



## Educational Opportunities

**June 8-11**  
Stateline, NV  
*Trustees and Administrators Institutes (IFEBP)*

**July 8-11**  
Lake Ozark, MO  
*Missouri Association of Public Employee Retirement Systems*

**July 14-16**  
Denver, CO  
*Benefits Conference for Public Employees (IFEBP)*

**July 17-20**  
San Francisco, CA  
*Trustee Workshop (NCTR)*

**August 1-6**  
Monterey, CA  
*National Association of State Retirement Administrators Annual Conference*

## Fiduciary Obligations of Board Members



### Introduction

By now, you have all heard the term “fiduciary” used in various contexts, both in and outside the boardroom. Since several of you have only been on the board a relatively short time, we decided to devote this edition of Operations Outlook to the topic of certain fiduciary duties that apply to you as members of MOSERS’ Board of Trustees. We think you will find that the four primary fiduciary duties focused on here are not just dry legal concepts – they are very useful tools to help guide you as you address major retirement policy issues. We will also spend some time exploring how the governance policies adopted by the board are designed to help you meet your fiduciary obligations and, at the same time, be more effective decision makers on the board.

Critical to discussion of this matter is an understanding of the fact that MOSERS is a “trust.” By law, you, as trustees, have the authority and responsibility to operate this trust. The following citation from a Missouri Supreme Court decision makes it clear that our state’s highest court views trustees to be fiduciaries:

- ◆ A trustee is a fiduciary of the highest order. He is required to observe meticulously the fiduciary relationship, to exercise utmost good faith in handling the funds in his hands, and in all respects to exercise a high standard of conduct and fidelity in respect to administration of his trust. **Bakewell v. Mercantile Trust Co.**, 319 S.W.2d 600 (Mo. 1959).

The four primary duties of a fiduciary that we’ll now address in some detail are the duty of loyalty, the duty of impartiality, the duty to delegate, and the duty to invest.



## Duty of Loyalty

The duty of loyalty embodies a number of concepts,

including (i) rules against self-dealing, (ii) handling conflicts of interest, and (iii) managing the pension fund solely in the interest of plan participants.

The prohibition against trustee self-dealing is addressed in state law as follows:

- ◆ “No trustee or employee of the System shall receive any gain or profit from any funds or transaction of the System, except benefits from interest in investments common to all members, if entitled thereto.” Section 104.500.6, RSMo.
- ◆ “Any trustee or employee accepting any gratuity or compensation for the purpose of influencing his action with respect to the investment of the funds of the System shall thereby forfeit his office and in addition thereto be subject to the penalties prescribed for bribery.” Section 104.500.7, RSMo.

Both of these statutory provisions require that you not have a personal stake in the outcome of any issue involving the system, with the goal being to assure your objectivity in the decision

making process. In other words, they are targeted at keeping “conflicts of interest” from influencing your decisions.

A conflict of interest arises when you have a personal or financial interest that conflicts or appears to conflict with your responsibilities as a board member. When the board is to decide an issue in which you have an unavoidable conflict of interest, it may be appropriate for you not to participate in the vote or the deliberation. For example, some of you, by virtue of your positions in state government or by being elected members, could find yourself taking a position on a matter that could be in conflict with your duties as board members. A current example of this can be seen in the budget crisis that is affecting states and local governments across the country. A class action lawsuit is pending against the San Diego City Retirement System, some of that system’s trustees, and the City of San Diego, claiming that the retirement board breached its fiduciary responsibilities by intentionally permitting the city to underfund the retirement system. The suit seeks additional funding, damages, and the removal of the trustees pursuant to California law. Robert Klausner (the attorney who addressed the board on fiduciary issues in the video we sent to all board members) indicated that the suit may cost the system up to \$500,000 to defend, assuming the case goes to trial and is defended on the merits. That does not include the cost of any judgment if

the defendants lose the case. This case illustrates the point that a conflicted trustee may not take advantage of the conflict when discharging his or her duties as a trustee and must act solely in the interests of plan participants. The best way to handle an actual or potential conflict can be difficult to determine and, in some cases, may be awkward. You can probably best resolve a conflict by disclosing it to the board, abstaining from a vote, or taking a position that is clearly in the best interest of the system and its members. A practical way to resolve an actual or potential conflict is to seek advice from either the executive director or the chief counsel upon becoming aware of the conflict. They can provide helpful advice and insight and will also consult with outside legal counsel, if necessary, to determine a prudent course of action. It is worth noting that a legal opinion addressing a conflict can provide useful protection to the system and the trustee if a conflict has been determined to exist.

