Board Governance and Fiduciary Duty presented to the Ohio Retirement Study Council

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Funston Advisory Services LLC

Introductions

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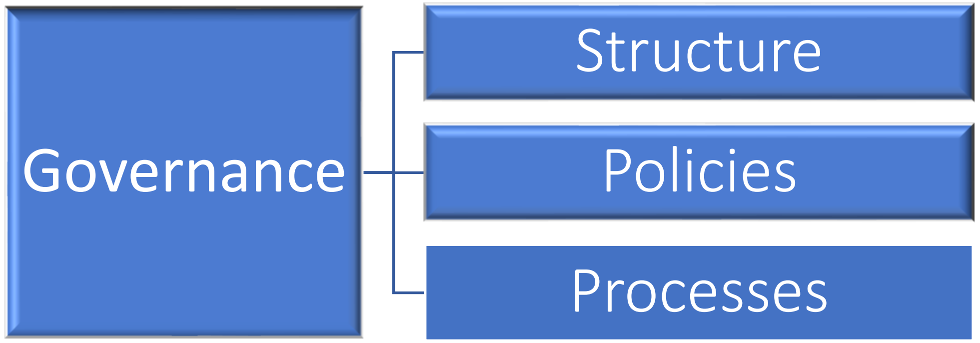
Governance

