

# The NAPPA Report

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2410 Hyde Park Rd., Suite B  
Jefferson City, MO 65109  
Phone: (573) 616-1895

[www.nappa.org](http://www.nappa.org)

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[Susie@nappa.org](mailto:Susie@nappa.org)

**Karen Holterman, Administrative Assistant**

[Karen@nappa.org](mailto:Karen@nappa.org)

**Brenda Faken, Administrative Technician**

[Brenda@nappa.org](mailto:Brenda@nappa.org)

**Doris Dorge, Administrative Aide**

[Doris@nappa.org](mailto:Doris@nappa.org)

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#### PERMISSION TO REPRINT NEWSLETTER ARTICLES

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— San Diego, CA —  
**Location of the 2019 Legal Education Conference**

*By: Johnny Tran*

### The City of San Diego

The City of San Diego is known for its mild year-round climate, natural deep-water harbor, beautiful beaches, and its strong military presence. Sometimes called “the birthplace of California,” San Diego was the first site on the West Coast to be visited by Europeans when Juan Rodriguez Cabrillo landed in San Diego Bay in 1542. With 1.4 million residents, San Diego is the eighth largest city in the country and the second largest in California.

### Things to Do Downtown (A couple of miles from the hotel)

#### *Gaslamp Quarter*

<https://www.gaslamp.org/>

This district is known for its nightlife, clubs, bars, and cocktail lounges, and is always bustling with activity. Gaslamp extends from Broadway to Harbor Drive, and from 4th to 6th Avenue, covering 16 ½ blocks. Most of its 94 historic buildings were constructed in the Victorian Era and are still in use today. Unsurprisingly, you will know you’re in the Gaslamp Quarter when you see gaslamps lining the street.



#### *San Diego Harbor & Seaport Village*

<https://www.seaportvillage.com/>



The harbor is the home port of several aircraft carriers and other major assets of the U.S. Pacific Fleet, which you can marvel at as you walk by. You can also visit the historic Star of India museum ship, a full-rigged iron windjammer ship built in 1863 and the oldest iron-hulled merchant ship still floating. The harbor is also home to the *USS Midway*, a naval aircraft carrier warship museum. It houses many life-at-sea exhibits, restored planes, and flight simulators. If you love whales, dolphins, sea lions, and sea birds, you might consider signing up for a whale and dolphin watching tour for an educational sightseeing experience. Or, if waterfront shopping and dining is more your style, be sure to peruse Seaport Village, with more than 70 shops, galleries, and eateries on 90,000 square feet of waterfront property.

#### *Petco Park (Home of the Padres)*

<https://petcoparkevents.com/>



If you’re craving a hot dog and a good time, stay an extra day or two and catch a San Diego Padres game; the Padres are playing the Cardinals at Petco Park on June 28, 29, and 30th.

#### *Little Italy*

<https://www.littleitalysd.com/>

Originally an Italian fishing neighborhood, today Little Italy is a scenic neighborhood with many Italian restaurants, retail shops, home design stores, art galleries, and residential units. This neighborhood frequently hosts festivals and other events, and has a weekly farmers’ market on Wednesdays, from noon to 2:00 p.m., and Saturdays from 8:00 a.m. to 2:00 p.m.



### Things to Do Around Town (A few miles or more from the hotel)

#### *Balboa Park*

<https://www.balboapark.org/>



San Diego’s version of Central Park, Balboa Park is a 1,200-acre urban cultural park just outside of the downtown area. If you enjoy walking among beautiful gardens, this is the place for you. Balboa Park is also home to 17 museums and cultural institutions, including the Museum of Man, the San Diego Museum of Art, and the San Diego Natural History Museum. Be sure to visit San Diego’s famous carousel, built in 1910, which is one of the fastest carousels in the United States and all but two of its animals are hand-carved European craftsmanship.

## San Diego, CA – Location of the 2019 Legal Education Conference (continued)

### San Diego Zoo and Safari Park

<https://zoo.sandiegozoo.org/>

The zoo, located in Balboa Park, houses over 3,700 animals and was a pioneer in the concept of open-air, cageless exhibits that recreate their occupants' natural habitats. The Safari Park is somewhat of an extension of the zoo and is located in



Escondido, about 45 minutes by car northwest of downtown. The Safari Park is primarily made up of free range exhibits and is well known for its California condor breeding program, which is largely responsible for bringing the condor back from near-extinction.

### Sea World

<https://seaworld.com/san-diego/>

If you have an interest in marine science and rollercoasters, you should visit SeaWorld in Mission Bay Park. You can enjoy the theme park as well as learn about marine animals at its oceanarium, outside aquarium, and marine mammal park.



### La Jolla

<https://lajollabythesea.com/>

This seaside community is right on the coast, surrounded on three sides by ocean bluffs and beaches. Here you can find upscale shops and restaurants with gorgeous views of the beachside cliffs. There are also beaches, which are popular spots for surfing, snorkeling, scuba diving, and kayaking. You will likely see dozens of seals and sea lions swimming and sunning themselves on the rocks in La Jolla Cove. La Jolla is also home to the Scripps Institution of Oceanography, one of the country's oldest and most famous oceanographic institutes.



### Torrey Pines

<https://torreypine.org/>

Also in La Jolla is 2,000 acres of coastal state park, named the Torrey Pines State Natural Reserve. The reserve consists of a plateau with cliffs that overlook Torrey Pines State Beach and a lagoon that is vital to migrating seabirds. You can also play a round of golf on the same course as the pros; Torrey Pines Golf Course has hosted the famous PGA Tour and Farmers Insurance Open.



### Casinos

<https://www.sandiego.org/explore/things-to-do/casinos.aspx>



If you're feeling lucky, or even if you just want to indulge in an all-you-can-eat buffet, head to one of many casinos located around San Diego County's Indian reservations, such as Valley View Casino Center located in Valley Center,

Barona Casino in Lakeside, Viejas in Alpine, or the Jamul Casino in Jamul.

### Coronado

<http://coronadovisitorcenter.com/#>

Across the San Diego Bay is Coronado, which is connected to the mainland by a narrow strip of land called the Silver Strand. "Coronado" means "crowned one" in Spanish, and thus the city is nicknamed the Crown City.

You can visit the famous Hotel Del Coronado, built in 1888 and supposedly the inspiration for the Emerald City in *The Wonderful Wizard of Oz*, and just a few blocks away you can see the house where L. Frank Baum wrote three books in the *Oz* series. If you don't feel like driving across the Coronado Bridge, you can catch a trip across the Bay every 30 minutes on the Coronado Ferry for \$4.75 one-way.



## San Diego, CA – Location of the 2018 Legal Education Conference (continued)

### *Cabrillo National Monument*

<https://www.nps.gov/cabr/index.htm>

This national monument is located at the southern tip of the Point Loma peninsula. It commemorates the landing of Juan Rodriguez Cabrillo at San Diego Bay in 1542. Besides the monument, you can view San Diego's harbor and skyline, Coronado, and during migration season you might even see whales breaching. The Old Point Loma Lighthouse, the highest point in the park, is also a small museum worth visiting. At the bottom of the monument are tide pools where you can walk around and look for sea life. The tide pools are also dog-friendly for your four-legged friends.



### *Old Town*

<http://www.oldtownsandiego.org/>



Explore Old Town San Diego State Historic Park, an open-air museum about local life in the 1800s with adobe buildings and interpretive performances. Old Town used to be the heart of the City of San Diego until the 1860s, when development skyrocketed at the site of present-day downtown San Diego. Within walking distance of Old Town is the Whaley House Museum. The Whaley House was built in 1857 as a Greek Revival style residence and has been featured as the number one haunted house in the United States on the Travel Channel's *America's Most Haunted*.

### *Shopping*

<https://www.sandiego.org/articles/shopping/san-diego-comprehensive-shopping-guide.aspx>

If you are in the mood to shop, then you might consider taking a trip to the California-Mexico border to browse Las Americas Premium Outlets. With 125 stores and 560,000 square feet, this is the area's largest outlet center. For a more upscale experience, try the stores at the UTC mall or Fashion Valley.

### *Legoland*

<https://www.legoland.com/california/>

For a family-friendly day, enjoy Legoland in Carlsbad, California, about 50 minutes north of downtown by car. The Legoland theme park is geared towards children ages 2-12 with more than 50 rides, shows, and attractions. Additionally, Legoland offers a water park, aquarium, and the Legoland hotel.



### *Mission Beach*

<https://www.californiabeaches.com/beach/mission-beach/>



Spanning almost two miles in length, Mission Beach is at the center of the Golden Strand, between South Mission Beach and Pacific Beach. This beach is family friendly and is San Diego's take on the classic

boardwalk beach town. You can visit Belmont Park to play games and ride the roller coaster built in 1925, or walk the boardwalk and visit one of the many bars or stores.

### *Brewery Tours*

<https://brewerytoursofsandiego.com/>

San Diego County is the epicenter of craft brewing. San Diego County alone has over 150 micro-breweries with locations in almost every part of the County. Check out the craft beer scene by booking a tour or just stop by.

### *Liberty Station*

<https://librystation.com/>

In Point Loma, northwest of the San Diego Airport, Liberty Station is located on the site of the former Naval Training Center. Liberty Station is an example of Spanish Colonial Revival style architecture and houses many restaurants, a public market, shops, a movie theater, and parks.

