

TO: Public Pension Boards of Trustees

FROM: NCPERS Executive Board of Directors

RE: Code of Conduct for Pension Service Providers- Fiduciary Analysis

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NCPERS has unveiled a code of conduct for vendors of public employee retirement plans. The providers of professional services to public pensions must be independent of conflicts in the same way trustees are. It is for this reason that NCPERS is recommending that all boards of trustees for public plans confirm with their service providers by having them execute a code of conduct that they are free from conflicts of interest that can arise with regard to services provided to defined benefit plans. NCPERS also recommends that the code of conduct be included as part of the request for proposal process when a plan is soliciting a service provider. The code of conduct was crafted so that it can be sent to not only investment managers, but all service providers to public plans, including investment consultants, attorneys, actuaries, and custodians. The code was created to help fiduciaries articulate strong, consistent ethical expectations for service providers across the board. This analysis is for the benefit of trustees when deciding whether to adopt the code of conduct for their plan. The intent is to arm trustees with the legal conclusion that it is part of their fiduciary duties to ensure that their professionals are free of conflicts of interest.

A person is a fiduciary with respect to an employee benefit plan to the extent he/she exercises discretionary authority with respect to the plan and its assets. Exercise of discretion is the key. As a general rule, fiduciary duties extend to attorneys, actuaries, accountants, investment management and consultants. The seminal decision in American jurisprudence on fiduciary duty is the decision of the New York Court of Appeals in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928). In that case, the Court determined that the common standard of the marketplace is unacceptable to fiduciaries. Based on the ruling, the general trust standard was expanded for pension trustees to include a definition of "undivided loyalty" to be applied with "uncompromising rigidity." Much later, in *NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981), the U.S. Supreme Court held that plan trustees have an "unwavering duty of complete loyalty" to members and beneficiaries. Trustees cannot serve any master other than the fund. Trustees of a retirement system have a fiduciary duty to insure the integrity of the System. *MaComb County v. AFSCME*, 294 Mich. 149, \_N.W.\_, 2011 WL 4374991 (Mich. App. 2011). The independence of the advice received and the actions taken by the fiduciaries in response is critical to accomplishing the high behavioral standards required by the law. *Board of Trustees v. City of Detroit*, 145 Mich. App. 651, 373 N.W.2d 173 (Mich. App. 1985). ERISA, although not applicable to governmental plans, codifies the duty of undivided loyalty to beneficiaries in several provisions, including the requirements that a plan fiduciary act "solely in the interest" of the plan and its participants and beneficiaries "for the exclusive purpose" of serving plan related goals. If a fiduciary takes action that he or she knows will harm a plan but will advance corporate or personal interests, that is a breach of the fiduciary duty to act "solely in the interest" of a plan.

In order for a plan's conflict of interest guidelines to be effective, trustees must have access to information that adequately describes service provider interests and relationships that could, at a minimum, give rise

to an appearance of impropriety. Trustees and staff should periodically affirm and verify compliance with conflict rules, regulatory reporting requirements, political contribution disclosures and other policies intended to protect the plan against the actuality or appearance of self-interested transactions and conflicts. Asking all service providers to sign a code of conduct helps fulfill this mission.

The responsibility for a trustee to be prudent covers a wide range of functions needed to operate a plan. Since you must carry out these functions in the same manner as a prudent person, it is in your best interest to consult experts in such fields as investments. What the courts refer to as prudence is actually a composite of separate duties of care, skill, prudence, and diligence. In general, the courts compare the conduct of a fiduciary to an objective standard of how a knowledgeable fiduciary would have acted under similar circumstances. Judicial decisions heavily emphasize the diligence component of the standard by examining whether and how the party considered issues that would be thought significant by a prudent fiduciary acting in similar circumstances. If a trustee cannot confirm that their outside plan experts are acting prudently and in the best interests of the plan, a case can be made that the trustee is not fulfilling his or her fiduciary responsibility to the plan.

In light of the clear legal standards, not only for the Board of Trustees, but for all of its advisors, it is essential that the Board ensure the exclusive duty of loyalty to the System is observed at all times and in all transactions. Trustees, in the usual course of plan business, should require all service providers to agree contractually that they are fiduciaries to the plan. The failure to have a provider agree that they are fiduciaries to the plan would allow them to skirt around the basic fiduciary considerations they owe to the plan. It is the duty of all fiduciaries to a retirement system to say “no” when any answer to the contrary is not in the best interest of the system. The code of conduct does not require a plan to fire a service provider should they not agree to execute the code. Merely, it should serve as a tool for trustees to identify and make informed decisions on behalf of their plan, and its members and beneficiaries should a conflict arise. NCPERS recommends that all boards of trustees of public retirement plans adopt use of the code of conduct to help promote the highest standards of ethics, education and professional excellence for the benefit of governmental defined benefit pension funds.