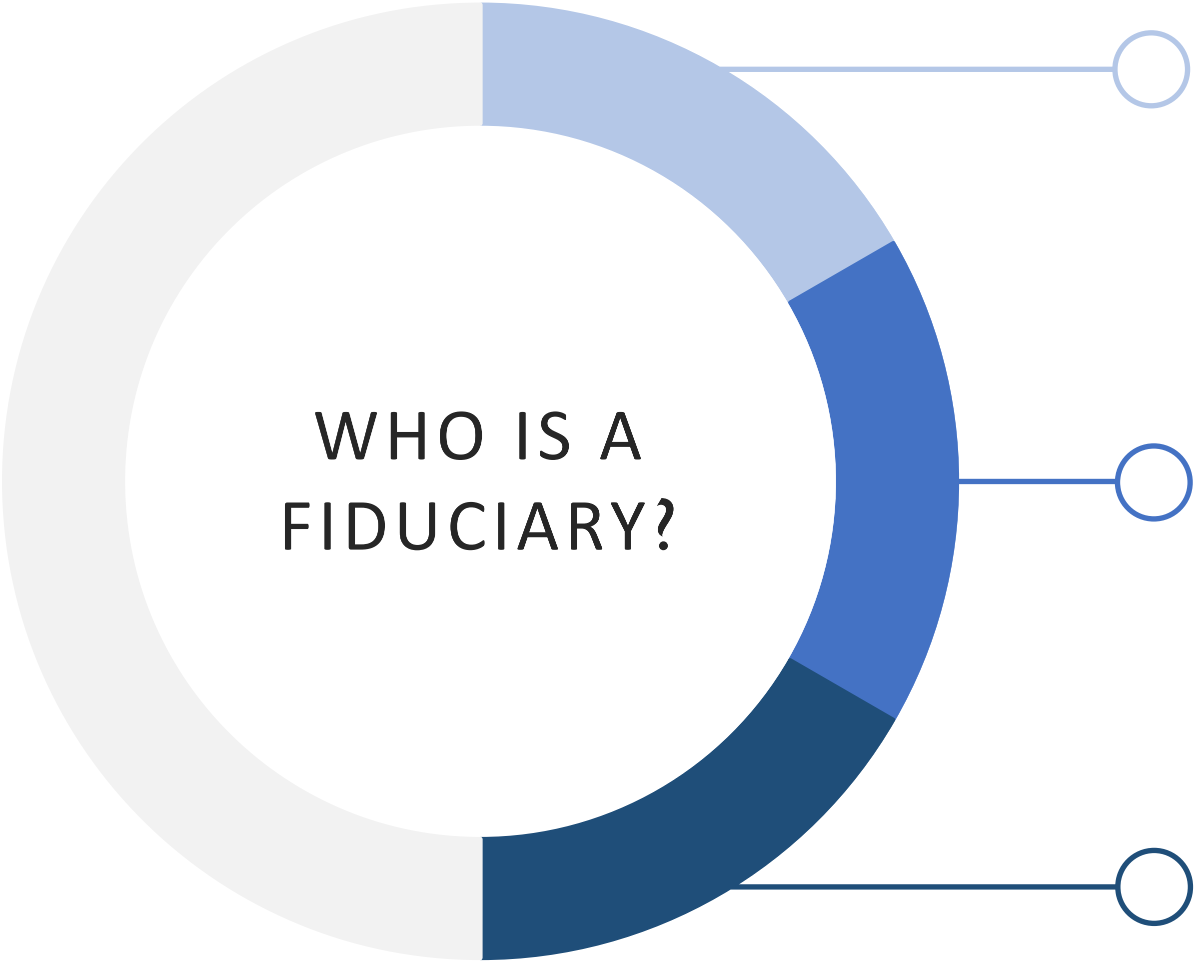


- Governance is about decision making.
- Board decision making is a collective process.
- Good governance requires effective structure, policies, and processes.
- Studies have shown that good governance policies and practices can improve public pension investment returns by 1 - 3%.
- Although many public retirement systems operate under similar structures and statutes, each must develop its own governance policies and processes.

Governance

- The governance structure is set by statute: board composition, purpose and vital functions, fiduciary standards, other requirements.
- Board policies and governance practices enable the fulfilment of fiduciary duties.
- The Board has five fundamental powers to fulfill its duties:
  - Conduct the Board’s Business
  - Set Direction and Policy
  - Approve Board Decisions and Prudently Delegate
  - Oversee Execution of Direction within Policy
  - Verify Results (then trust)
- Execution is the responsibility of executives and staff.

Fiduciaries



A fiduciary is any person or entity who makes, or has the authority to make, discretionary administrative or investment decisions related to the retirement plan.

A fiduciary is any person or entity who is named in a retirement plan or trust document as a fiduciary.

An entity or individual may be a fiduciary either by designation or by function.

Usually, there is a functional test to determine whether a person has the necessary discretion, authority, or control over the administration of the plan or management of the assets.

Fiduciaries

Who is a fiduciary?

- Board Members / Committee Members
- Executives and Certain Staff
- Investment Managers
- Investment Consultants
- Anyone who has agreed **to be a** fiduciary or functions as one

Investment Fiduciary Role is Different

Public pension plan fiduciaries are held to the highest legal standards of care and loyalty, stricter than the legal obligations applied to corporate directors, elected officials, and other kinds of board members.

- Investor fiduciary relationships involve an **inherent potential conflict of interest** between the fund's participants and their fiduciary agents.
- Pension fiduciaries exercise delegated control over fund participants' life savings. As a result, they have ample opportunity to squander, steal, or misuse large sums of money that are held in trust for someone else.
- In addition, complexity of pension investment concepts and the potential for delay in realization of harm from fiduciary misconduct or negligence makes it difficult for fund participants to detect and respond to wrongdoing in a timely manner.
- It is essential that trustees and other pension fiduciaries understand their legal fiduciary obligations. They place themselves at risk if they fail to recognize that their unique role imposes a very high standard of duty.
- Fiduciary duties set the foundation for sound fund governance structure, policies, and practice – in essence, for sound board decision-making.

Ohio Fiduciary Standards

From ORC Title 33, Chapter 3307 State Teachers Retirement System:

- solely in the interest of the participants and beneficiaries;
- for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the system;
- with 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;
- and by diversifying the investments of the system so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

Note: this phrase implies application of the strict "Prudent Expert" standard.

Fiduciary Standards

Sources of Fiduciary Standards & Guidance

OH Constitution	OH Statutes & Regulations	Court decisions and common law of trusts	ERISA and other pension fund laws/regulatory guidance
Restatement of Trusts	Practices of other similar fiduciaries	Attorney General Opinions	Advice of legal counsel
Internal Revenue Code	Model Codes	Governance Policies	Code of Ethics and Conduct

Fiduciary Standard of Care

Prudence is not static but continues to evolve over time:

> Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments.

Restatement of Trusts, Third, §227, Introduction

Ohio Fiduciary Restrictions

- Ohio statutes articulate restrictions on pension fund fiduciaries regarding:
  - Self dealing, either directly or indirectly;
  - Acting on behalf of a party with adverse interests to the system;
  - Receiving any personal consideration in connection with a transaction involving system assets; or
  - Participating in or concealing an act of omission of another fiduciary (co-fiduciary responsibility).

