OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM

BOARD OF TRUSTEES FIDUCIARY EDUCATION PROGRAM

DEER CREEK PARK LODGE AND CONFERENCE CENTER

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I. THE PURPOSE OF THE MATERIALS

The purpose of the following materials is to provide a sampling of legal, financial, ethical, and philosophical material related to the mission of a fiduciary. The idea of a fiduciary being the steward of another's property is centuries old. No one outline could cover the entirety of the volumes of court decisions, scholarly articles, and economic treatises on the subject. It is hoped that the materials here will provoke thought and discussion on an ongoing basis for the betterment of OPERS.

II. FIDUCIARY DUTY - A DEFINITION

A. <u>Fiduciary Defined</u>

1. A person is a fiduciary with respect to an employee benefit plan to the extent he/she exercises discretionary authority with respect to plan and assets.

2. Exercise of discretion is the key.

3. Can include more than just the trustees.

4. Extends to investment management and consultants.

5. Fiduciary duty is not subject to individual determination as to what is right for the organization. It is a collegial process dependent on acceptance of universal norms. It is important for trustees to speak freely, but act cohesively once a policy or direction for OPERS has been determined.

B. Judicial Standards

1. **Meinhard v. Salmon**, 164 NE 545 (Ct.App. 1928).

   Court determines that common standard of the marketplace is unacceptable to fiduciaries. General trust standard was expanded for pension trustees to include a definition of "undivided loyalty" to be applied with "uncompromising rigidity."

2. **NLRB v. Amax Coal Co.**, 453 U.S. 322 (1981).

   U.S. Supreme Court holds that plan trustees have an "unwavering duty of complete loyalty" to members and beneficiaries. Trustees cannot serve any master other than the fund. The pressures of undivided loyalty are inconsistent with the give and take of collective bargaining.

III. OHIO'S DEFINITION OF A FIDUCIARY

A. The Revised Code has Several Sources of Fiduciary Duty

1. R.C. 145.11 defines the Board as a fiduciary with regard to investment matters adopting the prudent investor standard.

2. R.C. 145.113 outlines a variety of prohibited behaviors, which includes taking any action contrary to the interests of the System as a whole or acting on behalf of others if that representation is contrary to the interest of the System.

3. R.C. 145.054(B)(9) prohibits false statements about the voting record of a trustee.

4. R.C. 145.04 places the general administration and management of the System in the hands of the Board.

B. Constitutional Authority for Pensions

Article II, Section 34 of the Ohio Constitution authorizes the General Assembly to provide a retirement system for the welfare of employees. *Board of Trustees v. Board of Trustees*, 12 Ohio St. 2d 105, 233 N.E. 2d 135 (1967)

C. Judicial Definition

Fiduciary duty to the members means to deal fairly and act in good faith in the fulfillment of the statutory duties. Wasting of assets can give rise to a claim of breach of fiduciary duty. *Ohio Ass'n of Public School Employees v. School Employees Retirement System*, 2004 WL 2988444 (Ohio App. 2004) (unreported).

D. OPERS Governance Policy Manual

Board members must act solely in the best interests of the participants and beneficiaries of the system and for the exclusive purposes of providing them with benefits and defraying reasonable administrative expenses. This duty of loyalty means that Board members must wear only one "hat" as a trustee and at the same time wear the hat of a partisan interest.

E. Where Does the Legal Duty to Act Lie?

1. Trustees have a duty to secure full payment of all contributions owed to the Fund in a timely manner.

2. Trustees have a duty to enforce the provisions of the legislation as written. If legislation proves to be unwise, it is a matter for the Legislature to resolve. Trustees have no authority to act beyond the powers conferred upon them by statute. *State ex rel. Willer v. Ohio Public Employees*

Retirement System, 2021 WL 6123320, 2021-Ohio-4575 (12/28/2021)

3. Trustees have a duty to adopt sound actuarial and investment policies designed to protect the interests of the members and beneficiaries of the System.

4. Trustees have a duty to act in a collegial manner and as a collegial body.

5. In recognition of the ever-changing duties and challenges facing trustees, continuing trustee education is statutorily mandated in R.C. 171.50

F. Modern Portfolio Theory - The Difference Between the Prudent Person, the Prudent Investor, and the Prudent Expert

1. In the literature discussing the duties of pension trustees in the area of investment responsibility, terms like "prudent person," prudent investor," and "prudent expert" are used. While the terms are sometimes used interchangeably, their histories and meanings are distinct.