*Johnny Tran is General Counsel of the San Diego City Employees' Retirement System.*

## The Management Fee Charade: What's Lost is What's Unrecovered, Not What's Paid

By: Marc Lieberman

Hardly a day goes by without someone expressing unbridled indignation about the “outrageous” management fees collected by fund advisors. Such indignation seems to suggest that the management fees paid (typically, 2% per year on committed capital) are never recovered, which is *not* the usual case. While it is certainly important for institutional investors to understand what fees they are paying to access private investments, it is simply wrong to imply that the fees paid are money thrown down the toilet, for in the usual case, such fees are fully recaptured during the course of the investment and returned to the investor with interest. In other words, in the typical case where a private investment returns all capital invested plus a preference return on top of that invested capital, *all fees paid have actually been recovered*, and this occurs *regardless* of whether any carried interest is also paid the manager.

As a result, is it really appropriate to characterize management fees in general as “lost expense?” Isn't it more appropriate to visualize management fees as capital which is expected to be fully recovered and in the usual case, is recovered except in those unusual instances where the capital invested is not even returned? And *if* this is a more accurate picture of what role management fees play in a private investment, wouldn't it be better to only treat those management fees *never recovered* as uncollectible expense, and treat those fees actually recovered as invested capital? Thus, it is wholly inappropriate to decry the *total* management fees paid by an institution, as so many are wont to do. Instead, only those fees that are never recovered are the true measure of what management fees actually cost the investor. In the scheme of things, this is a much smaller number indeed.

For example, for our clients, the percentage of fees paid but unrecovered by maturity of private equity investments is typically 0%. Put another way, our clients typically recover 100% of the management fees they paid. And that percentage is based upon actual distributions received, without regard to any additional value attributable to increases in remaining portfolio assets. This means that in general, and on the basis of distributions alone, our clients expect to recover their management fees, although in unusual cases, they might not recover them at all because distributions are insufficient to repay all contributed capital.

In our experience, between 1% and 11% of private equity investments fail to return management fees upon fund liquidation. Of course, the range of unrecovered fees will be dependent upon the skill used to select the particular investments in question, but we suspect that most professionally-managed alternative investment portfolios will have recovery experience similar to our clients.



*While it is certainly important for institutional investors to understand what fees they are paying to access private investments, it is simply wrong to imply that the fees paid are money thrown down the toilet, for in the usual case, such fees are fully recaptured during the course of the investment and returned to the investor with interest.*

Given the foregoing, the investment community should readily contest the notion that generally, management fees are lost expense. In actuality, they are usually recovered with interest, and *only* in those instances where invested capital is not recovered can it truly be said that the management fees are money down the drain.

The bottom line is this: It is perfectly fine for institutions to track total management fees paid. However, *the true measure of which of these fees are actually lost expense is the relatively small portion thereof which are never recovered*. Only by tracking *unrecovered* management fees can we really understand the actual out-of-pocket cost of such fees to the investor. Investors interested in their actual bottom line will do no less. Those

who seek to discourage investment in private equity by heralding total management fees paid instead of only that portion of such fees which are never recovered are being duplicitous, at best.

**Marc Lieberman** is Chair of the Institutional Investments Group, Kutak Rock LLP.

## Data Privacy Issues for Public Pension Plans

By: *Patricia Tarini*

Few topics have garnered more attention recently than data privacy. Media carries almost daily revelations of data breaches, practices, misuse and misrepresentation. Americans are becoming increasingly sensitive to, and wary of, what private data is maintained about them and what happens to it.

Data privacy issues fall into four very general categories: rights of individuals (consent, notice and access); controls (security and accuracy); lifecycle (from collection to destruction); and management (establishment of policies and compliance).<sup>1</sup> Legislative and administrative actions regarding data privacy focus on consent and notice; headlines center on security. As lawyers representing pension funds, we are tasked with providing counsel on all four.<sup>2</sup>

The terms cybersecurity and data privacy are sometimes used interchangeably, but while related, they are not synonymous. Cybersecurity focuses on criminal activity aimed at disruption of operations and/or monetizing data. Data privacy focuses on handling of data and unauthorized or undisclosed collection and sharing of data.

This article provides an overview of data privacy issues that face public pension plans. It will give practitioners a heads-up on where the law may go in the future, review federal and state requirements, and provide starting places to find requirements that impose public entity obligations. It will also review issues that arise with respect to public pension plans as employers and as website hosts.

### Sources of Law

#### Federal Laws

In the United States, there is currently no Federal law of general applicability regarding data privacy. The approach until now has been economic sector-specific laws, such as HIPAA, Gramm-Leach-Bliley Act, and many others.<sup>3</sup> This approach has created disparities in definitions, preemption rules, enforcement jurisdiction, private rights of action, and in other ways. Further, federal agencies overlap with respect to regulatory and enforcement authority.

While public pension plans are exempt from direct regulation by most *Federal* privacy acts, our clients are not exempt from the growing public expectations around data privacy. Also, depending on their structure, public pension plans are employers

and website hosts, both of which come with data privacy issues. Expectations regarding the passage of a national private sector data protection law are currently high. The recently adopted California Consumer Privacy Act of 2018 (Cal. Civ. Code 1798.100 - 1798.199) is a comprehensive and far-reaching privacy act, and since its enactment, other states are considering similar acts. This has fueled Congressional interest, and members are holding hearings, drafting bills and listening to constituencies. The central interest is preemption, both for uniformity of, and control over, requirements.<sup>4</sup>

#### State Laws

Faced with the current lack of a generally applicable data privacy law, the states have sought to fill the void.

#### Security Breach Notification Laws

While all fifty states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands now have security breach notification laws, not all of these apply to government entities. Security breach notification laws typically define what triggers coverage (location versus affected individuals), definitions of “personal information,” what constitutes a breach requiring notification, and exceptions.<sup>5</sup>

The following is a table of states with security breach notification laws that apply to governmental entities.<sup>6</sup>

### Data Breach Notification Laws - Applicable to Governments

State	Statute
Alabama	2018 S.B. 318, Act No. 396
Alaska	Alaska Stat. § 45.48.010 et seq.
Arizona	Ariz. Rev. Stat. § 18-545
Arkansas	Ark. Code §§ 4-110-101 et seq.
California	Cal. Civ. Code §§ 1798.29, 1798.82
Delaware	Del. Code tit. 6, § 12B-101 et seq.
Florida	Fla. Stat. §§ 501.171, 282.0041, 282.318(2)(i)
Hawaii	Haw. Rev. Stat. § 487N-1 et seq.
Idaho	Idaho Stat. §§ 28-51-104 to -107
Illinois	815 ILCS §§ 530/1 to 530/25
Indiana	Ind. Code §§ 4-1-11 et seq., 24-4.9 et seq.
Iowa	Iowa Code §§ 715C.1, 715C.2
Kansas	Kan. Stat. § 50-7a01 et seq.

## Data Privacy Issues for Public Pension Plans *(continued)*

Kentucky	KRS § 365.732, KRS §§ 61.931 to 61.934
Louisiana	La. Rev. Stat. §§ 51:3071 et seq.
Maine	Me. Rev. Stat. tit. 10 § 1346 et seq.
Maryland	Md. Code Com. Law §§ 14-3501 et seq., Md. State Govt. Code §§ 10-1301 to -1308
Massachusetts	Mass. Gen. Laws § 93H-1 et seq.
Michigan	Mich. Comp. Laws §§ 445.63, 445.72
Missouri	Mo. Rev. Stat. § 407.1500
Montana	Mont. Code §§ 2-6-1501 to -1503, 30-14-1701 et seq., 33-19-321
Nebraska	Neb. Rev. Stat. §§ 87-801 et seq.
Nevada	Nev. Rev. Stat. §§ 603A.010 et seq., 242.183
New Jersey	N.J. Stat. § 56:8-161 et seq.
New York	N.Y. State Tech. Law 208
Ohio	Ohio Rev. Code §§ 1347.12, 1349.19, 1349.191, 1349.192
Oklahoma	Okla. Stat. §§ 74-3113.1, 24-161 to -166
Pennsylvania	73 Pa. Stat. §§ 2301 et seq.
Rhode Island	R.I. Gen. Laws §§ 11-49.3-1 et seq.
Tennessee	Tenn. Code §§ 47-18-2107
Vermont	Vt. Stat. tit. 9 §§ 2430, 2435
Virginia	Va. Code §§ 18.2-186.6, 32.1-127.1:05
Washington	Wash. Rev. Code §§ 19.255.010, 42.56.590
West Virginia	W.V. Code §§ 46A-2A-101 et seq.
Wisconsin	Wis. Stat. § 134.98
Guam	9 GCA §§ 48-10 et seq.
Puerto Rico	10 Laws of Puerto Rico §§ 4051 et seq.
Virgin Islands	V.I. Code tit. 14, §§ 2208, 2209

### *Data Security Protection Laws*

As set out in the table below, at least nineteen states have data security laws requiring state agencies to have specific policies and take specific measures to ensure the security of data. At least fourteen of those include destruction and disposal requirements.<sup>7</sup>

### Data Security Laws Applicable to Governemnt

State	Statutory Citation/ Link	Applies to Government
Alabama	2018 S.B. 318, Act 2018-396	The state, a county or a municipality or instrumentality of same and third-party agents.
Arizona	Ariz. Rev. Stat. § 18-105	State budget units and state agencies.
California	Calif. Govt. Code § 11549.3 et seq. Calif. Govt. Code § 8592.30-8592.45 Calif. Govt. Code § 8586.5	State agencies.
Colorado	C.R.S. §§ 24-37.5-401 et seq.	Public agencies, institutions of higher education.
Connecticut	C.G.S. § 4e-70	Any state agency with a department head and any state agency disclosing confidential information to a contractor pursuant to a written agreement with such contractor for the provision of goods or services for the state.
Florida	Fla. Stat. § 282.318, Fla. Stat. § 20.61	State agencies.
Georgia	Georgia Code § 50-25-4	Agencies.
Idaho	Idaho Code §§ 67-827, 67-827A	State agencies.
Illinois	30 ILCS 5/3-2.4	State agencies.

