension was not impaired. The court held that the contract right was not as to the assets, but rather as to the “promised pay.” The court held it was also not unconstitutional to direct the pension board’s power to invest.

State Regional Jail and Correctional Facility Authority v. West Virginia Investment Management Board, 508 S.E.2d 130 (W.Va. 1998)

Responsible Investing: Doing Well by Doing Good

Divestiture Law Held Unconstitutional

Darfur Investment Restrictions Struck Down by Federal Court.

National Foreign Trade Council v. Alexi Giannoulias, 2007 WL 627630 (N.D. Ill. Feb. 23, 2007).

Congress later acted to enable state action in the Sudan Accountability and Divestment Act of 2007.

Responsible Investing: Doing Well by Doing Good

Constructive Engagement

- Many states, as an alternative to divestiture, have adopted laws requiring constructive engagement. This involves requiring managers to inquire of companies holding stock in areas of concern to directly engage those companies to seek change within the challenged area. Florida has a direct prohibition relating to Cuba in 215.472, which will be directly impacted by recent federal outreach to normalizing relations with Cuba. For example, as an alternative to divestment, which would have substituted the legislature as the fiduciary for the boards of trustees, Louisiana law encourages public retirement systems to engage companies to foster change from within rather than simply withdraw from the marketplace. This shifted the decision making back to the boards of trustees who are tasked with ensuring positive investment performance, based on non-political factors.

Responsible Investing: Doing Well by Doing Good

Divestiture of Fossil Fuels

- Generally shunned by pension plans and large endowments as destructive of the mission of achieving the highest and best return at a reasonable risk.
- Divestiture has most recently been criticized for loss of an investor voice in a critical industry that directly impacts virtually every economic sector in which pension plans are invested.
- The goals of ESG, particularly in the area of sustainability, are directly compromised by loss of the presence at the corporate table, thereby making divestment of fossil fuels a “futile act,” according to Professor Edward Zelinsky of the Cardozo School of Law.
- The first question to be asked in any mission based divestment decision is whether the divestment will advance or damage the long term return of the system or will otherwise enhance or resist risk management in the portfolio. If the increased risk or diminished return is the most likely result, the social issue, no matter how worthy must take a “back seat” to the primary mission of the fiduciary to invest system assets for the highest and best return with a reasonable degree of risk.
- The California Assembly is considering a bill to require CalPERS and CalSTRS to divest of companies that are primarily sellers of thermal coal. See, Cal. SB 158 (2015)

Responsible Investing: Doing Well by Doing Good

Department of Labor Issues Advisory Opinion on Political Proxies

- The DOL stated it is the duty of fiduciaries to weigh the cost of developing proxy resolutions, proxy voting services and the likely effect of such activities on the value of the plan investment.
- The DOL went on to state that any activities designed to monitor or influence the management of a corporation is consistent with the fiduciary duty under ERISA only to the extent it is expected to enhance the value of the plan investment in an amount over and above the cost of the activity. The opinion clearly advises fiduciaries against proxy activities that relate to political or social issues unless it can be shown that the activity will also enhance the value of the stock. DOL Advisory Opinion 2007-07A

Responsible Investing: Doing Well by Doing Good

What is the ERISA Standard?

2509.94-1 Interpretive Bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments.

- This Interpretive Bulletin sets forth the Department of Labor's interpretation of sections 403 and 404 of the ERISA, as applied to employee benefit plan investments in "economically targeted investments" (ETIs), that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan.
 - Sections 403 and 404, in part, require that a fiduciary of a plan act prudently, and to diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. In addition, these sections require that a fiduciary act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to their participants and beneficiaries. The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.
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Responsible Investing: Doing Well by Doing Good

- With regard to investing plan assets, the Department has issued a regulation, at 29 CFR 2550.404a-1, interpreting the prudence requirements of ERISA as they apply to the investment duties of fiduciaries of employee benefit plans.
 - The regulation provides that the prudence requirements of section 404(a)(1)(B) are satisfied if
 - The fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and
 - The fiduciary acts accordingly.
 - This includes giving appropriate consideration to the role that the investment or investment course of action plays (in terms of such factors as diversification, liquidity and risk/return characteristics) with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility.
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Responsible Investing: Doing Well by Doing Good

- Other facts and circumstances relevant to an investment or investment course of action would, in the view of the Department, include consideration of the expected return on alternative investments with similar risks available to the plan. It follows that, because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.
- The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements are met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate section 404(a)(1) (A) and (B) and the exclusive purpose requirements of section 403.

59 FR 32607, June 23 1994

What Do Suits Against Fiduciaries Look Like?

Fallout from Unfavorable Investment Performance

- The common result of an unfavorable investment results has been a proliferation of suits against the trustees and even by trustees against each other. The following are some notable examples.

What Do Suits Against Fiduciaries Look Like?

Case against teachers retirement system dismissed based on lack of injury.

Texas courts issued the first decision on fiduciary duty and pursuit of investment policy. Although it is an unreported decision, meaning it has no precedential value, it nonetheless warrants some review.

