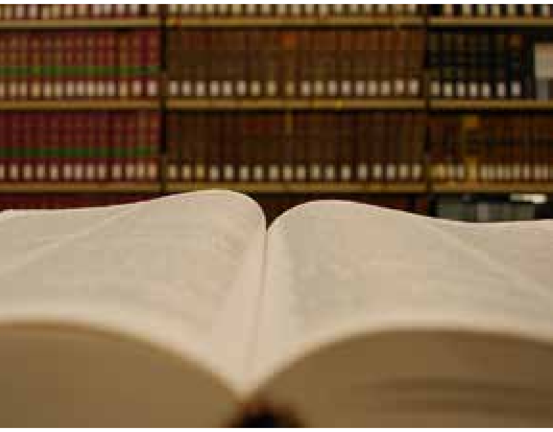
Pension Pointers



Eight Questions

By Carolyn Welch Clilffod
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The largest public pension system in the United States, the California Public Employees' Retirement System (CalPERS), periodically updates its "Board of Administration Governance Policy." The policy addresses CalPERS's basic governance principles, the role and powers of the board, as well as its relationships with its staff and each other as trustees of the pension system. While a much larger and more complex organization than the Article 3 and 4 pension funds in Illinois, the CalPERS policy provides some principles that are instructive for even the smallest of pension funds.

One component of CalPERS's focus on governance is how it makes sound board decisions consistent with applicable fiduciary duties. The duties of care and loyalty are a constant presence in any pension board discussion and decision. Before casting their votes, the board members asked themselves, "What should trustees ask themselves in order to be confident that they are complying with their fiduciary duty before making a decision?" The resulting **"Eight Questions"** were developed by CalPERS to help focus the board's decision-making to the underlying fiduciary duties pension fund trustees must meet.

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1 - Do the agenda materials and presentation/discussion at the board meeting provide all of the information necessary for a proper understanding of the issue so that we can make a sound, informed decision?

This first question addresses a trustee's fiduciary "duty of care," which means the duty to act with the care, skill, prudence and diligence that a prudent person under similar circumstances would demonstrate. The duty of care emphasizes *process over outcome*. In other words, the focus is on the *conduct* of the trustee as fiduciary; specifically, has the trustee properly investigated the issue and acted "procedurally prudent" in obtaining the information needed to make the decision.

Thus, this first question is a fundamental place to start in decision-making: has the board been provided with the relevant materials and appropriate presentation for review from its professional advisors, and then engaged in thoughtful discussion, to make the decision?

2 - Have all the potential benefits and risks resulting from this decision been appropriately identified and analyzed?

The second question similarly invokes the duty of care and prudent process. When a pension board is confronted with a decision, it is important that both the benefits and risks are identified. Too often the risks or downsides are not properly explored in decision-making; as fiduciaries, making sure these have been identified and analyzed is critical.

3 - Have all viable alternatives to this proposal been appropriately identified and analyzed?

When engaged in decision-making, pension boards may find that only one proposal or path has been provided. To ensure the duty of care, trustees should not rely on good faith alone; having a "good heart, empty head" is not good enough to meet the fiduciary duty of care. Thus, when confronted with a proposal, make sure all viable alternatives are presented as well.

4 - Are outside experts in agreement on the recommended course of action? If not, are the bases for disagreement adequately explained? Are both recommendations reasonable (so that I can reasonably choose/decide between them), or do we need to seek another opinion?

Pension boards may find from time to time that their professional advisors do not always agree. There may be situations where the auditor and accountant have different views, or the attorney has a different recommendation from another fund advisor. Where reasonable advisors disagree, the pension board should determine if additional information or additional expert opinions are needed to resolve a path to decision-making.