## Data Privacy Issues for Public Pension Plans *(continued)*

Indiana	Ind. Code § 4-13.1-2-2	State agencies.
Kentucky	K.R.S. § 42-724 K.R.S. § 61.932(1)	Public agencies and nonaffiliated third parties.
Maryland	Md. State Govt. Code §§ 10-1301 to -1304	An executive agency, a department, a board, a commission, an authority, a public institution of higher education, a unit or an instrumentality of the State; or a county, municipality, bi-county, regional, or multicounty agency, county board of education, public corporation or authority, or any other political subdivision of the State.
Massachusetts	Mass. Gen. Laws Ch. 93H § 2(c)	The legislative branch, the judicial branch, the attorney general, the state secretary, the state treasurer and the state auditor.
Minnesota	Minn. Stat. § 16E.03	State agencies in the executive branch of state government, including the Minnesota Office of Higher Education, but not the Minnesota State Colleges and Universities.
Montana	Mont. Code § 2-6-1502	Each state agency that maintains personal information.
New York	New York State Tech. Law § 103	State agencies.
North Carolina	N.C. Gen. Stat. § 147-33.110 to -33.112	State agencies.

Ohio	Ohio Rev. Code § 125.18	State agencies.
Oklahoma	62 Okl. St. § 34.32	Each state agency that has an information technology system.
Oregon	ORS § 182.122, 2016 Ore. Laws Chap. 110	State agencies.
South Carolina	2017-18 H.B. 4950 (appropriations bill)	All state agencies.
Texas	Tex. Govt. Code § 2054.0286	State agencies.
Utah	Utah Code § 63F-2-102	State executive branch.
Virginia	Va. Code § 2.2-603 Va. Code § 2.2-2009	Every agency and department in the executive branch of state government, including those appointed by their respective boards or the Board of Education.
Washington	RCW § 43.105.054 RCW § 43.105.020 RCW § 43.105.215	State agencies (certain provisions also apply to institutions of higher education, the legislature, and the judiciary).
West Virginia	W.V. Code § 5A-6-4a	Every agency and department.
Wyoming	Wyo. Stat. § 9-21-101	Every agency, department, board, commission, council, institution, separate operating agency or any other operating unit of the executive branch of state government.

## Data Privacy Issues for Public Pension Plans *(continued)*

### Data Disposal Laws

The following table lists states that have data disposal laws applicable to governments.<sup>8</sup>

#### Data Disposal Laws Applicable to Governments

State	Statute
Alabama	2018 S.B. 318
Alaska	Alaska Stat. § 45.48.500 et seq.
Arizona <i>(Applies to paper records only)</i>	Ariz. Rev. Stat. § 44-7601
Arkansas	Ark. Code §§ 4-110-103, -104
Delaware	Del. Code tit. 6 § 5001C to -5004C, tit. 19 § 736
Hawaii	Haw. Rev. Stat. §§ 487R-1, 487R-2, 487R-3 Haw. Rev. Stat. § 261-17.7(d), Haw. Rev. Stat. § 52D-14(c) – (2018 S.B. 2738)
Illinois	20 ILCS 450/20, 815 ILCS 530/30, 815 ILCS 530/40
Indiana	Ind. Code §§ 24-4-14-8, 24-4.9-3-3.5(c)
Kansas	Kan. Stat. § 50-7a01 Kan. Stat. § 50-7a03 Kan. Stat. § 50-6, 139b(2)
Massachusetts	Mass. Gen. Laws Ch. 93I, § 2
Maryland	Md. State Govt. Code §§ 10-1303
Michigan	MCL § 445.72a
New Jersey	N.J. Stat. § 56:8-161, -162
Oregon	Ore. Rev. Stat. § 646A.622
South Carolina	S.C. Code § 37-20-190, S.C. Code 30-2-310
Texas	Tex. Bus. & Com. Code § 72.004, § 521.052
Virginia	Va. Code § 2.2-2009 (F)
Washington	Wash. Rev. Code § 19.215.020
Puerto Rico	2014 Law #234-2014

### The Plan as Employer

Pension plans are also employers and, as such, they are subject to a myriad of regulation. Pension plans frequently use credit and other background checks as security measures when screening applicants and, sometimes, current employees. The Fair Credit Reporting Act of 1971, as amended by the Fair and Accurate Credit Transactions Act of 2003, indirectly imposes duties on employers concerning the handling of credit reports. The direct regulation falls on credit reporting agencies (such as Transunion, Experian, Equifax and many other smaller organizations); however, crediting reporting agencies require certifications of compliance from customers as a condition of service.<sup>9</sup>

Plans that want to obtain a consumer report for any employment purpose must first provide applicants and employees with a written disclosure stating their intent to obtain a consumer report. The plan must also receive written authorization from the applicant or employee before obtaining the consumer report. These must all be stand-alone documents.

If the plan is considering adverse action based on information obtained in a consumer report, it must provide:

- the applicant or employee with a copy of the consumer report;
- a “pre-adverse action” letter explaining that the plan is considering taking adverse employment action based on information in the report; and,
- a written “summary of rights” under the FCRA.

The applicant/employee must receive these documents prior to taking any adverse employment action. If a plan takes adverse employment action, it must then provide notice to the applicant or employee, and provide him/her with certain information required by statute, including another copy of the summary of rights.<sup>10</sup>

Human resources generally handles this process, but it is an area of private data management that counsel should consider along with all others.

### Pension Fund as Website Host

The use of website notices of privacy practices arose out of actions taken by the Federal Trade Commission in its enforcement of the FTC Act. The Act does not mention privacy or information security, but its application to privacy and information security

## Data Privacy Issues for Public Pension Plans *(continued)*

is clearly established today. The FTC's enforcement authority applies only to unfair and deceptive acts "in commerce," and does not apply to nonprofit organizations or governmental entities. However, state consumer protection laws as well as common law provide avenues for citizens' recourse. In some jurisdictions, there is no need to show harm to support a violation and attendant fines. Claims arise concerning what information is being gathered and shared, and user tracking.

The takeaway here is that it is wise to periodically review your client's notice of privacy practices to make sure that the notice accurately reflects actual practice.<sup>11</sup>

### Conclusion

Public concerns about data privacy are growing, as are demands for action. Legislative bodies are struggling to keep pace. As our clients hold large amounts of private data, there are steps we can and should take:

1. Assemble a multi-departmental team of subject matter experts and stakeholders to engage in an intentional review of your client's private data. Discover:
  - what private data is collected;
  - where it lives;
  - how it is classified;
  - how and by whom it is accessed and used;
  - whether it is all necessary;
  - how it flows through the organization;
  - what protections are in place (physical, electronic and human);
  - when and how it is destroyed; and
  - who monitors these matters.<sup>12</sup>
2. Learn and keep up with the laws applicable to your client's data privacy. Are there any other states or countries where participants live that could expose the plan to liability there?
3. Get cyber-insurance, if applicable to your client, and understand it. Use an experienced broker to navigate the landmines.
4. Keep fiduciaries in the know – law is developing in the private sector that fiduciaries must know about how company private data is held and protected.<sup>13</sup> Focus on pension fund fiduciaries cannot be far behind.

Getting ahead of the curve on this issue can not only help keep your plan out of court and out of the newspapers, but most importantly, keep money in the fund for retirees.

*Patricia Tarini is a Senior Attorney at the Michigan Municipal Employees' Retirement System.*

### ENDNOTES:



*Public concerns about data privacy are growing, as are demands for action.*

<sup>1</sup>Peter Swire, CIPP/US and DeBrae Kennedy-Mayo, CIPP/US, "International Association of Privacy Professionals" U.S. Private-Sector - Privacy Law and Practice for Information Privacy Professionals (Second Edition), Section 1.4.1.

<sup>2</sup>Cohen for Ferenczy Benefits Law Center, "Identity Theft: The Rising Threat to Retirement" in Solutions in a Flash, Issue February 2019.

<sup>3</sup>*IBID*, Chapter 4.

<sup>4</sup>See, e.g., "Congressional Committees Hold Hearings on Federal Privacy Legislation" Wilmer Cutler Pickering Hale and Dorr LLP, Association of Corporate Counsel Newstand, March 1, 2019.

<sup>5</sup>Peter Swire, CIPP/US and DeBrae Kennedy-Mayo, CIPP/US, "International Association of Privacy Professionals" U.S. Private-Sector - Privacy Law and Practice for Information Privacy Professionals (Second Edition), Chapter 6.

<sup>6</sup>Used by permission of the National Conference of State Legislatures.  
<sup>7</sup>*IBID*.

<sup>8</sup>*IBID*.

<sup>9</sup>Peter Swire, CIPP/US and DeBrae Kennedy-Mayo, CIPP/US, "International Association of Privacy Professionals" U.S. Private-Sector - Privacy Law and Practice for Information Privacy Professionals (Second Edition), Sections 8.1, 11.2.

<sup>10</sup>Meg Vergeront for the State Bar of Wisconsin, "Employer Obligations When Using Third Parties to Conduct Background Checks," March 12, 2019.

<sup>11</sup>Peter Swire, CIPP/US and DeBrae Kennedy-Mayo, CIPP/US, "International Association of Privacy Professionals" U.S. Private-Sector - Privacy Law and Practice for Information Privacy Professionals (Second Edition), Chapter 5.

<sup>12</sup>*IBID*, Section 1.4.1.3.

<sup>13</sup>Alexa King, Carly O'Halloran Alameda and Olga V. Mack, "Get the Board on Board: Fulfilling Cybersecurity Governance Duties" Association of Corporate Counsel Docket, October, 2016.