Ohio Revised Code s. 3307.181

Core Fiduciary Principles

Based upon federal laws, Ohio statutes, court rulings, and all the referenced sources of fiduciary standards and guidance, the following are key fiduciary principles:

1. Loyalty
2. Impartiality
3. Prudence
4. Diversification
5. Cost management
6. Transparency and accountability
7. Compliance with laws and plan documents

Fiduciary Principle: Loyalty

The Duty of Loyalty Requires:

Undivided Loyalty

- A fiduciary must act "solely in the interest of the participants and beneficiaries" – meaning *current and future* beneficiaries.
- No hierarchy of considerations – it's all about the beneficiaries – today and tomorrow.

Fair Dealing

- Fiduciaries must deal with beneficiaries fairly.
- "Conduct in administering a trust cannot be influenced by a trustee's personal favoritism" [Restatement of Trusts 3rd, s. 79, Comment b].
- Communicate to beneficiaries all material facts.

No Self Dealing

- No transactions involving trust property (or affecting trust property) if it is for the fiduciary's personal benefit.
- Avoid conflicts of fiduciary duty and personal interest.
- Avoid transactions that may cause future conflict between fiduciary duty and personal gain.

Fiduciary Principle: Loyalty

Exclusive Benefit Rule

Under the Internal Revenue Code, "[no] part of the corpus or income [may] be ... used for, or diverted to, purposes other than for the exclusive benefit of [the] employees or their beneficiaries.

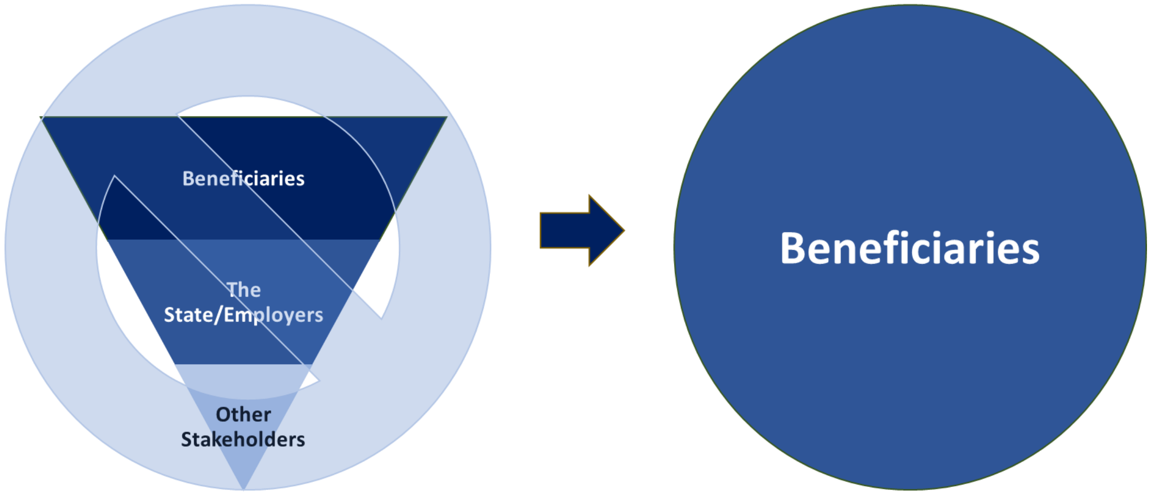
Internal Revenue Code § 401(a)(2)

Fiduciary Principle: Loyalty

How Boards Ensure Loyalty

- Ethics and conflicts of interest policies
- Trustee discipline policy
- Education/training policy (including fiduciary duty refreshers)
- Board self-evaluations
- Organizational culture - tone at the top
- Audit and compliance functions

Duty of Loyalty – To Whom?