The foregoing principles support the precept that MOSERS must be managed solely in the interest of plan participants. Regarding this issue, the MOSERS’ law stipulates that:

- ◆ All property, money, funds, investments, and rights which shall belong to, or be available for expenditure or use by, the system shall be dedicated to and held in trust for the members and for the purposes herein set out and no other. Section 104.440, RSMo (and similarly referenced in section 104.1069, RSMo).

You are required to make decisions as trustees with one consideration in mind – the best interests of plan participants. You may not direct that MOSERS be administered in a manner advocating an agenda that relates to or prefers some other interest. Furthermore, you must make policy decisions that protect and result in the prudent management of the trust funds. This implicitly requires a high degree of independence in your approach toward the system. That is a very difficult proposition for some boards of public retirement funds because they are typically composed of current and former employees, many of whom are in positions of labor and management leadership as part of their regular employment. That can make things very difficult when it comes to acting independently from general policies being advocated by the governmental entity sponsoring the retirement fund. While a superficial look at the structure and makeup of the MOSERS board may give the



impression that there will naturally be conflicts of interest, there are numerous examples of board action illustrating extreme vigilance and undivided loyalty in the exercise of fiduciary duties. Continuation of the level of independence that has been demonstrated historically will lead to the continued success of the system and go far in protecting trustees against claims of violations of fiduciary duties.

### Duty of Impartiality

As trustees, you may not show partiality to any beneficiary or group of beneficiaries. All groups of similarly

situated benefit recipients must be afforded equal treatment under the statutory provisions applicable to MOSERS' retirement plans.

While not directly related, this duty is very similar to the constitutional requirement that groups be treated equally under the law. That concept is covered by the equal protection clause in the Missouri Constitution that reads as follows:

- ◆ That all constitutional government is intended to promote the general welfare of the people; that all persons have a natural right to life, liberty, the pursuit of happiness and the enjoyment of the gains of

their own industry; **that all persons are created equal and are entitled to equal rights and opportunity under the law**; that to give security to these things is the principal office of government, and that when government does not confer this security, it fails in its chief design. Source: Const. of 1875, Art. II, § 4.

A similar provision exists in the U.S. Constitution. MOSERS has first hand experience with issues involving the equal protection clause. Various groups of current and future benefit recipients have challenged benefits legislation affecting MOSERS that, on its face, resulted in similarly situated groups not being treated equally. As a consequence, corrective legislation has been enacted and cash settlements have been made at a cost of millions of dollars. For the most part, we believe statutory provisions that were problematic have been satisfactorily addressed (but that is not to say that all potential areas of concern have been eliminated). We continue to periodically identify problem language and attempt to make corrections through annual cleanup legislation.



### Duty to Delegate

Historically, a trustee had a duty not to delegate to others if the trustee could reasonably

perform the necessary functions required by the trust document.

However, that view changed materially as trusts became more complex. The Third Restatement of Trusts (the bible of trust law) includes the following comments regarding delegation:

- ◆ A trustee’s discretionary authority in the manner of delegation may be abused by imprudent failure to delegate as well as making an imprudent decision to delegate. In administering the trust’s investment activities, the trustee has the power, and may sometimes have a duty, to delegate such functions and in such manner as a prudent investor would delegate under the circumstances. (From comments a. and j. in section 171 of Restatement (Third) of Trusts.)

The reality that delegation may be necessary and can be appropriate in managing a modern pension fund as complex as MOSERS (with tens of thousands of members and billions of

dollars in assets) has been acknowledged by the Missouri General Assembly through the following statutory language:

- ◆ Trustees of a board may delegate to employees of the system, or to an agent, functions that a prudent trustee acting in a like capacity and familiar with those matters could properly delegate. Section 104.1069, RSMo.

Your ability to delegate is essential, given that there is no requirement that MOSERS trustees have the training, experience, and time necessary to handle all aspects of system administration and investment management functions. That includes calculating benefits, communicating with members, maintaining retirement records, handling legal issues and litigation, and investing assets of the system. Through the governance policies you have adopted, you have delegated prudently by giving clear direction to qualified personnel and establishing procedures for monitoring performance based on that delegation.



### Duty to Invest

Your primary mission is to make sure the system pays retirement benefits. To accomplish that task, you have established a program for the investment of employer contributions to

fund current and future retirement benefit obligations of the system. The standard of care that you must follow with regard to the investment program requires that you:

- ◆ Act with the same care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a similar capacity and familiar with those matters would use in the conduct of a similar enterprise with similar aims. Section 105.688, RSMo.