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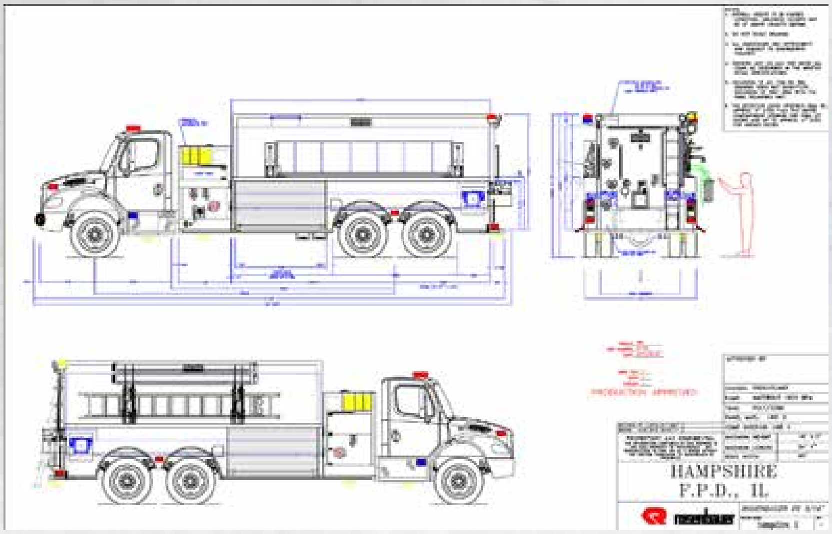

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5 - Were any questions that we had before and during the discussion of the item sufficiently addressed?

Sometimes a pension trustee asks a reasonable question that gets lost in the shuffle of discussion. It is important as a fiduciary to be satisfied that all questions have been addressed, even if it means tabling final action until those questions are answered.

6 - Do I have any actual or potential conflicts of interest that prevent me from participating in this decision or make it advisable for me not to do so?

The issue of conflicts of interest goes right to the heart of the duty of loyalty. Judge Benjamin Cardozo (*later Justice Cardozo of the U.S. Supreme Court*) once famously wrote:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. [citation omitted] Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court. (*Meinhard v. Salmon,* 249 N.Y. 458, 464 (1928))

In plain English, what Judge Cardozo essentially meant was that a fiduciary must not harm the interests of the pension fund and its members by doing any of the following:

- Self-dealing
- Acting in the interests of a third party (such as the municipality or the union)
- Favoring one group of members or beneficiaries over another (which is the duty of impartiality)

The position of trustee involves wearing various "hats." These hats of Articles 3 and 4 pension funds include roles as employee, employer, beneficiary, citizen, and union member. It also involves personal relationships with other fund members and even professional advisors. But even if a trustee is able to put on his or her "trustee hat," the issue of conflict of interest remains, and must be answered before the trustee participates in decision-making on behalf of the pension board. Sometimes, even if an *apparent* conflict does not arise to a legal conflict of interest, just the *appearance of impropriety* is enough for a trustee to pause and consider recusal on any particular matter.

7 - Does my intended decision reflect what I feel to be in the best interests of the pension fund's members, beneficiaries and retirees as a whole, without regard to the interest of any constituency or appointing power responsible for my position as a board member?

On the "checklist" of a fiduciary's duty of loyalty is a reflection by each trustee as to whether the decision he or she will be making is for the greater good of the pension fund and its membership and without regard to another third party's interest. This can be difficult for some trustees to separate, but it is a question that should – and must -- be asked.

8 - Will the results of the board's decision favor the interests of one group of the fund's members, beneficiaries or retirees over those of another group?

The duty of impartiality does not require absolute equality in making a decision, but trustees who make a decision to favor one group over another must make that decision carefully after weighing different interests. Knowing that the board may be "second-guessed," trustees may want to mitigate toward avoiding decisions favoring one group over another if otherwise prudent to do so.

Good decision-making is fundamental to good governance. Using these eight questions, pension trustees can find a process to make sure they are meeting their core fiduciary responsibilities for the fund as a whole with integrity and accountability. ■