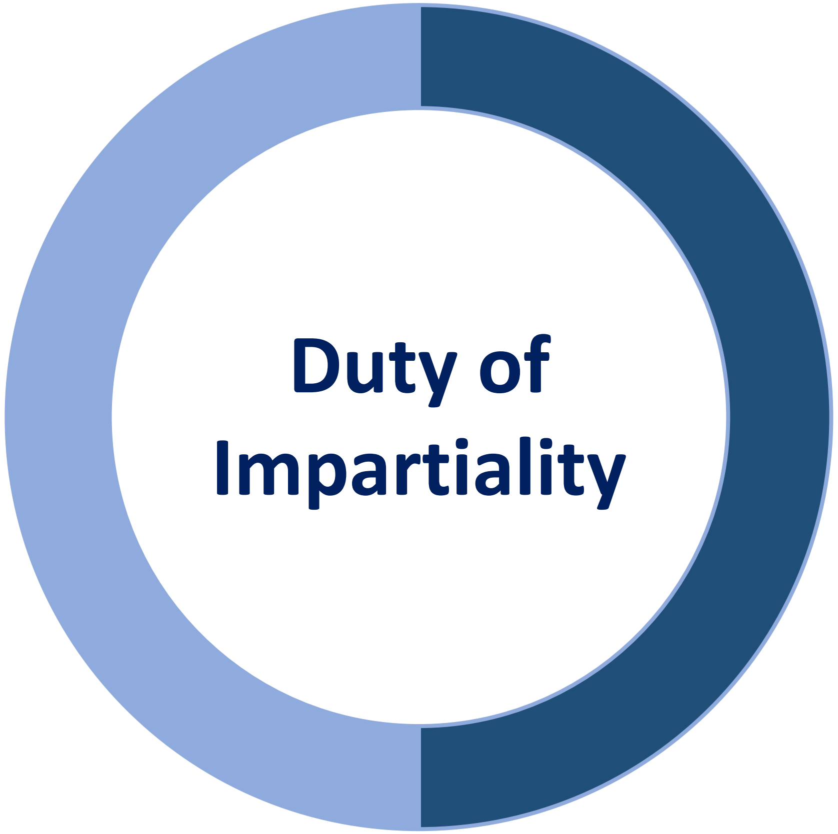
Trustees are appointed, elected, or ex officio and typically represent different stakeholder groups:

- Active members
- Retirees
- Employers
- General public (often investment experts)

Fiduciary Principle: Impartiality

Impartiality

- Administer trust in a manner impartial to the various beneficiaries
- Requires attention to inter-generational equity
- Ethics compliance and managing conflicts of interest
- Applies to consulting and communicating with beneficiaries
- No beneficiary favoritism



Income Productivity

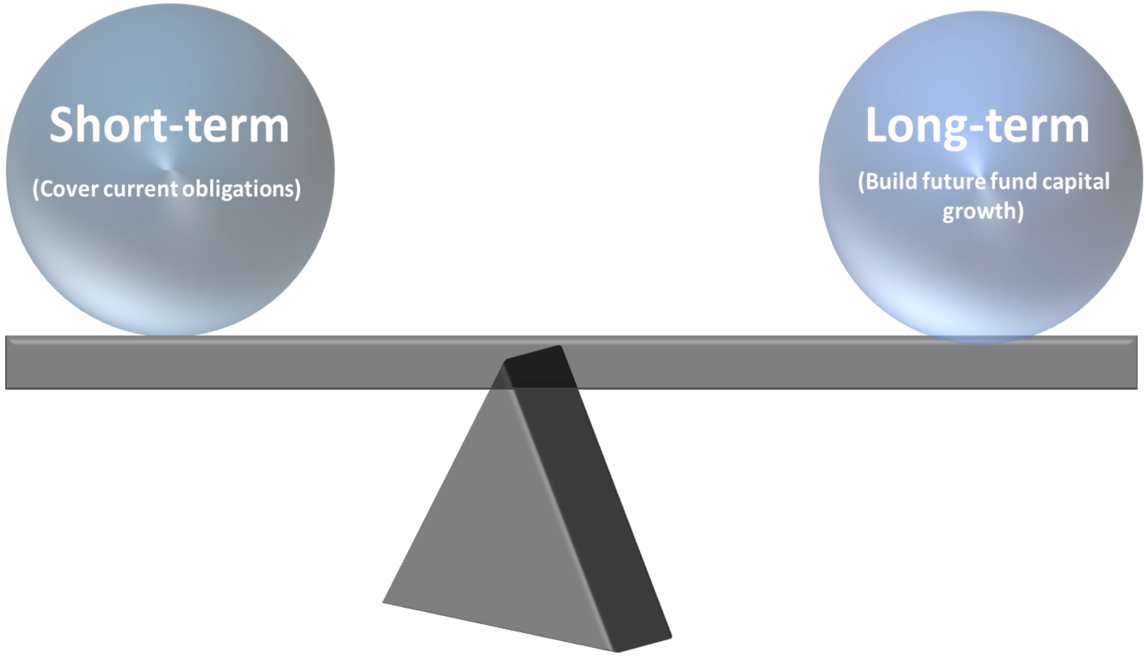
- Invest and administer trust to produce income reasonably appropriate to the present and future interest of beneficiaries
- Monitor investments and mitigate underperformance (over the appropriate time horizon for the trust)
- Duty applies to whole portfolio, not individual assets