# Opportunities and Challenges for Public Pension Plans in the New Congress

By: Tony Roda

This article is designed to arm our public pension plan counsels with, at a minimum, a frame of reference and foundational starting point for their responses to questions on key federal legislative issues. I address topics that counsels absolutely need to know about, such as those bearing on taxation, as well as those that are more indirect to plans but may have particular personal importance to plan trustees or members. Sometimes this latter set of issues carries the strongest emotional appeal.

## Tax Front

For public pension plans, tax policy is the appropriate starting place for an analysis of federal legislation. Although created by state or local law, our plans must be “qualified” under the federal tax code. Qualification bestows certain key tax attributes on plans, plan sponsors and participants, including that employer contributions are not taxable to members, earnings on pension trust assets are not taxable to the trust or members, and employers and members do not pay employment taxes when employer contributions are made or benefits paid. Certainly, then, federal tax qualification is an important matter.

### *PEPTA and UBIT*

In the current 116<sup>th</sup> Congress, the House Ways and Means Committee and Senate Finance Committee are likely to develop tax legislation in the retirement area. Over the past few years, the public pension plan community has been resigned to playing more defense than offense on federal tax policy. While proposals such as the Public Employee Pension Transparency Act (PEPTA)<sup>1</sup> and the extension of the Unrelated Business Income Tax (UBIT) to certain investments of state and local plans are much less likely to gain traction in a Democratic-controlled House, our opponents could easily shift their strategy on the two issues to push for action in the GOP-controlled Senate.

PEPTA was first introduced in 2010 by Rep. Devin Nunes (R-CA), who is now the second most senior Republican on the Ways and Means Committee. The legislation would impose a requirement on plan sponsors to report the funding status of state and local pension plans to the U.S. Treasury Department using two distinct methods: (1) the plan’s own economic assumptions

and rates of return; and (2) the U.S. Treasury bond obligation yield curve.

The yield curve method would result in funding status outcomes that would show a dramatically lower funded status for the vast majority of public plans. Of course, this will create negative headlines for plans and confuse and concern active and retired members. However, it will not add any new useful economic data to aid in the analysis of the financial health of the plans. In addition, it is important to note that non-compliance by a plan sponsor would result in a loss of their ability to issue bonds that are exempt from federal tax.



*For public pension plans, tax policy is the appropriate starting place for an analysis of federal legislation.*

Regarding UBIT, in 2017 the House approved legislation that included a provision to subject certain investments of public pension plans to the tax. Private equity and hedge fund investments would have been most affected. The provision was described as a “clarification” of current law. Proponents of the provision argued the following: (1) public pensions are qualified plans under Internal Revenue Code (IRC) Section 401(a); (2) IRC Section 401(a) is referenced in the UBIT section of the tax code, Section 511(a)(2); therefore, (3) public

pension plans are already covered by UBIT and the legislation simply clarifies that point. Public plans took a very different view, stating that we are exempt from federal tax by virtue of IRC Section 115, which excludes from gross income certain income of entities that perform an essential government function. Furthermore, application of a federal tax to state and local pension plans would erode the principle of intergovernmental tax immunity, which protects both states and the federal government from taxation by the other. The UBIT provision was not included in the final tax law. While we have not seen the provision since 2017, it could be raised again in future tax legislation.

### *Pick Up Rule*

Another provision that was included in House-passed legislation in the previous Congress dealt with the pick up rule, which is widely used by state and local pension plans. Under IRC Section 414(h)(2), governmental entities may pick up (i.e., pay for) their employee’s pension contributions and, in effect, transform post-tax employee contributions into pre-tax employer contributions. Employee contributions that are picked up by the employer are not includible in the employee’s gross income.

## Opportunities and Challenges for Public Pension Plans in the New Congress (continued)

While there are no regulations under Section 414(h)(2), Revenue Ruling 2006-43 and related private letter rulings (PLR) provide guidance. The rules do not permit participating employees to have a right to a cash-or-deferred arrangement (CODA). Therefore, participating employees must not be allowed to opt out of the pick up treatment or receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

In recent years PLR requests were made seeking approval of the use of the pick up in situations where a new pension plan or tier with a different employee contribution rate was created and plan sponsors wished to give the existing plan participants the ability to choose between the plans or tiers. Treasury and IRS reasoned that by being able to choose between the plans or tiers, existing employees would have a right to a CODA. Therefore, the election between tiers would not be permitted.

Federal legislation to make the pick up rule more flexible has been introduced in three of the last four Congresses.<sup>2</sup> It is expected to be introduced in the current Congress as well. The Family Savings Act,<sup>3</sup> which passed the House last fall, also included a provision on the pick up:

“...contribution shall not fail to be treated as picked up by an employing unit merely because the employee may make an irrevocable election between the application of two alternative benefit formulas involving the same or different levels of employee contributions.”

While revising the pick up rule to provide more flexibility for plan sponsors was a priority for the GOP-controlled House during the 115<sup>th</sup> Congress, it is much less likely that the Democratic-controlled House will share that view. Instead, efforts on this issue are likely to turn to the Senate, the Treasury and IRS.

### **Retiree Health Premiums (Public Safety)**

IRC Section 402(l) allows public safety officers to exclude from their gross income up to \$3,000 per year from pension distributions if the monies are used for qualified health care premiums. There is interest in the public pension community,

particularly from plans in Ohio, Oklahoma and Iowa, to streamline this provision by repealing the direct payment requirement. Current law requires that the monies go directly from the pension fund to the insurance provider, which is administratively burdensome for some plans and stifling innovation in retiree health care programs. This modification could be made as part of bipartisan legislation on retirement policy.



*House Budget Committee Chairman John Yarmuth (D-KY) is developing legislation that would create a National Infrastructure Development Bank, which would be financed through the sale of \$75 billion worth of Rebuild America Bonds on the full faith and credit of the U.S.*

### **Financial Transactions Tax**

Senator Brian Schatz (D-HI) and Rep. Peter DeFazio (D-OR) have introduced the Wall Street Tax Act,<sup>4</sup> which would tax the sale of stocks, bonds and derivatives at 0.1 percent. The new tax would raise an estimated \$777 billion over 10 years. The tax would apply to the fair market value of equities and bonds as well as the payment flows under derivatives contracts. This proposal faces a steep uphill climb in the GOP-controlled Senate and is not expected to be enacted in this Congress. In future Congresses, it could be used as a deficit reduction tool or revenue offset for a new federal program or benefit.

## **Infrastructure**

### **Tax Treatment of Bonds**

Congress has often looked at ways to encourage public pension plans to invest more heavily and directly in infrastructure projects. Legislation was introduced in the previous Congress that was designed to promote investments in and acquisitions of public infrastructure projects by state and local governmental pension plans by clarifying the tax law related to the underlying bonds.<sup>5</sup>

The author of the legislation, then-Rep. Mike Bishop (R-MI), did not win his bid for re-election in 2018. It's not yet clear who will introduce the legislation in the current Congress. Sen. Ron Wyden of Oregon, who is the senior Democrat on the Finance Committee, and Sen. Todd Young (R-IN), who is a new member of the Committee, have been mentioned as possible sponsors.

### **Infrastructure Bank**

House Budget Committee Chairman John Yarmuth (D-KY) is developing legislation that would create a National Infrastructure Development Bank, which would be financed through the sale

## Opportunities and Challenges for Public Pension Plans in the New Congress (continued)

of \$75 billion worth of Rebuild America Bonds on the full faith and credit of the U.S. An additional \$300 billion in bonds could be issued at the request of the Bank. Under draft legislation, the bonds mature in 40 years and may not be resold until 10 years after the date of issuance. The bonds will bear an interest rate of 200 basis points above the 30-year Treasury bond.

Of interest to the public pension plan community, the bonds may be purchased only by pension plans – both plans governed by the Employee Retirement Income Security Act (ERISA) and governmental plans as defined by ERISA, which includes state and local governmental pension plans.

### Health Care

On the health care front, in addition to the IRC Section 402(l) direct payment issue discussed above in the tax section, Sen.

Sherrod Brown (D-OH) is developing an alternative to Medicare-for-All that would allow retired first responders who have reached age 55 to opt into Medicare. Recognizing that public safety employees generally retire in their mid-fifties and that there is always a significant gap in time from retirement to the Medicare eligibility age of 65, Sen. Brown believes this group should be given a choice to enroll in Medicare at an earlier age.

This proposal would not directly affect public plans. However, with the early retirement ages in the public safety workplace, retiree health care is a major area of focus for our members. In addition, due to the rising cost of health care, many state and local governments and some pension plans that have provided retiree health are scaling back or eliminating their plans.

### Social Security

At a House Ways and Means Committee hearing in early February, it became clear that there is bipartisan interest in pursuing a solution to Social Security's long-term funding concerns. Of particular interest to public employees, concern over Social Security's Windfall Elimination Provision (WEP) was raised by several members, including Chairman Richie Neal (D-MA) and senior Republican Kevin Brady of Texas.

WEP does not affect public plans directly, but the penalty is triggered by earning a pension benefit from non-Social Security-

covered employment, which still accounts for approximately 25 percent of state and local workers today. Legislation has been introduced since the 1980s to fully repeal WEP and the Government Pension Offset, which affects spousal and survivor benefits.<sup>6</sup> However, most observers do not believe full repeal legislation is viable.