A member of the Teachers Retirement System claimed that the Teachers Retirement System and the trustees violated their constitutional duty to refrain from engaging in speculative investments. The court ultimately dismissed the lawsuit based upon the doctrines of standing and ripeness. The court determined that since the system was a defined benefit plan, the member did not have standing because there was no real controversy between the parties as the defined benefit plan guaranteed benefits to all members. The court also held that the case was not ripe because an injury had not occurred to the members. The court did state that if the system denied any retirement benefits to any teachers, or the Texas Legislature increased mandatory contributions as a result of the investment loss, then at that time they may be able to state a claim.

It would appear that to the extent a particular form of investment has no measurable impact on member account values, the same result would apply.

Ramon v. Teachers Retirement System of Texas, 2010 WL 1241293 (Tex. App. - Hous. April 1, 2010)(unreported)

What Do Suits Against Fiduciaries Look Like?

New Mexico retirees cannot sue for investment losses to system.

New Mexico teachers were held to lack standing to recover 2008 investment losses. The court held that plaintiffs could not show that their benefits were threatened, that the system was currently underfunded, or that the challenged investment caused the underfunding. The court also held that breach of fiduciary duty is not one of the tort claims for which the New Mexico legislature chose to waive governmental immunity under New Mexico's Tort Claims Act. After granting the motion to dismiss in part, the federal district court remanded the case to New Mexico state court given a lack of subject matter jurisdiction.

Hill v. Vanderbilt Capital Advisors, 834 F.Supp2d 1228 (D.N.M 2011)

What Do Suits Against Fiduciaries Look Like?

Alabama Trustees Discretion Not Subject to Member Challenge.

Members of the Alabama Employees' Retirement System and Teachers' Retirement System brought class action against chief executive officer of the Retirement Systems, and officers and members of the boards of the Systems. Plaintiffs alleged defendants breached their fiduciary duties by investing in certain Alabama investments, which “have historically yielded lower returns than investments which could or should have been made in compliance with the mandates of the law, the Prudent Man Rule, and the Investment Policy of the Retirement Systems of Alabama (RSA).”

The court first considered Alabama’s codification of the “prudent investor rule,” and articulated that the rule provided many considerations a trustee should consider, in addition to the rate of return on an investment. The “prudent-man rule” is a standard that allows for the exercise of ample discretion, providing general, guiding principles against which a court could assess a claim of personal liability or perhaps removal of a private trustee accused of making imprudent investment decisions.

What Do Suits Against Fiduciaries Look Like?

However, the court held, the rule does not advance a specific duty that could serve as a basis for an order by the judicial branch to the executive branch to take certain action going forward.

The court then considered whether, notwithstanding the difficulties involved in examining trustee investment decisions, the plaintiffs could overcome the wall of sovereign immunity to articulate a cause of action against the state. The court concluded that any oversight of investment choices made by RSA boards would be a task for which courts are not equipped. The “[l]ack of judicially discoverable and manageable standards” supports the conclusion that the making and oversight of such choices has been, and should be, left to a branch of government other than the judicial.

Ex parte Bronner, 2014 WL 7403996 (Ala. 2014)

What Do Suits Against Fiduciaries Look Like?

Individual Members Of A Board Of Trustees Could Assert A Claim Against Fellow Board Members For Breach Of Duty

Trustees of the New Orleans Firefighters' Pension and Relief Fund filed a petition for mandamus to compel the City of New Orleans to make certain statutory contributions owed to the Fund. The City responded with a counter-claim against the Trustees, alleging they mismanaged the investments and assets of the Fund. The circuit dismissed the counter-claim as stating no cause of action, and the appellate court affirmed.

Norman Foster, in his official capacity as Chief Financial Officer and Director of Finance of the City of New Orleans, wanted to amend the counter-claim to assert a cause of action as a statutorily named member of the Board of Trustees. In that capacity, Foster asserted he had a statutory duty to remedy any breach by another trustee of which he had knowledge and should be allowed to amend his petition to state his cause of action. The LA Supreme Court held that because the city's counter-claim alleged various trustees breached their fiduciary duties to the Fund through their mismanagement, Foster, as a member of the Board and in accordance with his statutory duty of accountability, should be allowed to amend the petition independently to clearly state his cause of action in his capacity as a board member.

New Orleans Fire Fighters Pension & Relief Fund v. City of New Orleans, 157 So.3d 581 (La. 2015)

Emerging Manager and
Directed Investment Programs
Investment Consultant's Perspective

Establishing the Program

- Who is the sponsor?
 - Trustee
 - Investment staff
 - Beneficiaries

Establishing the Program

- What are the program objectives?
 - Achieve acceptable risk adjusted rate of return
 - Access the full universe of investment opportunities
 - Develop relationships with the next generation of core investment managers

Establishing the Program

- Defining an emerging manager
 - First time fund
 - First time investor
 - Experienced investor team
 - Team spinouts
 - First institutional fund
 - Owned or managed by people who have been underserved

Establishing the Program

- How will the program be staffed?
 - Necessary skill sets
 - Internal
 - Outsourced

Establishing the Program

- Most critical factors to consider
 - Attractive investment thesis – scalable and repeatable
 - Prior relevant investing experience
 - Team dynamics
 - Edge in sourcing
 - Clearly articulated strategy
 - Strategy adherence in early funds
 - Alignment of interests

Establishing the Program

- For the complete report go to:
<http://www.calpers.ca.gov/eip-docs/about/committee-meetings/agendas/invest/201403/item08d-01.pdf>

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