Fiduciary Principle: Impartiality

How Boards Ensure Impartiality

- Funding policy
- Actuarial assumptions/policy
- Education/training policy (including annual calendar)
- Strategic planning process
- Asset allocation
- Investment policy and risk management
- Benefits eligibility and disability determinations

Duty of Impartiality = Balancing Act



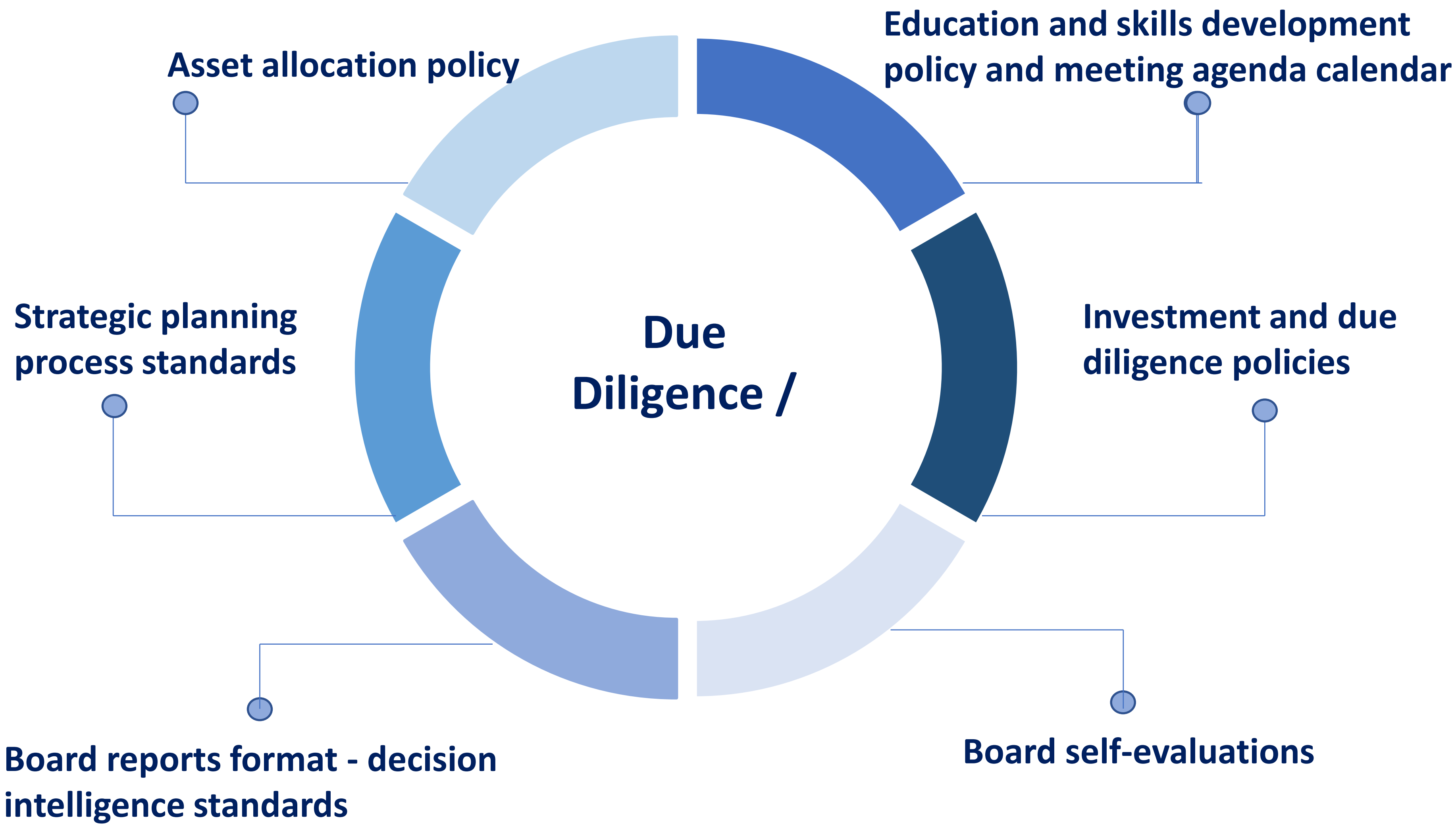
The common law of trusts [made applicable to ERISA §§404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interest of all beneficiaries. [*Varity v. Howe,* 516 U.S. 489 (1996)]