It is essential that trust assets be productively invested. You are not required to guarantee successful outcomes – only to establish and follow a prudent investment process. That process is described generally in the governance investment ends policy, and in detail in the Investment Policy and Risk Policy. The primary driver of the investment program is the real return objective established by the board. From that objective flows the board’s asset allocation decision that is intended to achieve that return objective with a minimum level of risk. The remaining aspects of the program involve (i) prudent delegation of responsibility to the executive director to operate the program based on the objectives established by the board and (ii) monitoring performance based on appropriate benchmarks.

It should be noted that staff intends to talk to you about certain proposed changes to the governance policies at

the board retreat. The primary changes involve the incorporation of investment limitations into the governance policies that are currently in place under the system's Investment Policy. In addition, staff proposes simplifying the investment ends policy and streamlining the investment performance report to make both easier to understand. Finally, we will discuss the link between the chief investment officer and the board as well as look at a detailed succession policy regarding the executive director and the chief investment officer positions. These items will be included on the agenda for your consideration during the board meeting portion of the retreat.



### **Relationship Between the Governance Policies and Fiduciary Duties**

How do the governance policies ensure that your fiduciary obligations are met? The governance policies require the board to focus on all of the major issues facing the system and define the responsibilities of the various parties involved. The board has the responsibility to establish the broad policies of the system. Policy implementation is the responsibility of the executive director. This structure not only allows the board to meet its fiduciary responsibilities but it also

helps the board avoid pitfalls that lead to potential breaches of fiduciary duty. An examination of the four primary fiduciary duties covered in this newsletter, in the context of the governance policies, follows:

The duty of loyalty requires you to assure that the system operates in the exclusive interests of plan participants and at the same time requires that you avoid conflicts of interest and self-dealing. Boards that attempt to micromanage the operations of a system are more likely to face loyalty issues that can lead to problems than are those who properly delegate. For instance, boards who hire investment managers tend to be overwhelmed with contacts from marketers, particularly around the time hiring or firing decisions need to be made. Marketers can exert persuasive pressure through contacts with board members but may neglect to provide an objective investment rationale for a hiring or firing decision. As a result, trustees may end up making a decision based more on appearances and treatment rather than on substantive grounds. That could lead to claims that you have breached your duty of loyalty by not acting in the best interests of plan participants because of what appears to be a conflict of interest. By delegating the hiring and firing decisions to staff, you have effectively eliminated that possibility and, at the same time, ensured that decisions are made on a substantive basis by investment professionals whose interests

are aligned with the performance of the fund. This provides significant evidence that you are managing the investment program in the best interest of plan participants.

The duty of impartiality requires you to be objective and treat plan participants fairly. You have established the guidelines for fair treatment in the benefits ends policy. That policy requires staff to provide members with excellent service, clear communications concerning benefits, and timely and accurate benefit payments. You measure that performance through regular reports provided by the executive director and the deputy executive director/chief operations officer. With regard to equal protection issues, the legislative ends policy requires staff to carefully review legislative proposals to determine if any legal problems may result from enactment. If problems are identified, staff immediately notifies the sponsor of the bill regarding the issue and recommends changes to the bill to eliminate the problem before the bill passes. These mechanisms are designed to give you assurance that staff is attending to details affecting benefits in a fair and appropriate fashion.

The duty of delegation is an important and practical way for you to carry out your responsibilities for operating the system. MOSERS board has chosen the governance policies as the framework for delegation with regard to all aspects of the system. You established your

performance expectations in the ends policies. You have delegated the responsibility to achieve those ends to the executive director, subject to specific limitations on his authority to achieve those ends. Finally, you monitor results. This procedure reflects a responsible delegation plan and greatly reduces the risk of a breach of any of your fiduciary duties.

Your duty to invest is one of your primary responsibilities. As mentioned, you have established the parameters of the investment program and monitor performance closely. That coincides with your authority to prudently delegate and suggests the board is meeting the investment standard of care by following a well-designed process that employs the expertise of professional and knowledgeable investment staff together with the talents of the investment consultant retained by the board.

## **Conclusion**

Our objective with this newsletter was to provide you with a reasonably comprehensive overview of the fiduciary duties you assumed by virtue of your roles as trustees. We hope you have found it to be of value. All members of the board are encouraged to:

- ◆ Read the Governance Policy.
- ◆ Ask questions if you do not understand any aspect of your role as a trustee or any of the issues and information presented to you while you are a member of the board.
- ◆ Attend educational conferences and seminars.

Finally, if there is anything staff can do to assist you in your trustee role, please ask – we are at your disposal.

## **OPERATIONS STAFF**

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