City of Los Angeles Board of Deferred Compensation Administration Fiduciary Education

January 16, 2024 / Melanie Walker, JD, Senior Vice President, National Compliance

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Today's Agenda

General Fiduciary Responsibilities

Role of Trustees, Staff and Advisors

Best Practices in Plan Governance

Recent Litigation

Questions?

Who is a Fiduciary? Anyone Who…

1. Exercises discretionary authority over management of the plan or disposition of plan assets
2. Provides or has the responsibility or authority to provide investment advice for a direct or indirect fee or other compensation
3. Has discretionary authority or responsibility over administration of the plan

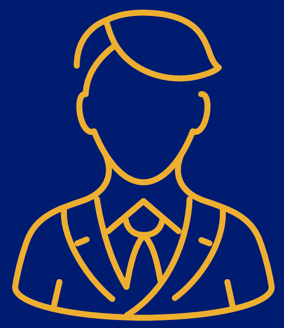
Exercise of **discretion** is the key

Can include more than just the trustees

Examples:

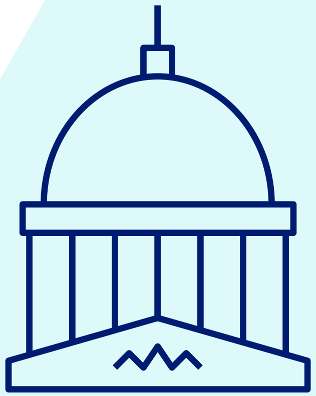
- City employees
- Investment advisors

Are You a Fiduciary?



Sources of Fiduciary Responsibilities in Governmental Plans

- United States Constitution contracts clause ("No state shall…pass any…law impairing the obligation of contracts…")
- Internal Revenue Code §401(a)(2) exclusive benefit rules and §4975 prohibited transactions
- ERISA can provide guidance even if your plan is not subject to it
- State Constitution, statutes and local codes on plan creation, ethics and conflicts of interest
- Common law and applicable court decisions



Primary Fiduciary Responsibilities

Under ERISA §404(a)(1), affirmative duties are:

- Act prudently with respect to plan assets and expenses
- Diversify assets to minimize risk of large losses
- Act solely in the interests of beneficiaries for the exclusive purpose of providing plan benefits and paying plan expenses
- Comply with plan provisions and applicable laws
- Select service providers and monitor performance, conflicts of interest
- Communicate with participants about their benefits

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State of California Constitution – Article XVI, Sec. 17

- The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries.
- The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.
- The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.
- The members of the retirement board of a public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, ***unless under the circumstances it is clearly not prudent to do so***.

Fiduciary Standards

The Board of Deferred Compensation Administration ("Board") has fiduciary responsibilities and the individual Board members are fiduciaries.

- The Board's fiduciary responsibilities stem from delegated functions as specified in State statutes/Plan rules.
- The legal standards applied to fiduciaries (duties of prudence and loyalty) are the highest standards under the law and are often difficult to understand.
- Meeting the fiduciary standards requires more than just common sense or a good faith attempt.
- The fiduciary standards are the same for all Board members regardless of how they became a member.
- The fiduciary standard is not applied on a "sliding scale," therefore, all members of the Board are instantly held to this very high standard as soon as they join the Board.

Duty of Prudence or Duty of Care

- A retirement plan fiduciary is to manage the plan with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. **This level of care is known as the "prudent expert" rule**.

- A determination of whether a fiduciary has exercised prudence in an investment decision must be made by considering the investment of all of the assets of the trust over which the Board has management and control, rather than by considering the prudence of a single investment. **This description of the duty of prudence comes from "modern portfolio theory" and reflects current best practices.**

Duty of Prudence

- Technically, ERISA does not apply to public retirement plans. ERISA only protects those in the private sector; however, there is no good policy reason to provide less protection to public employees by using lower standards.
- Fiduciaries for public retirement plans who do not live up to the prudent expert standard are not following current best practices in the public retirement arena and are depriving their members of the protections afforded to employees in the private sector.

Duty of Loyalty

- The duty of loyalty is another basic fiduciary duty imposed upon Boards. Essentially, it requires that the Board members act solely for the benefit of the members and beneficiaries of a trust in investment matters and all other decisions. It is a long-standing principle in the common law of trusts
- The decisions of the Board must be for the "exclusive benefit" of the active and retired members, their survivors, and beneficiaries

Duty of Loyalty

- This duty is not well understood, especially by those outside the retirement plan who are accustomed to balancing multiple interests when making policy decisions. What is required is that decisions are made in the best interest of the “plan,” not an individual participant or group of participants
- Avoiding conflicts of interest is one of the most difficult fiduciary responsibilities to execute. Thus, it is important for fiduciaries to mitigate this moral hazard by:
  - Establishing rules and procedures for all Board members to follow
  - Monitor and enforce such rules on Board members and all responsible parties under the plan
  - Avoid and manage risk through oversight and due diligence

Role of the Board, Staff and Advisors

Role of the Board and Staff

Board’s Role

- Strategic governance
- Establish internal controls
- Audit of processes and people
- Examination of issues and options
- Due diligence activities