Fiduciary Principle: Prudence

Good Governance Practices Demonstrate Prudence

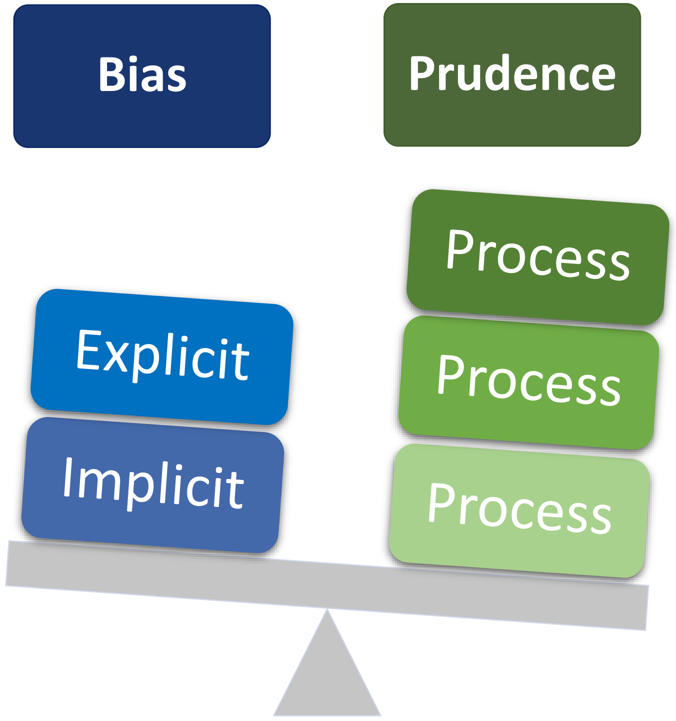
- The duty of prudence is a core fiduciary principle.
- Prudence requires trustees to exercise care, skill, and diligence.
- The development and consistent application of reasonable governance practices can demonstrate the absence of negligence.
- Governance policies establish expectations in advance for challenging situations, e.g., conflicts of interest or trustee discipline policies.
- Ethics policies/standards of conduct provide clear guardrails and support duty of loyalty compliance.

Fiduciary Principle: Prudence



Fiduciary Principle: Prudence

Prudent Governance Controls for Bias



People are not agnostic, so your *process* has to be.

Fiduciary Principle: Prudence

How boards demonstrate prudence:

- Exercise board powers reserved and prudent delegations
- Funding policy
- Education/training policy
- Board self-evaluations
- Asset allocation policy
- Strategic planning process
- Budget and personnel policies
- Investment policy and beliefs, including risk management, benchmarks, due diligence and proxy voting
- Performance monitoring practices
- Reporting practices
- Documentation standards
- Procurement and manager selection processes
- Audits and compliance functions

Fiduciary Principle: Prudence

Peer practices are an important reference point for prudence – but are not the final word.

Peer practices serve as a reference point but are not dispositive. Mindless herding around similar practices should be avoided.

Fiduciary Principle: Diversification

How boards demonstrate diversification:

- Risk reduction is achieved through setting and managing to the asset allocation:
  - Consider performance correlations between asset classes;
  - Practice regular rebalancing to policy; and
  - Appropriately diversify within asset classes.
- Other key elements of diversification include:
  - Limits to size of single investments;
  - Exposure limits to specific investment managers and other counterparties; and
  - Mitigating for specific risks.