*At a House Ways and Means Committee hearing in early February, it became clear that there is bipartisan interest in pursuing a solution to Social Security's long-term funding concerns.*

As a consequence, WEP-only reform bills have been introduced as well. The most recent legislation<sup>7</sup> introduced in the previous Congress would have created a proportional formula, which is referred to as the Public Servant Fairness formula (PSF), based on each worker's actual work history. The new formula would become effective for those first becoming eligible for Social Security (age 62) beginning in 2025. For current retirees, a flat-rate rebate of \$100 per month (\$50 per month for a spousal benefit) would begin in 2020. The rebate would be indexed each year. The

legislation would also direct the Social Security Administration (SSA) to report uncovered years on the annual SSA statement and initiate a study to explore whether public pension plans have any information that could aid in the collection of accurate and complete data.

### Conclusion

While it is a given that changes to state and local law must be monitored closely by our plan counsels, modifications to federal law could also have profound implications for public plans, including issues relating to tax qualification and the taxation of participants, trusts and investments. Please be assured that I will keep my fellow NAPPA members apprised of any major developments in these areas.

*Tony Roda is a partner at Williams & Jensen.*

### ENDNOTES:

- <sup>1</sup>H.R. 6290 (115<sup>th</sup> Congress).
- <sup>2</sup>H.R. 2187 (115<sup>th</sup> Congress).
- <sup>3</sup>H.R. 6757 (115<sup>th</sup> Congress).
- <sup>4</sup>H.R. 1516 and S. 647 (116<sup>th</sup> Congress).
- <sup>5</sup>H.R. 6276 (115<sup>th</sup> Congress).
- <sup>6</sup>H.R. 141 and S. 521 (116<sup>th</sup> Congress).
- <sup>7</sup>H.R. 6933 (115<sup>th</sup> Congress).

# Into the Abyss: Legal and Practical Considerations for Negotiating Agreements With Pharmacy Benefit Managers

By: Steven Day and Amelia Larsen

## Introduction

Pharmacy benefit managers (or “PBM”) play an important role in administering and negotiating prices for pharmacy benefit programs. As pharmacy benefits are often the largest contributor to increased costs for health plans, plan sponsors are focusing more attention on arrangements with their PBMs to control costs and increase transparency. However, service agreements between plans and PBMs are notoriously convoluted and ambiguous, providing PBMs too much discretion to interpret the contract in their favor and to the disadvantage of plan sponsors. Ambiguous terms in a service agreement could cost plans millions of dollars if a PBM engages in profit-seeking activities that are technically permitted (or not prohibited) under the contract, but perhaps against the spirit of the deal. This article discusses some key contractual terms plan sponsors and their counsel should consider when negotiating service agreements with PBMs, especially in light of new pricing models emerging within the industry.

Due to the increased focus on cost-control and transparency, the market is trending away from “spread pricing” models to “pass-through” models. Under the spread pricing model, PBMs are compensated by keeping the difference between the rebates and drug prices they negotiate for plans and what the plans actually pay in benefits. Under the pass-through model, PBMs charge plans an administrative fee based on its number of members or claims and pay the plans any rebates or other revenues the PBMs receive from drug manufacturers or other sources (or a portion of the revenue if the arrangement is not a 100% pass-through model).

As the industry develops, it is increasingly important for plan sponsors to review carefully new service agreements with PBMs to ensure the contract language reflects the business arrangement. PBMs often provide plan sponsors with their own service agreement template, which will, of course, be written to provide the PBM with the most discretion and protection as possible. Many of the definitions and terms in a PBM’s template are often more appropriate for a spread pricing model than a pass-through model. Ambiguous or vague language often works to the benefit

of the PBMs, allowing them to charge additional fees or retain payments that would have otherwise been passed through to the plans. Accordingly, plan sponsors should engage advisors and legal counsel with experience in reviewing, negotiating, and drafting service agreements to ensure their PBMs are not given too much discretion or interpretive flexibility.



*Ambiguous terms in a service agreement could cost plans millions of dollars if a PBM engages in profit-seeking activities that are technically permitted (or not prohibited) under the contract, but perhaps against the spirit of the deal.*

Plan sponsors and their advisors will want to hone in on the contractual and business terms discussed below. However, before addressing specific contractual provisions, it is worth taking a look at the stages leading up to the written contract. By addressing the business terms up front, plan sponsors will be in a better position when the wording of the agreement is memorialized.

## Selection Process

When selecting a new PBM, plan sponsors should first assess what their negotiating power will be with the candidates. Smaller plans with fewer participants might not have the ability to push for a 100% pass-through model, because the per-participant or per-claim fees might not make economic sense for the PBM. Therefore, plan sponsors might consider joining a consortium made up of other similarly sized plans that can combine participant size and negotiating power to reach a more cost-effective arrangement with the PBM. Larger plans, which can adequately compensate a PBM on a per-member or per-claim basis, should push for as much revenue to be passed through as possible.

Plan sponsors should then work with experienced consultants on their request for proposal (“RFP”) to implement the bid process among PBM candidates. Ideally, the RFP would include a model contract drafted by the plan sponsor, which would serve as the basis for the parties’ underlying agreement. The RFP should address key business, contractual, administrative and auditing points, many of which are discussed below.

## Contractual Terms

Once the PBM is selected, plan sponsors and their counsel should ensure the points agreed to in the RFP are adequately covered in

## Into the Abyss: Legal and Practical Considerations for Negotiating Agreements With Pharmacy Benefit Managers *(continued)*

the service agreement. Plan sponsors should not be led to believe that the PBM's template is "standard" or "market" for their business arrangement. Due to the specificity of the terms agreed to in the RFP, each agreement should be tailored to the parties' arrangement. The template might appear to address certain business points raised in the RFP, but the language is often ambiguous or vague enough to provide the PBM with the discretion to act in ways that are counter to what the plan sponsor expects yet are technically permitted under the terms of the contract.

### **Rebates**

The definition of "Rebate" should reflect the underlying payment arrangement agreed to in the RFP process. If the arrangement is a 100% pass-through arrangement, the service agreement should clearly state that the PBM is required to pay the plan all revenues it receives from any pharmaceutical manufacturer or other sources due to its services to the plan. All revenues received by the PBM should be covered by the definition, which may include standard rebates, administrative fees, price protection payments, performance payments (market-share payments) or other service revenues. If the parties agree that the PBM may retain some revenues, any exclusion to the definition of "Rebate" should be defined narrowly. For example, if "Administrative Fees" are excluded from the definition of Rebate (and, therefore, retained by the PBM), the definition of "Administrative Fees" should specifically exclude any other revenue streams intended to be passed through to the plan sponsor, such as price protection payments or performance payments.

In addition, the definition of "Rebate" should apply to rebates for all drugs, including drugs not listed on the formulary, specialty drugs, or drugs deemed to be generic drugs under the contract's definition of generic. The PBM's financial disclosure document, which describes the nature of payments it may receive from manufacturers, should be reviewed to ensure all revenue streams are either included in the definition of "Rebate" or specifically excluded if the PBM is allowed to retain a certain stream of revenue.

### **Spread Pricing**

If the arrangement prohibits spread pricing, the service agreement should clearly state that the amount paid by the plan for a claim will be the same amount the PBM pays to the pharmacy. The plan sponsor will want to have the right to pharmacy audits to

ensure the amounts paid to the pharmacies for a given claim were the same as what the plan paid to the PBM.

### **MAC Lists**

Most PBM arrangements include a Maximum Allowable Cost price list ("MAC List"), which sets forth the maximum amount a PBM will pay for generic drugs or brand drugs with more than one manufacturer (multi-source brands). The MAC List is used to control the wide range of generic drug prices. A PBM will maintain different MAC Lists for different clients and has the ability to add or remove drugs from the list at any time.



*PBMs may use MAC Lists to establish spread pricing arrangements, by providing a plan sponsor with a MAC List with higher prices than the MAC List it uses for the pharmacies, pocketing the difference between the plan sponsor's maximum cost and the maximum cost the PBM will pay the pharmacy.*

PBMs may use MAC Lists to establish spread pricing arrangements, by providing a plan sponsor with a MAC List with higher prices than the MAC List it uses for the pharmacies, pocketing the difference between the plan sponsor's maximum cost and the maximum cost the PBM will pay the pharmacy. If the parties have agreed to a 100% pass-through arrangement, the service agreement should clearly state that the PBM may not engage in spread pricing by using different MAC Lists for the plan sponsor and the pharmacies.

Because the PBM will have the ability to remove drugs from the MAC List at any time, plan sponsors will also want to review carefully any contract language related to generic guarantees to make sure guarantees apply to all generic drugs dispensed and not just the drugs listed on the MAC List. Otherwise, the discount guarantee would apply only to the drugs that the PBM chooses to leave on the MAC List.

The pricing terms of the contract should also require the PBM to charge the plan sponsor for the lesser of the MAC List price or other pricing mechanisms, such as the discount off Average Wholesale Price (AWP). This requirement should apply to all pharmacy types, including retail, mail order, and specialty

In addition, as the industry is pushing for more transparent pricing, plan sponsors are requiring PBMs to share their MAC Lists. Due to a PBM's ability to manipulate pricing and guarantees based on what it includes or removes from the MAC List, plan sponsors should review the MAC List periodically to determine if any changes to the MAC List resulted in higher costs to the plan. Plan sponsors might also consider including provisions in their service agreements prohibiting the PBM from manipulating the MAC List to increase its revenues or meet guarantees.

## Into the Abyss: Legal and Practical Considerations for Negotiating Agreements With Pharmacy Benefit Managers *(continued)*

### *Mail Order Package Quantities*

PBMs typically own and operate the mail order pharmacy used by a plan. PBM contracts often base prices for mail service drugs on 100-unit package sizes (or lower). However, a PBM might purchase larger quantities of the drug at lower bulk prices, then repackage the drugs into smaller package sizes with higher list prices, allowing the PBM to pocket the difference between the lower bulk price and the price charged for a package dispensed through its mail service pharmacy. Plan sponsors should ensure that any pricing definitions, such as AWP, are based on the actual pill count the PBM purchased and not the re-packaged size dispensed to the participants. In addition, the contract should prohibit the PBM from changing the 11-digit National Drug Code (“NDC”) used for the drugs purchased by the PBM when it repackages the drugs into smaller package sizes. The NDC number will identify the unit size the PBM purchased to supply the drug.