2. In *The New Prudent Investor Rule and Modern Portfolio Theory: A New Direction for Fiduciaries,* Alberts and Poon, 34 AMBJ 39 (1996), the history of fiduciary duty is explored at length from its biblical origins in Luke 16:1-8, 10 (the parable of the stewards) and St. Thomas Aquinas' *Treatise on Prudence and Justice* through the creation of the prudent expert rule under ERISA. American jurisprudence is said to begin with the decision in *Harvard College v. Amory*, 26 Mass. (9 Pick) 446 (1830) in which the Court held:

> *All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the*

probable income, as well as the probable safety of the capital to be invested.

3. The adoption of the Employee Retirement Income Security Act of 1974, further extended this rule to a new, higher standard. The operative provisions of Section 404(a), codified as 29 U.S.C. 1104 (a)(1)(B), require a fiduciary to discharge his or her duties:

> **"with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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."**

4. While ERISA Section 404 (a) has its foundations in the prudent person and prudent investor rules, legal scholars have concluded that the statute created a new "prudent expert rule."

5. While the ERISA standard is obviously based on the common law prudent investor rule, in many respects ERISA goes well beyond traditional requirements. For example, ERISA requires the care that a "man 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 has been termed the "prudent expert" rule (as opposed to the prudent investor rule's "managing his own property" standard) and is perceived as imposing a higher standard. The legislative history indicates that the "enterprise of like character" language was intended to form a standard that would consider the attributes and diversity of employee benefit plans in federalizing the common law of trusts. Another major change wrought by ERISA is that it permits a fiduciary to emphasize the performance of the overall portfolio as compared with the performance of each individual investment. At common law, the fiduciary was required to defend the performance of each individual investment in the portfolio. Bobo, *Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule,* 33 Emory L J 1067, 1078 (1984). See also, Hughes, *Hot Topics*

and Important Considerations for Retirement Plan Fiduciaries, 57 - Jul Advoc 38 (June/July 2014), Note 7.

6. The key, according to the prudent expert standard is whether the trustees, at the time they engaged in an investment, employed appropriate methods to investigate the merits of the investment and its structure. *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.,* 173 F.3d 313 (5th Cir. 1999); *Donovan v. Mazzola,* 716 F.2d 1226 (9th Cir. 1983). Perhaps more importantly, the prudent expert standard (found in the Restatement (Third) of Trusts) greatly expands a trustee's ability to delegate to investment professionals. See, Langbein, *Reversing the Non-Delegation Rule of Trust - Investment Law,* 59 MOLR 105 (1994).

7. ERISA specifically exempts governmental plans like OPERS. The reasoning at the time, and continuing today, is the management and funding of state and local government retirement plans is not a federal issue. It has been deemed a reserved power of the states under the 10th Amendment of the U.S. Constitution.

IV. RESPONSIBLE INVESTING

A. Environmental, Social and Governance (ESG) - Incorporates these issues into the investment decision making process. These approaches may involve active proxy voting, company engagement, and public policy work**.**

B. The Growing Trend Toward Political Divestment

1. Darfur Investment Restrictions Struck Down by Federal Court.

In an effort to deny support for the government of Sudan and its affiliated Jinjaweid militia in light of the atrocities and genocide in Darfur, the state adopted the Illinois Act to End Atrocities and Terrorism in the Sudan. The act attempted to

impose various restrictions on the investment of public pension funds in Sudan-connected entities and on the deposit of state funds in financial institutions whose customers have certain links with Sudan. Among other things, the Act amended the Illinois Pension Code to prohibit the fiduciary of any pension fund established under the Code from investing in any entity unless the company managing the fund's assets certified that the fund managing company has not loaned to, invested in, or otherwise transferred any of the retirement system or pension fund's assets to a forbidden entity any time after the effective date of the Act. Several Illinois municipal pension funds and beneficiaries challenged the constitutionality of the statute in a suit brought under 42 USC 1983 against the state treasurer and attorney general. The plaintiffs argued that the Act is preempted by federal law governing relations with Sudan, interferes with the federal government's ability to conduct foreign affairs, violates the Constitution's Foreign Commerce Clause, and is preempted by the National Bank Act. The court recognized that the Illinois Legislature acted with laudable motives. The Federal District Court for the Northern District of Illinois held that the Illinois act violated various federal constitutional provisions precluding the states from "taking actions that interfere with the federal government's authority over foreign affairs and commerce with foreign countries." The District Court enjoined the state from enforcing the act.