Staff’s Role

- Implementation of administrative and reporting activities
- Operations, documentation and research
- Assist trustees in fact finding, auditing processes and communicating with advisors

Role of Advisors

Type of Advisors

Investment Consultant

External Counsel

Auditor

Reporting Structure

- Clarify reporting schedule and content
- Reporting structures can vary depending on the service providers' focus

Selection Process

- Selection is done in the best interest of the participants
- A prudent, clearly defined process is key
- Assures competitive cost for value
- Adhere to appropriate due diligence processes
- Identify selection decision responsibility

Best Practices in Plan Governance

Best Governance Practices

Provide a Governance Manual to all Board Members

- Deferred Compensation Plan’s mission statement, by-laws
- Governing plan documents (statutes, regulations, plan summaries)
- Organizational chart, role descriptions and summaries of contracts
- Governance policies and procedures, including an Investment Policy Statement
- Relevant rulings and agreements that determine benefits and contribution levels
- Board meeting schedules and rules of procedure

Best Governance Practices

Develop Board Practices

- Develop a strategic investment plan that guides the Plan toward its goals
- Adopt a fiduciary education program to improve skill sets
- Establish key committees, if appropriate
- Perform periodic audits to evaluate internal controls, performance and risks to fund and its fiduciaries
- Establish financial reporting guidelines

Best Governance Practices

Make a Strategic Plan

- Set goals and performance measures for key functions
- Long-term investment goals, risk tolerance and diversification objectives
- Multi-year budget needs
- Set service quality goals and process for improving plan compliance

Maintain Written Policies

- Standards of conduct, ethics and conflict of interest rules
- Investment policy that includes goals, monitoring procedures and risk tolerances
- Procurement guidelines that document procedures to select/monitor contractors
- Privacy and information policy

Conduct Risk Oversight

- Ensure governance structure defines risk and accountability
- Assess internal controls and test risk events
- Determine key measures that assess exposure to risk (including financial, operational, reputational)

Governance Policies: *Purpose*

Intent

- Implement plan documents/applicable laws
- Provide governance framework
- Communicate to stakeholders
- Establish historic record

Guidance

- Provide direction to fiduciaries and their delegates
- Set expectations for Board and individual member conduct

Protection

- Set out due diligence processes
- Establish monitoring and reporting processes

Key Governance Policies

Ethics

- Code of Conduct
- Gifts and consideration
- Travel and Expenses

Governance

- Define Board and staff roles
- Implementation of plan rules
- Modification of governing documents, forms

Investment

- Asset conflicts of interest
- Guidance on class diversity
- Benchmarks
- Avoidance of evaluation and changes

Key Governance Policies

Education

- Describe educational objectives
- Require justification for any educational sessions attended
- Include expense reimbursement rules
- Best practice is annual education session

Communication

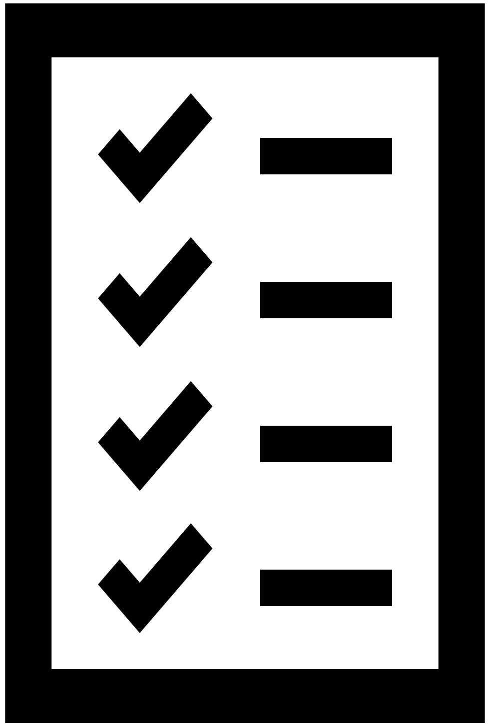
- Identify rules for Board to communicate with stakeholders
- Guidelines for Board communications (with participants, external parties)
- Specify how information is disseminated
- Protect member privacy
- Comply with FOIA laws
- Address security concerns with service providers

Defined Contribution Litigation

- In 2015, the United States Supreme Court addressed *Tibble v. Edison International*, 575 U.S. __, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (May 18,2015)
  - Ruling under trust law that a trustee has a “continuing duty to monitor trust investments and remove imprudent ones.”
- This began a flood of lawsuits against DC plans under ERISA, that attempt to litigate a various fiduciary issues and claims of action:
  - Excessive fees for investments or administration
  - Low-cost investments underperform their benchmark
  - Use of proprietary mutual funds
  - Imprudent investment selection process
  - Failure to take recordkeeper out to bid periodically
- Thus far, there have been few useful court rulings, some of which have conflicting results

Fiduciary Governance Checklist

- Avoid conflicts of interest and perception of conflict
  - Contracting
  - Investments
- Develop decision processes
  - Follow the process
  - Record the process
  - Make facts-supported decisions
- Monitor and verify results
  - Performance reviews
  - Compliance reviews
  - Financial audits
- Ask Questions – Get Answers!



Questions?

Melanie Walker
SVP, National Compliance

mwalker@segalco.com

303.241.5880