*Because many pricing discounts and guarantees are based on whether a drug is deemed to be brand or generic, the agreement should specify clearly how drugs will be identified as brand or generic.*

### *Generic Drug vs. Brand Drug*

Because many pricing discounts and guarantees are based on whether a drug is deemed to be brand or generic, the agreement should specify clearly how drugs will be identified as brand or generic. The definition of “Generic Drug” should include any generic drug produced by a single source (which a PBM may otherwise characterize as a “Brand Drug”). Likewise, the definition of “Generic Drug” should also include any brand drug produced by more than one manufacturer, including multi-source brand drugs. The contract should reference a national reporting service, such as Medi-Span or First DataBank (but only one), to be used as an objective source to identify generic drugs. The reporting service’s actual classification should be used instead of permitting the PBM to use the reporting service’s classification as an “indicator” or a “basis” for the PBM’s determination. The contract should also reference the appropriate “dispense as written” codes applicable to generics. Plan sponsors will want to avoid definitions permitting the PBM to use its own algorithm or any other classification methods that are not an objective third-party’s classification. The contract should provide that any change to the reporting service used for classification needs to be mutually agreed upon by both parties.

### *Guarantees*

PBM service agreements typically include several guarantees, including guarantees on pricing, rebates and performance. As discussed above, having clear and precise definitions, such as definitions for “Generic Drug” and “Rebate,” will help ensure

guarantees are properly applied without giving the PBM too much discretion to obfuscate the numbers. Plan sponsors should include language in reconciliation or reporting provisions that prohibits the PBM from offsetting under-performance on one guarantee by over-performance in another guarantee. Any shortfalls for a particular guarantee should be returned to the plan.

### *Inflation Protection Programs*

Some PBMs now offer inflation protection programs or inflation caps to address the high rate of inflation of drug costs. Under these programs, the PBM guarantees that the inflation rate for brand drugs will remain below a certain level. To the extent the actual inflation costs exceed the agreed upon cap, the PBM will refund the plan a certain amount. Plan sponsors should understand how the amount of the refund is determined as well as any conditions that must be met to receive the refund, such as meeting certain utilization thresholds and not disrupting the formulary in a way that prevents the PBM from effectively managing the program. An inflation protection program is another example of the importance of having proper definitions of brand and generic drugs to avoid allowing the PBM to use generic drugs towards its performance goals.

### *Market Checks*

The PBM contract should allow for periodic market checks. A market check allows the plan sponsor to re-negotiate the service agreement if the pricing or the terms have fallen out of market. A PBM Agreement of an extended term should include a market check after the first 18 months and then annually thereafter.

### *Audit Rights*

The PBM service agreement should include robust audit rights for the plan sponsor. Plan sponsors should have the discretion to choose its own auditing firm, without approval by the PBM or exclusions of certain types of auditing firms. In addition, plan sponsors should remove any limitations on the frequency of audits, including any blackout periods, or how many claims can be audited.

*Steven Day is a Partner and Amelia Larsen is an Associate with Calfee, Halter & Griswold, LLP.*

## Where Do You Draw the Line? Garnishing State Public Pension Funds Pursuant to Restitution Orders and the IRS Exclusive Benefit Rule

By: Debra Lefing

While a majority of states have legislation prohibiting a public official or public employee from receiving retirement benefits or funds if the official or employee is convicted of, or pleads guilty to, a crime related to his or her public employment,<sup>1</sup> only a handful of states permit a court to order garnishment of pension or retirement payments for criminal or civil restitution not related to the employee's public employment. These states include Ohio,<sup>2</sup> Alabama,<sup>3</sup> and Washington.<sup>4</sup> While these states have anti-alienation provisions,<sup>5</sup> state law allows for the garnishment of a public pension or public retirement funds to satisfy a state criminal restitution order. By statutorily providing this exception, are states violating the IRS exclusive benefit rule,<sup>6</sup> as someone other than the member or the member's beneficiary becomes entitled to a member's retirement payments?

### Line of Cases Involving Garnishment of Retirement Funds Pursuant to Federal Criminal Restitution Laws

A line of federal cases and IRS rulings have determined the exclusive benefit rule is not violated when a garnishment order resulting in the recovery of criminal restitution or criminal fines *by the federal government* is honored. For example, in a Private Letter Ruling, the IRS held that the qualified plan at issue would not violate U.S.C. § 401(a)(13) or the exclusive benefit rule by honoring the garnishment order from the federal government pursuant to the Federal Debt Collection Procedure Act of 1990.<sup>7</sup> Using this Private Letter Ruling, the Ninth Circuit determined that a federal statute, the Mandatory Victims Restitution Act (MVRA) of 1996, does allow for the garnishment of retirement benefits covered by Employee Retirement Income Security Act of 1974 (ERISA) and state public pension plans.<sup>8</sup> Similarly, the Fifth Circuit held that if a state desires to participate in the management of pension benefits, "it must submit to federal criminal and civil laws allowing for debt-collection measures."<sup>9</sup>

In the Ninth Circuit case of *U.S. v. Novak*, the court set limitations on what actually can be garnished from an ERISA account under the MVRA.<sup>10</sup> The court noted that the "steps into the shoes" doctrine permits the federal government to require

payment of any post-retirement payments from an ERISA account, including monthly post-retirement payments that would otherwise go to the member.<sup>11</sup>

The *Novak* court also specified that the government "can immediately garnish the corpus of a retirement plan to satisfy a MVRA judgment—rather than merely obtain post-retirement payments that otherwise would have gone to the defendant—if, but only if, the terms of the plan allow the defendant to demand a lump sum payment at the present time."<sup>12</sup> The court followed the reasoning in *U.S. v. Nat'l Bank of Commerce*, in which the Supreme Court held that "[i]n a levy proceeding, the IRS 'steps into the taxpayers' shoes' and the 'IRS acquires whatever rights the taxpayer himself possess.'"<sup>13</sup>



*While a majority of states have legislation prohibiting a public official or public employee from receiving retirement benefits or funds if the official or employee is convicted of, or pleads guilty to, a crime related to his or her public employment,<sup>1</sup> only a handful of states permit a court to order garnishment of pension or retirement payments for criminal or civil restitution not related to the employee's public employment.*

While these cases and rulings are expressly limited to garnishment by the federal government pursuant to a federal law, they are instructive regarding the validity of state garnishment laws, as the cases and rulings interpret and apply the federal exclusive benefit rule. Thus, in light of *Novak*, an entity seeking garnishment of pension benefits to satisfy a judgment under a state restitution order could garnish monthly post-retirement payments available to the member under the terms of the plan. An entity seeking garnishment might also be able to garnish the lump sum payment if, and only if, the terms of the plan allow the defendant to demand a lump sum payment at that time. Thus, to the extent that these state laws permit garnishment of retirement funds *that have already been distributed to a member*, there is no conflict with the IRS Exclusive Benefit Rule. In contrast, if a criminal restitution order provides for garnishment of state public pension funds that have not yet been distributed to the member, the statutory anti-alienation provisions applicable to state-administered pension plans probably prohibit the garnishment of the funds.

In a recent Washington state case, the court determined that the Law Enforcement and Fire Firefighters Retirement System "does not exempt retirement funds from garnishment after they have been paid to the retiree."<sup>14</sup> The court reasoned that the member's retirement allowance was not disturbed because it had already

## Where Do You Draw the Line? Garnishing State Public Pension Funds Pursuant to Restitution Orders and the IRS Exclusive Benefit Rule *(continued)*

been deposited into the member's personal checking account.<sup>15</sup> "At that point, [the member's] right was satisfied and does not extend so far as to provide a permanent shield from all his debts."<sup>16</sup> Thus, pursuant to that Washington state case, once payments have been made to retirees, a party can garnish the money in the possession of the retiree or beneficiary. While that case did not involve a state garnishment order, its holding is useful for examining what portion of a state's public pension funds can be garnished in compliance with a state's anti-alienation laws.

But, if a state statute provides that money held by the state prior to any disbursement can be garnished pursuant to a state criminal restitution order, it could violate the IRS exclusive benefit rule. This is because "state pension exemption statutes plainly prohibit any garnishment at all of pension funds while still in the hands of the State."<sup>17</sup> Second, the IRS exclusive benefits rule prohibits the use of plan assets for the benefit of anyone other than the employees and their beneficiaries.<sup>18</sup>

This is supported by the federal cases and IRS private rulings, which permits garnishment of retirement funds that have already been distributed to a member. This is also directly in line with other states' cases involving garnishing of ERISA pensions pursuant to a state restitution order.<sup>19</sup> For example, in New Jersey, the court held that once a defendant "has actually received pension benefits, those benefits are subject to judgement" as the restitution is "paid out of funds that are unprotected because they are in the pensioner's possession, not out of protected benefits that are owed to the pensioner."<sup>20</sup> Second, in Michigan, the Court ruled that ERISA did not protect pension proceeds that a prisoner had already received in his personal account, and thus, the state could distribute those funds to the extent permitted under the state's Correctional Facility Reimbursement Act.<sup>21</sup> Finally, in Wisconsin, a court's order for a defendant to withdraw funds from his pension plan and transfer the money to victims of his embezzlement crime to satisfy restitution was found by the appellate court to violate ERISA's anti-alienation clause.<sup>22</sup>

Thus, the garnishment of retirement funds pursuant to a state garnishment law already distributed to a member would probably

not violate the exclusive benefit rule. However, if a state criminal restitution order provides for the garnishment of retirement funds

that have not yet been distributed to the member, garnishing of the funds might not be permissible unless the terms of the plan allow the defendant to demand a lump sum payment at that time, under the federal case law cited above. Accordingly, any other garnishment of retirement funds pursuant to a state restitution order could cross the delineation drawn on the federal level, and the state's public pensions funds could be at risk for violating their own anti-alienation laws and the IRS' exclusive benefit rule.



