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TEXAS MUNICIPAL RETIREMENT SYSTEM

TRUSTEE TRAINING ON FIDUCIARY DUTY AND ETHICAL ISSUES FACING FIDUCIARIES

AUSTIN, TEXAS
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Executive Summary Outline

I. Fiduciary Matters

A. Fiduciary Defined - One responsible for the care of the property of another in a relationship of trust

B. Fiduciary Responsibility - To act in the best interest of the members and beneficiaries and to exercise prudent decision making.

C. Fiduciary Duty - Trustees have an exclusive duty of loyalty to plan participants

D. Observance of Plan Statutes, Rules, and Policies - The Board is a statutory creation and is charged with administering the plan in accordance with the governing laws. While the Board may adopt rules and policies, it may not conflict with the legislation governing the plan. TMRS is governed by the Constitution, the TMRS Act, the Texas Trust Code, and other statutes.

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E. Standards of Conduct - The behavior of trustees is governed by ethics statutes relating to conflicts of interest. While the Board may delegate responsibilities to staff and professionals, it retains the ultimate responsibility.

F. Prohibited Transactions - System assets may not be used for any purpose other than the payment of benefits and defraying the reasonable expenses of administering the System. Both Federal Tax Code provisions and state constitutional and statutory provisions limit certain Board actions.

G. Fiduciary Roles of Pension Professionals - Both Texas law and general trust principles recognize the need for trustees to retain professional advisors to assist in System administration. TMRS has accomplished that through retention of permanent staff and hiring of select professionals in investment, accounting, governance and legal areas. The advisors are just that - they advise, educate, and recommend. The Board retains certain decision making authority, as well as continuing duty to monitor staff and professional compliance with Board policies and their performance.

II. Governance

A. Appointment and terms of trustees - Trustees are appointed by the Governor in accordance with state law. Trustees must maintain qualification for office throughout their terms. If a replacement is not qualified by the end of a term, a trustee may hold over until a replacement is properly appointed.

B. Role of the Board - It is important for the Board to appreciate its role as a policy maker and a policy enforcer through accountability. Both TMRS staff and outside consultants have specific roles in the delivery of services to the System and its members.

C. Best Practices - While there is no specific definition of "best practices," the Board has a duty to establish policies related to all aspects of fiduciary management. The Board should engage in a dynamic program of strategic planning which includes measuring accountability, delegation of authority and succession planning.

III. <u>Ethics</u>

A. Applicable Texas Statutes - Texas has a detailed statutory regime addressing conflicts of interest and financial disclosure which provides both civil and criminal penalties for violations.

B. What is an Ethics Policy? - It is a set of agency directives designed to implement state ethics laws and prescribe approved and disapproved practices as they relate to the specific mission of the Agency.

C. What Should an Ethics Policy Include - An ethics policy should address avoiding conflicts which are inconsistent with the duty of loyalty and the high behavioral standards required of trustees. The policy should address conflicts in investment; maintaining confidentiality; avoidance of self dealing and managing disclosed conflicts.

D. Addressing Conflicts of Interest - The ethics policy should address a means of reporting conflicts or possible violations of state ethics laws or Board policy. Trustees should remain vigilant in their conduct and in ensuring adherence to ethical standards by staff and consultants.

E. Ethics in Investment - Many TMRS investments have strict confidentiality requirements. Trustees must also avoiding self dealing based on inside. information.

F. Common ethics issues - Many Texas Ethics Commission opinions address common problems related to nepotism and gifts. Specific exceptions apply to each and the Board's ethics policies should take specific consideration of what is or is not permissible.

IV. <u>Investments</u>

A. Due Diligence - This is process of throughly vetting all aspects of an investment strategy and provider to assess risk and reward.

B. Role of the Board - The Board has the ultimate responsibility for the success of the investment program and to monitor the staff and professionals to whom it has delegated certain investment functions. Assets are to be invested as person of common prudence would do in the management of their own property.

C. Role of Investment Staff and Professionals - Under Texas law and the general law of trust permits (and in many instances requires) the delegation of certain investment functions to TMRS staff and outside consultants. The role of these professionals is to perform the essential due diligence necessary to enable the trustees to oversee the overall performance of the portfolio.