National Foreign Trade Council v. Alexi Giannoulias, 2007 WL 627630 (N.D. Ill. Feb. 23, 2007).

Congress later acted to enable state action in the Sudan Accountability and Divestment Act of 2007.

C. Divestment of Fossil Fuels and Statutory Anti-Divestment

1. The first question is whether this is Board driven or statutorily driven.

2. California adopted statutes mandating divestment of thermal coal investments.

3. Maine adopted a statute mandating total divestment of fossil fuels by 2026.

4. By contrast, there is a growing trend to require divestment from companies that engage in certain boycotts. Several states have laws requiring divestment from companies refusing to do business with Israel.

5. Texas requires divestment in companies that boycott the fossil fuels industry. Is a decision not to invest or to divest illegal because a manager believes clean energy is a more favorable investment versus a social decision to divest as part of an ESG program?

D. What is the ERISA Standard?

The answer depends on which party controls the White House. DOL guidance on ESG principles has changed repeatedly. The latest guidance encourages consideration of climate change and social issues in decisions relating to investment. A proposed rule in October 2021, effectively repealed then existing guidance which warned against using ESG considerations unless secondary to expected returns. On March 22, 2022, the DOL released further request for information concerning whether the intersection between climate change and retirement savings should be further regulated.

The DOL guidance **is in no way binding** on a state or local government plan due to the ERISA exemption for governmental plans, but it is instructive in the shifting view that the ESG component of an investment may well have a measurable economic impact on the System. This is especially so for a fund like OPERS with language closely mirroring that of ERISA.

V. SUMMARIZING THE ESSENTIAL PRINCIPLES OF GOVERNANCE

A. Appointment and terms of trustees - Trustees are appointed or elected in accordance with state law. But all trustees have the same duty to the System and its members, without regard to the constituency that placed them on the Board.

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

OPERS 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 OPERS.

D. Don't micro-manage your staff. Between the development of policy and the measuring of accountability, those tasks belong to OPERS staff and outside advisors.

E. Is anything ever de minimis from the Board's perspective?

VI. WHAT DOES DE MINIMIS MEAN IN THE FIDUCIARY CONTEXT?

A. How the Process Has Been Applied in Investment Decisions

1. In deciding to follow or to decline a divestiture mandate, the System has looked to whether the effect on the portfolio is "de minimis."

2. How is de minimis defined?

3. Black's Law Dictionary defines de minimis as "of the least" or "trifling; minimal" and a fact or thing that is "so insignificant that a court may overlook it in deciding an issue or case."

4. In the context of an investment decision when is an effect de minimis?

5. *De minimis non curat lex* - The law does not concern itself with trifles.

6. At least one state, New York**,** rejected the above maxim in the context of a fiduciary duty. In *Sorin v. Shahmoon Industries*, 220 N.Y.S.2d 760 (N.Y. App. 1961)**,** a waste of corporate assets challenge, the court held that where a fiduciary's duty

to account is at issue, it is a question of "principle," not principal. When a fiduciary is to account for funds entrusted to his or her care, it means all funds "not some, or even most."

7. The leading (and really the only) case in this context remains *Board of Trustees v. Mayor and City Council*, 562 A.2d 720 (Md. 1989). The trustees of the City pension fund sued to challenge ordinances requiring divestiture of holding in companies doing business with the Apartheid government of South Africa. In upholding the ordinances, the Court observed that given "vast power that pension funds exert in American society, it would be unwise to bar trustees from considering the social consequences of investment decisions," where the cost was de minimis. In the Baltimore case, the trial court found that the initial cost of divestment was 1/32 percent (3 basis points) and the on-going cost was 1/20 percent (2 basis points. To date this remains the only public pension case giving some concrete definition to the term "de minimis" in the divestment context.

8. A similar holding was reached by an Oregon trial court concerning investment by the State Investment Council but the decision was overturned on appeal when the student plaintiffs were found to lack standing sufficient to challenge the investment decision. *Associated Students v. Oregon Investment Council,* 728 P.2d 30 (Or. App. 1986).