*But, if a state statute provides that money held by the state prior to any disbursement can be garnished pursuant to a state criminal restitution order, it could violate the IRS exclusive benefit rule. This is because "state pension exemption statutes plainly prohibit any garnishment at all of pension funds while still in the hands of the State."<sup>17</sup>*

*Debra Lefing is Assistant Attorney General for the Washington Office of the Attorney General, representing the Washington State Department of Retirement Systems.*

### ENDNOTES:

<sup>1</sup>See e.g., 43 P.S. § 1313 (In Pennsylvania, "no public official or public employee . . . shall be entitled to receive any retirement or other benefit or payment of any kind except a return of the contribution paid into any pension fund without interest, if such public official or public employee is convicted or pleads guilty or no defense to any crime related to public office or public employment"); see also California Code 7522.72 (a public employee convicted by a state or federal trial court of any felony for conduct arising out of in the performance of his or her official duties shall forfeit "all accrued rights and benefits in any public retirement system in which he or she is a member"). Similar forfeiture provisions, with differing specifications are also found in Alabama, Alaska, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Rhode Island, Tennessee, Texas, Utah, Vermont, and Virginia.

<sup>2</sup>Ohio Revised Section Code 742.461, 2907.15 (providing that pension payments pursuant to the state's public employees retirement systems can be garnished to pay a criminal restitution order from the Court).

<sup>3</sup>Alabama Code 36-27-28 (restitution or any other financial obligations in a criminal case are not subject to the exemption against the garnishment of pension or retirement allowance, so long as specific requirements in that statute are met).

<sup>4</sup>RCW 9.94A.7601 (Washington state specifically allows for the garnishment of state pensions as it defines "earnings" as "compensation paid or payable for personal services, whether denominated as wages, salary, commission, hours, or otherwise, and notwithstanding any other

## Where Do You Draw the Line? Garnishing State Public Pension Funds Pursuant to Restitution Orders and the IRS Exclusive Benefit Rule (*continued*)

provision of law making such payments exempt from garnishment, attachment, or other process to satisfy court-ordered legal financial obligations, specifically includes periodic payments pursuant to pension or retirement programs, or insurance policies of any type.”)

<sup>5</sup>See Ohio Revised Code Section 742.47; Ala. Code 36-27-28; and RCW 41.26.053(1), RCW 41.34.080, and RCW 41.40.052(1) (setting forth anti-alienation provisions for Washington state’s different retirement systems).

<sup>6</sup>26 U.S.C. § 401(a)(2) provides that a plan will not be qualified unless it prohibits assignment or alienation of the Plan’s benefits.

<sup>7</sup>Private Letter Ruling 200426027 (While IRS letter rulings are not binding, the court in *Novak* relied on this letter in its decision, noting that “the Commissioner’s position makes eminent sense.” *U.S. v. Novak*, 476 F.3d 1041, 1064 (9th Cir. 2007)).

<sup>8</sup>*Novak*, 476 F.3d at 1064.

<sup>9</sup>*U.S. v. DeCay*, 620 F.3d 534, 543 (5th Cir. 2010).

<sup>10</sup>476 F.3d at 1063.

<sup>11</sup>*Id.* at 1062.

<sup>12</sup>*Id.*

<sup>13</sup>472 U.S. 713, 725, 105 S. Ct. 2919, 86 L. Ed. 2d 565 (1985).

<sup>14</sup>*Anthhis v. Copland*, 173 Wn.2d 752, 766, 270 P.3d 574 (2012).

<sup>15</sup>*Id.* at 765.

<sup>16</sup>*Id.* at 766.

<sup>17</sup>*Id.*

<sup>18</sup>26 U.S.C. § 401(a)(2).

<sup>19</sup>The issue examined in this memorandum is novel. The author reached out to membership of NAPPA and found that only a few states actually have a state restitution statute, which allows an exception for the state to garnish state pensions. However, the author could not locate any state case law involving these state garnishment statutes involving state public pensions.

<sup>20</sup>*State v. Pulasty*, 136 N.J. 356, 361, 642 A.2d 1392 (1994).

<sup>21</sup>*State Treasurer v. Abbott*, 486 Mich. 143, 160, 660 N.W.2d 714 (2003).

<sup>22</sup>*State v. Kenyon*, 225 Wis.2d 657, 669, 593 N.W.2d 491 (1999).



# 2019

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## Fiduciary Duties and Proxy Voting Oversight

By: Keith Johnson and Terri Jo Saarela

Congress and the Securities and Exchange Commission (SEC) are once again focusing on corporate pushback against proxy voting practices of institutional investors and their proxy voting advisors. However, largely missing from that debate has been an understanding of the investor fiduciary duties which apply to management of proxy voting. This presents major public policy risks for pension funds and other long-term investor fiduciaries with obligations that extend across generations and require creation of sustainable value. Misinformed regulatory interventions that impede the independent communication between shareholders and boards that is provided by proxy voting or which disrupts the state law corporate governance balance between management, boards and shareholders could have serious consequences. This article provides an up-to-date overview of the fiduciary duty principles which underlie proxy voting and offers related guidance for pension fund fiduciaries. We believe that a more robust implementation of fiduciary principles could improve both proxy voting oversight and asset management results, as well as address many of the issues driving the current political pushback.



*Misinformed regulatory interventions that impede the independent communication between shareholders and boards that is provided by proxy voting or which disrupts the state law corporate governance balance between management, boards and shareholders could have serious consequences.*

loyalty with respect to services undertaken on the client's behalf, including proxy voting.”

### Duty of Prudence

The duty of care cited by the SEC has often been viewed as merely requiring that fiduciaries follow practices that are being used by similar investors. After all, the ERISA prudence standard requires application of the same care, skill, diligence and prudence as peers. However, prudence is not a “lemming standard” which contemplates blindly following peers. Peer practices serve as a reference point, but each fiduciary must undertake due diligence based on its own investment beliefs, strategy, liability structure, risk tolerance, resources and governing documents. Since fiduciary duty is process oriented, it is not unusual for investors using the same prudent processes to reach different results.<sup>2</sup>

Prudence is also not unidimensional. It has additional aspects which are especially relevant to proxy voting. They include:

- Prudence is forward looking and not limited to projection of past patterns into the future. The word “prudent” originates from the Latin word meaning to act with or show care and thought for the future.
- Fiduciaries must investigate and verify facts material to investment decisions. Personal biases or preferences (whether liberal or conservative) cannot be the basis for decisions.
- Understanding of fiduciary principles is not static. It evolves over time as circumstances and the knowledge base change. For example, after investment theory evolved during the 20<sup>th</sup> century to finally treat investment in company stock as prudent, an introductory note was added to chapter 17 of the *Restatement of Trusts (Third)* in 1992 to recognize, “Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments.”

### Application of Fiduciary Duties to Proxy Voting

It is well established that investor fiduciary duties under the Employee Retirement Income Security Act (ERISA), which serve as a model for most public pension funds, apply to management of proxy voting rights. The Federal Department of Labor (DOL) advised ERISA funds in 1988 that “[t]he fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.”<sup>1</sup>

Both the DOL and SEC have more recently confirmed that fiduciary duties apply to proxy voting. For example, in DOL Interpretive Bulletin 2016-01 (December 29, 2016), the DOL noted that “[t]he Department’s longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies and other exercises of shareholder rights.” In Staff Legal Bulletin No. 20 (June 30, 2014), the SEC confirmed, “As a fiduciary, an investment adviser owes each of its clients a duty of care and

## Fiduciary Duties and Proxy Voting Oversight (*continued*)

### Evolution in Application of Prudence to Proxy Voting

An appreciation that fiduciary duty principles evolve over time is especially relevant when it comes to proxy voting. For example, the DOL issued an Interpretive Bulletin at the end of 2016 which reflected advances in thinking after the Great Recession that confirmed environmental, social and governance (ESG) factors can be material to proxy voting practices and corporate sustainability.<sup>3</sup> This was again affirmed by the DOL in 2018:

“[There] may be circumstances, for example involving significantly indexed portfolios and important corporate governance reform issues, or other environmental or social issues that present significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders with respect to which reasonable expenditure of plan assets to more actively engage with company management may be a prudent approach to protecting the value of a plan’s investment.”<sup>4</sup>

BlackRock, the world’s largest institutional investor, demonstrated this evolution in 2018 and 2019 letters to companies from its Chairman and CEO, Larry Fink. The 2018 letter said:

“[You] must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to climate change—affect your potential for growth.”<sup>5</sup>

Larry Fink’s 2019 letter added:

“BlackRock’s Investment Stewardship engagement priorities for 2019 are: governance, including your company’s approach to board diversity; corporate strategy and capital allocation; compensation that



*Accordingly, as a trust fund asset, proxy votes must be managed impartially, balancing the interests of both young and old fund participants.*

promotes long-termism; environmental risks and opportunities; and human capital management. These priorities reflect our commitment to engaging around issues that influence a company’s prospects not over the next quarter, but over the long horizons that our clients are planning for.”<sup>6</sup>

This evolution is also evident through changes in proxy voting trends.<sup>7</sup> For example:

- Ernst & Young (EY) reports that environmental and social resolutions at Russell 3000 companies which received vote support levels of 30% or more increased from 29% of those resolutions in 2017 to 41% in 2018.
- PwC found that overall institutional investor support for political spending disclosures has grown over the last four years from 21% to 29%. In 2018, PIMCO and Legal & General supported them 100% of the time.
- BlackRock, Vanguard, Fidelity and American Funds began voting in favor of climate change reporting resolutions at select companies in 2017. In 2018, the 50/50 Climate Project found that the thirteen largest investors voted for 42%, of climate change resolutions at companies in carbon intensive industries.
- An EY 2019 survey reports the top issues investors plan to engage companies on are director diversity, ESG issues (particularly climate risk) and human capital (management of talent and culture).

