TMRS

November 18, 2021

To: **Board of Trustees**

From: **Christine M. Sweeney, Chief Legal Officer** CS

Re: **Agenda Item 22: Board Education: A Trustee's Fiduciary Responsibilities**

The Board's Fiduciary Counsel, Bob Klausner, of Klausner, Kaufman, Jensen & Levinson, will provide an educational overview of a Trustee's fiduciary responsibilities.

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A PARTNERSHIP OF PROFESSIONAL ASSOCIATIONS
ATTORNEYS AT LAW

TEXAS MUNICIPAL RETIREMENT SYSTEM

TRUSTEE TRAINING ON FIDUCIARY DUTY AND ETHICAL ISSUES FACING FIDUCIARIES

AUSTIN, TEXAS
December 2, 2021

I. BASIC TRUST PRINCIPLES

A. TMRS is a trust established by statute.

B. A trust is a legal entity created by a settlor (the State of Texas) to provide for the safekeeping of money and other property for the benefit of another person or entity (the beneficiary).

C. The party charged with management of the trust (trustee) has the duty to safeguard the property for the exclusive use of the intended beneficiary.

D. Trust law has Biblical origins. Modern trust law traces back to the mid-19th century with the introduction of the Prudent Person Rule.

E. Pensions trusts for government employees are created by state statute or local ordinance.

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F. Private sector pension trusts are governed by the Employee Retirement Income Security Act of 1974 (ERISA).

G. Collective bargained plans in the private sector are also governed by the provisions of the federal Taft-Hartley laws.

II. <u>FIDUCIARY MATTERS</u>

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 and a duty of prudence in all decisions.

D. Duty of Loyalty - This is a rigid legal standard requiring the trustees to act in the exclusive interest of the members and beneficiaries of the System. A trustee cannot wear "two hats," meaning there is only a duty to the membership as a whole and not to any single individual or to any other constituency such as a city, a labor organization, etc.

E. Duty of Prudence - This is decision making standard that governs the Board. The TMRS Act uses the prudent person standard, meaning what a reasonably prudent person would do dealing with their own property. This standard applies to all decision making for the System, not just investment decisions. The TMRS Investment Policy requires a higher "prudent expert" standard for investment consultants and managers. The standard of prudence is an evolving one.

F. 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 Texas Constitution, the TMRS Act, the Texas Trust Code, and other statutes.

G. Standards of Fiduciary Conduct - While the Board may delegate responsibilities to staff and professionals, it retains the ultimate responsibility.

H. Standards of Ethical Conduct - The behavior of trustees is governed by ethics statutes relating to conflicts of interest and the TMRS Ethics Policy.

G. 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.

I. 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.

J. Co-Fiduciary Liability - If a trustee or other Fiduciary has actual knowledge of misconduct or a breach of fiduciary duty by any other fiduciary and takes no action, then that Fiduciary has breached his or her duty. You are your brother and sister's keeper.

III. <u>GOVERNANCE</u>

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 legal 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. What is a best practice for one fund, may not be best for TMRS.

IV. ETHICS

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. Additional information about these statutes can be found in the Board Ethics Training Module located in the Resource Center on Diligent.

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, self-enrichment, disclosure of conflicts, and managing disclosed conflicts consistent with statutory mandates.

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. **When in doubt - seek advice**.

E. Ethics in Investment - Many TMRS investments have strict confidentiality requirements. Trustees and staff 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. **Again, when in doubt - ask first, act after.**

V. <u>INVESTMENTS</u>

A. Due Diligence - This is a process of thoroughly vetting all aspects of an investment strategy and provider to assess risk and reward and to assure compliance with constitutional and statutory investment limitations.

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. Trustees are subject to the "Prudent Person" standard, meaning they must act as persons of common prudence would do in the management of their own property when making investment decisions.

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. Investment professionals are held to a higher standard of professional competence.

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) and the TMRS Investment Policy Statement expressly provide 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 those to whom it has delegated responsibilities to ensure accountability. Persons and entities accepting that delegation submit to the jurisdiction of Texas courts.

VI. ACTUARIAL MATTERS

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.

VII. 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 their rights and options regarding TMRS benefits 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 qualified domestics relations orders (QDRO) and the law. The System has a duty to preserve member information in a cyber-secure manner to try to help 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.

VIII. 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.

F. Avoiding Liability - Trustees may be protected from personal liability by fiduciary insurance which can cover negligence. Trustees may also be protected from personal liability by indemnification from the System under sovereign and discretionary immunity and by relying in good faith on the advice from the Board's experts.

G. Best Practices to Avoid Liability - A trustee's best defense is education. An educated trustee is a prudent trustee. Engaging in a thorough decision-making process is consistent with best practices and can avoid liability, particularly when the decision making process is part of an on-going monitoring and oversight of System advisors. Trustees should never hesitate to engage its senior staff and outside experts in specialized decision-making areas such as investment and setting actuarial assumptions. All of the foregoing are part of a robust governance structure. While the Board can and should seek advice and even delegate the execution of certain functions, in the end "the buck stops" with the Board.

FIDUCIARY DUTY
A QUICK STUDY OF THE ESSENTIALS

Presented by

Robert D. Klausner, TMRS Fiduciary Counsel

WHAT IS A FIDUCIARY?

- A fiduciary is a person or corporation in a position of trust on behalf of another.
- In the case of the TMRS Board of Trustees, you are fiduciaries to the members and beneficiaries of the System.
- Your actions must be in the best interest of the System and its participants as a whole.
- A fiduciary cannot claim to have divided loyalties and serve each one equally well.

PRUDENT FIDUCIARIES CREATE POLICY AND DEMAND ACCOUNTABILITY

- It is important to know who has what job?
- Delegation is expressly provided for in Texas law
- What is the difference between delegation and abdication of a fiduciary duty?

WHAT CAN AND CANNOT BE DELEGATED?

- The Board can delegate investment functions
- The Board cannot delegate ultimate responsibility
- The Board can delegate day to day management of the System to the ED, staff and outside advisors
- The Board cannot delegate ultimate accountability for the actions of its agents
- In the end, “The Buck Stops Here.”

WHAT MAKES A PRUDENT FIDUCIARY?

- Be curious – if you don’t know something, ask questions
- There are no dumb questions
- Don’t micromanage – you have a chain of command
- Don’t undermine your senior staff and advisors by taking complaints to staff – If you aren’t satisfied with the process, hold the leadership accountable
- Above all, remember we serve our members