B. <u>What if Survival Is at Stake - Are the Rules Different</u>?

1. In *Withers v. Teachers' Retirement System*, 447 F.Supp. 1248 (S.D.N.Y. 1978), the Board of Trustees agreed to buy $2.53 billion (approximately $10 billion in 2015) in New York City bonds to prevent the City from becoming insolvent. This commitment raised the amount of the portfolio in City securities to more than 37%. Members of the plan sued the trustees for breach of fiduciary duty. Ultimately, the Court ruled that trustees acted reasonably as the insolvency of the City would have led to depletion of the retirement system within less than 10 years. The court rejected the claim of breach of fiduciary because the motivation of the decision was the long-term solvency of the System and not the long-term

welfare of New York City. The trustees reasonably feared that in bankruptcy, the protection of employee benefits would be secondary to claims of bondholders and the preservation of essential public services.

C. What is De Minimis in the Context of Board Governance?

1. The Board has a duty to the membership as a whole and not any particular segment of the membership to the detriment of any other.

2. Decision making must reflect that standard.

3. Vigorous and healthy debate internally is critical. Trustees should feel unconstrained to speak their minds.

4. How does this idea of vigorous debate change after a decision has been reached by the Board?

5. What process should a prudent board of trustees employ in making decisions that have uneven effects on membership?

6. Board decisions may end up subject to judicial review but that does not mean the Board acted without authority. *Duncan v. Tennessee Valley Authority Retirement Systems,* 833 F. 3d 567 (6th Cir. 2016).

7. What about First Amendment considerations? Does the censure of a board member of a public entity by the board on which that member serves violate his or her First Amendment Rights?

8. In *Houston Community College System v. Wilson*, ___S.Ct. ___, 2022 WL 867307 (March 24, 2022), the United States Supreme Court unanimously rejected a claim that a board censure was a materially adverse action that could give rise to an actionable First Amendment retaliation claim. Wilson was elected to the board of trustees that operated several public community colleges. He frequently complained about the actions of his fellow board members and publicly (as well as in civil actions) stated that the Board was acting unethically and

in violation of its own bylaws. Ultimately the Board adopted a public resolution of censure and Wilson was deemed ineligible to hold a board office. Wilson sued claiming his First Amendment rights were violated. A federal trial court dismissed the claim, but a panel of the U.S. Court of Appeals for the Fifth Circuit disagreed finding that a verbal reprimand fro a statement concerning public policy did state a claim for violation of the First Amendment. The college board sought review in the Supreme Court. In a unanimous opinion, the Supreme Court held that the censure from the board was itself a form of free speech. The single trustee's First Amendment right could not be sed to silence the First Amendment rights of the other trustees.

9. Whose responsibility is defense of a statute?

In *Ohio Association of Public School Employees v. School Employees Retirement System*, 2020 Ohio 3005, 2020 WL 2537669, the retirement board voted to suspend COLAs for three years beginning in 2018. A legislative amendment that year allowed for COLAs but only after a period of time as determined by the board. The retirees sued claiming that the statute gave unconstitutional law making authority to the board and that the board and its actuaries procured the amendment by fraud. A trial court granted motions to dismiss. On appeal, the court affirmed the trial court decision. The appeals court found that any dispute over the statute was between the legislature and the retirees. Since the board and not the legislature was sued, there was no dispute between the board and the retirees to be litigated. The fraud allegation was not raised in the appeal and was abandoned. Lastly, the claim that freezing the COLA was a constitutional violation was not reached by the court because it was able to resolve the case without reaching the level of a constitutional analysis.

VII. WHAT HAVE WE LEARNED?

A. In large measure fiduciary duty is common sense about right and wrong. If an issue gives one pause for thought that it might be wrong, it probably is.

B. The primary duty of a pension fiduciary is to act in the best interests of ALL members and beneficiaries of the System. Only if that result abides, do additional concerns enter the decision process.

C. Liability is largely the product of poor planning and a failure to recognize its consequences.

D. Pension trustees have 2 jobs - (1) set policy and (2) demand accountability that the policy is being properly executed.

E. Understand the subject matter. Ask appropriate questions to get an answer.

F. Delegation to staff and professionals IS the exercise of fiduciary duty if there is continuing accountability.

G. Micro management and policy making are poor partners and are NOT the appropriate exercise of fiduciary duty.

VIII. CONCLUSION

IF YOU HAVE ANY QUESTIONS OR COMMENTS CONCERNING THIS PRESENTATION, CONTACT ROBERT D. KLAUSNER, ESQUIRE, KLAUSNER, KAUFMAN, JENSEN & LEVINSON, 7080 N. W. 4TH STREET, PLANTATION, FLORIDA 33317, (954) 916-1202, FAX (954) 916-1232, E-MAIL bob@robertdklausner.com. Visit our website www.robertdklausner.com.

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