The duty of prudence contemplates that fiduciaries understand and evaluate the factors driving these trends.

### Duties of Loyalty and Impartiality

ERISA explicitly provides in section 404 that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries.” The United States Supreme Court expanded this in *Varity v. Howe*, 516 U.S. 489 (1996), by holding “the common law of trusts [made applicable to ERISA §§404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interest of all beneficiaries.”

Accordingly, as a trust fund asset, proxy votes must be managed impartially, balancing the interests of both young and old fund participants.

## Fiduciary Duties and Proxy Voting Oversight (*continued*)

### Potential Investment Manager Conflicts of Interest

The SEC has recognized that investment manager conflicts of interest could influence their voting decisions when a manager holds proxy voting authority for asset owners. In its 2003 rule on delegation of proxy voting duties, the SEC mandated, “[t]o satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.”<sup>8</sup>

However, when asset owners delegate voting to managers, they retain monitoring and oversight duties. The DOL confirmed, “The fiduciary duties described at ERISA §404(a)(1)(A) and (B)...also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions.”<sup>9</sup>

Unfortunately, a number of recent studies have found that mutual fund manager business interests do influence proxy voting decisions. For example, a 2016 study published in the *Journal of Finance* concluded, “[We] find that business ties significantly influence pro-management voting at the level of individual pairs of fund families and firms after controlling for [ISS] recommendations and holdings. The association is significant only for shareholder-sponsored proposals and stronger for those that pass or fail by relatively narrow margins.”<sup>10</sup>

These conclusions raise oversight challenges for fiduciaries that have delegated proxy voting authority to investment managers who have potentially conflicting business interests (e.g., manage defined contribution assets for corporate pension funds).

Another example of how investment manager conflicts of interest can play out is illustrated by a statement in BlackRock’s *Investment Stewardship 2018 Annual Report*:

“During our direct engagements with companies, we address the issues covered by any *shareholder proposals that we believe to be material to the long-term value of that*

*company. Where management demonstrates a willingness to address the material issues raised, and we believe progress is being made, we will generally support the company and vote against the shareholder proposal.”* [Emphasis added.]

On its face, this indicates that BlackRock votes against shareholder resolutions that it believes are material to long-term shareholder value. While BlackRock might have reasons for this, voting for management over what is in the best interests of clients raises duty of loyalty questions that BlackRock’s asset owner clients might want to examine. Monitoring of delegates’ proxy votes for conflicts and consistency with public statements or policies should also be a priority.<sup>11</sup>



*The SEC has recognized that investment manager conflicts of interest could influence their voting decisions when a manager holds proxy voting authority for asset owners.*

### Systemic Risks and the Duty of Impartiality

Portfolio company practices that have systemic risk implications (like climate change, environmental damage, health and safety issues) can often go unnoticed over the short term, though they have the potential to degrade returns over time and generate risks that can spread across companies in a pension fund’s portfolio.

As a result, systemic risks can produce uncompensated cross-generational risk transfers. Unmeasured and unmanaged, they can also raise fiduciary duty of impartiality concerns when voting on related proxy issues (e.g., climate risk).<sup>12</sup>

Fortunately, there are resources to help shareholders identify material ESG and sustainability risk issues and opportunities. For instance, the Sustainability Accounting Standards Board (SASB) has developed standards that identify industry-specific sustainability factors. The SASB standard setting process involves company, investor and stakeholder representatives and follows the U.S. Supreme Court’s definition of investment materiality.<sup>13</sup> SASB standards can be used to inform proxy voting policies.

### Implications for Pension Fund Fiduciaries

Proxy voting is an intricate part of the investment management process, with corresponding fiduciary duties. How to best address those duties will vary between funds. Nevertheless, there are a number of common options to consider:

## Fiduciary Duties and Proxy Voting Oversight (continued)

- Staff up or outsource? Some investors have the resources to handle proxy voting issues internally; others must rely on outside advisors. Expertise and specialized training is needed.
- Who is responsible? Proxy voting should be integrated with the investment function, and the responsible manager should report at a high level of the organization.
- Do we have the right advisors, consultants and managers? Include demonstrated proxy voting expertise and resources as a requirement in RFPs. Use knowledgeable consultants or advisors to help develop policies.
- What do our advisor and manager contracts provide? Consider provisions on: a) the full range of fiduciary duties; b) expertise, resources and policies; c) procedures for handling business conflicts, policy exceptions and public statement consistency; d) evaluation of current research and voting trends; e) consideration of sustainability, systemic risks and time horizon impartiality; and f) voting reports, exceptions and audits.
- Is proxy voting part of annual evaluations? Include presentation and analysis of proxy issues in advisor and manager evaluations.
- Can we collaborate? Join with other investors and investor organizations on opportunities for education, development of model practices, cost management and engagement with service providers, including proxy advisors.



*Do we have the right advisors, consultants and managers? Include demonstrated proxy voting expertise and resources as a requirement in RFPs. Use knowledgeable consultants or advisors to help develop policies.*

*Keith Johnson chairs the Institutional Investor Services Group at Reinhart Boerner Van Deuren. Terri Jo Saarela is the former Corporate Governance Director at the State of Wisconsin Investment Board.*

### ENDNOTES:

<sup>1</sup>Letter from the Department of Labor, to Helmut Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988).

<sup>2</sup>For a more detailed application of the fiduciary duties that apply to proxy voting, see Johnson, Williams and Aguilera, “*Proxy Voting Reform: What is on the Agenda, What isn’t on the Agenda, and Why it Matters for Asset Owners*,” Forthcoming, 99 Boston University Law Review (2019), <https://www.reinhartlaw.com/wp-content/uploads/2019/03/Proxy-Voting-Reform-What-is-on-the-agenda-what-isnt-on-the-agenda-and-why-it-matters-for-asset-owners.-1.pdf>.

<sup>3</sup>DOL Interpretive Bulletin 2016-01, Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy

Voting Policies or Guidelines (Dec. 29, 2016) at <https://www.dol.gov/sites/default/files/ebsa/2016-31515.pdf>.

<sup>4</sup>DOL Field Assistance Bulletin 2018-01 at <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>.

<sup>5</sup>Larry Fink’s 2018 Letter to CEOs: A Sense of Purpose, BlackRock, <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter>.

<sup>6</sup>Larry Fink’s 2019 Letter to CEOs: Purpose & Profit, BlackRock, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

<sup>7</sup>Proxy voting trends data from Rob Berridge, *Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds?*, CERES (December 21, 2017), <https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about>; EY Center for Board Matters, *2018 Proxy Season Review* (2018), [https://www.ey.com/Publication/vwLUAssets/EY-cbm-proxy-season-review-2018/\\$FILE/EY-cbm-proxy-season-review-2018.pdf](https://www.ey.com/Publication/vwLUAssets/EY-cbm-proxy-season-review-2018/$FILE/EY-cbm-proxy-season-review-2018.pdf); Kimberly Gladman, 50/50 Climate Project, *Asset Manager Proxy Scorecard* (2018), <https://5050climate.org/wp-content/uploads/2018/09/FINAL-2018-Climate-Scorecard-1.pdf>; Broadridge & PWC, *ProxyPulse 2018 Proxy Season Review* (October 2019), <https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-broadridge-proxypulse-2018-proxy-season-review.pdf>; and EY Center for Board Matters, *2019 Proxy Season Preview* (2019), <https://www.ey.com/us/en/issues/governance-and-reporting/ey-2019-proxy-season-preview>.

### Conclusion

Improved linkage of proxy voting practices with an up-to-date application of the full range of investor fiduciary duties has potential to improve long-term investment performance, reduce unwanted risk exposures and address concerns generating demands for regulatory intervention. With a few targeted policy and practice adjustments, asset owner fiduciaries could drive positive change that better serves fund participant interests in a cost-effective manner.

## Fiduciary Duties and Proxy Voting Oversight (*continued*)

<sup>8</sup>Proxy Voting by Investment Advisors, Exchange Act Release No. IA-2106, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003), <https://www.sec.gov/rules/final/ia-2106.htm>.

<sup>9</sup>DOL Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines (2016), <https://www.law.cornell.edu/cfr/text/29/2509.2016-01>.

<sup>10</sup>Cvijanović, Dasgupta & Zachariadis, *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933, 2933-66 (2016), [http://eprints.lse.ac.uk/65929/7/Dasgupta\\_Ties%20that%20bind\\_author\\_LSERO.pdf](http://eprints.lse.ac.uk/65929/7/Dasgupta_Ties%20that%20bind_author_LSERO.pdf).

<sup>11</sup>Exceptions to policy provisions are not necessarily problematic, if they are supported by company strategy or circumstances.

<sup>12</sup>For a detailed analysis of the impact of systemic risks, see *Hawley & Lukomnik, The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons*, 41 SEATTLE U. L. REV. 449, 450 (2018), <https://digitalcommons.law.seattleu.edu/cgi/viewcontent.cgi?article=2507&context=sulr>.

<sup>13</sup>See <https://www.sasb.org/>.

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