D. Understanding Investment and Asset Allocation - Trustees have a duty to appreciate risk and reward in investment strategies. TMRS may only invest in securities as defined by law. Trustees have a duty to understand all investment strategies employed by the System so that decision making is based on informed prudence.

E. Delegation of Investment Authority - Texas Prudent Investor Act (Chapter 117, Texas Property Code) expressly provides rules for delegation. Delegation of due diligence duties is not an abdication of ultimate decision making responsibility. The Board remains responsible to monitor the activities of entities and persons to whom it has delegated responsibilities and ensure accountability. Persons and entities accepting that delegation submit to the jurisdiction of Texas courts.

V. <u>Actuarial Matters</u>

A. Role of Actuary - The actuaries are responsible for determining the long term economic needs of the System to meet its benefit obligations. This includes developing assumptions relating to investment return, salary growth, mortality, rate of retirement and inflation. The actuary advises the Board on required contribution rates.

B. Role of the Board in Adopting Assumptions - The Board has the statutory duty to adopt the actuarial assumptions. This requires a keen understanding of the valuation process and the development of those assumptions.

C. Reasonable Assumptions - Reasonable assumptions are those that will lead to proper funding of the System to enable it to pay benefits as and when they become due. Reasonableness is not a static calculation. It must be tested on a continuing basis including periodic review of System experience.

D. Long Term vs. Short Term Concerns - While valuations are performed annually and implementation of actuarial standards are an on-going process, it is important to remember that the System is not merely a series of annual calculations. The trustees must address the long term needs of the System as well as the determination of annual contribution rates.

VI. Benefit Administration

A. Duty to Members - The System's duty to members is multi-layered. The System assets must be invested for the highest and best return with reasonable risk. Members must be advised as to the rights and options throughout employment and particularly as they approach retirement. The System has a duty to ensure timely and accurate payment of benefits, including managing division of marital property in accordance with law. The System has a duty to preserve member information in a cyber-secure manner to prevent identity theft and to maintain statutorily required confidentiality.

B. Duty to Participating Cities - The Board has a duty to provide accurate and timely information to cities. As with members, the System has a duty to provide continuing guidance to enable member cities to select benefit design options.

C. Role of the Board - The Board has the responsibility to be informed concerning membership / participating-city policies and their effectiveness. While the details of service are primarily a staff responsibility, the Board is responsible for ensuring the adoption and enforcement of effective policies and procedures.

D. Controlling Fraud and Correction of Errors - Errors in payment are inevitable. Texas law provides a specific manner and limitations on correction and collection of overpayments. Maintaining effective measures to prevent and detect fraud is an essential element of benefit management and administration.

E. Tax Matters - Maintaining the qualified status of the System is vital to both members and the City members. This also means adjusting policies and practices as changing federal tax policies and guidance require.

VII. Risk Management

A. Fiduciary Risks - Risk, in and of itself, is not imprudent. All policies, particularly in investment, carry an element of risk. The task is to match the reasonableness of the risk to the anticipated reward. To determine risk, the trustees should rely on internal audit risk identification; actuarial experience and investment projections. Like best practices, managing risk is a dynamic process.

B. Sovereign Immunity - Texas law provides sovereign immunity for the exercise of discretionary activities by the Board. Sovereign immunity effectively deprives the courts of jurisdiction to review certain decisions. As a statewide public retirement system, TMRS also has immunity from most damage claims in federal courts.

C. Internal Controls - Part of the risk management model is the development and enforcement of reasonable internal controls, which are essentially a System designed set of checks and balances on all aspects of System operations. To that end, the Internal Auditor, who is intended to be independent of the staff structure assists the Board in testing these desired controls.

D. Audit and GASB Disclosures - Government accounting standards require significant disclosures which are essential to the member Cities and their ability to issue debt for capital projects. In working with its external auditors, the Board has a responsibility to be informed of observed weaknesses in System internal controls and to take corrective action. The external audit process also assures the sponsoring governments and the membership of the financial integrity of the System.

E. Addressing Claims - A program of addressing claims, whether related to investment matters or an error in member account information, is an essential part of risk management. This program involves legal analysis of risks, close observation of investment issues, and meaningful accountability at all levels of System management. While the TMRS staff is responsible for the management of the program, reviewing its success or deficiencies is a continuing duty of the Board.

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