Fiduciary Principle: Cost Management

How boards demonstrate cost management:

- Management costs must be appropriate for the strategies employed based upon:
  - Comparisons made to other similar investors;
  - Consideration of net long-term returns after expenses; and
  - Reasonable implicit hidden costs based upon best net execution on transactions.
- The Board is prohibited from expending trust funds to achieve unrelated social or policy goals.
  - However, identification, evaluation and management of long-term investment related risks and opportunities is proper and necessary.
- Spending too little can also cause problems and result in lower investment returns.

Fiduciary Principle: Transparency and Accountability

How boards demonstrate transparency and accountability :

- Effectively-implemented stakeholder communications plan with proactive messaging.
- Effective investment reporting practices*:
  - Making investment policy statements comprehensive, transparent, and readily accessible to stakeholders.
  - Disclosing bottom-line performance, not only gross of fees but also net of fees, which reflects the return on investments after subtracting fees paid to investment managers.
  - Adopting comprehensive fee-reporting practices for private equity investments, including performance fees.
- Availability of audit, compliance and peer benchmarking reports.

* “Transparency in Investment Disclosures Helps Promote Effective Public Pension Administration,” Pew Charitable Trusts, October 31, 2023

Fiduciary Principle: Compliance with Laws and Plan Documents

How boards demonstrate compliance:

- Adherence to laws and regulations.
- Following plan documents.
- Updating plan documents.
- Consistent application.
- Documentation and record keeping.
- Monitoring compliance.
- Auditing to obtain independent reassurance.
- Reporting and disclosures.

Fiduciary Principles and Common Challenges

Fiduciary Principles

1. Loyalty
2. Impartiality
3. Prudence
4. Diversification
5. Cost management
6. Transparency and accountability
7. Compliance with laws and plan documents

Common Challenges

- Tough and often thankless job
  - Do your duty at your own peril
  - Not a popularity contest
- Whom do trustees represent?
  - Retirees vs. active members
  - Taxpayers vs. Beneficiaries
  - Appointing authority vs. Beneficiaries
- Delegated tough policy choices, e.g.:
  - Health care
  - COLA
- Investment sourcing by trustees
- Transparency re: private markets

Questions?

For Further Information

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Presenter Biographies

Randy Miller

Randy has been Chief Operating Officer (COO) of Funston Advisory Services LLC since its founding in 2010. He leads our fiduciary and operations reviews and is an expert in public retirement system governance. Randy also leads FAS's InGov® peer benchmarking for public retirement systems. He is also COO of Board Smart LLC, a sister company that provides an online eLearning platform for public retirement system trustees and executives.

Together with Rick Funston, Randy has co-led assignments with many major public retirement systems. Randy has been the project manager on virtually all the FAS assignments since its founding, including ORSC fiduciary performance audits of the Highway Patrol Retirement System (2023), the Ohio Police & Fire Pension Plan (2022), the State Teacher Retirement System (2022) and the School Employees Retirement System (2017).

Randy has authored and co-authored a number of white papers on the topics of public pension fund governance, operations, and risk. He is also a key member of the Board Smart® faculty and developed the Board Smart talks entitled, "The Board's Focus on Strategy" and "How to Make the Best Use of the Board's External Advisors."

Randy left Deloitte Consulting LLP in 2010 after 27 years of service, where was a senior partner in the Strategy & Operations group. He received an AB degree from Dartmouth College with a major in Engineering Sciences. He also received a BE from the Thayer School of Engineering and an MBA from the Amos Tuck School of Business, both also at Dartmouth.

Presenter Biographies

Tiffany Reeves

Tiffany Reeves leads the Institutional Investor practice at Faegre Drinker. She is a trusted adviser to institutional investor clients in domestic and international private investments. Tiffany's experience extends to a broad range of alternative investment strategies, including buyouts, credit, venture, real estate, infrastructure, energy, and natural resources. She also advises institutional investor clients on fiduciary, governance, legislative and general administration matters. Tiffany has significant experience advising institutional asset owners on leading practices. She regularly advises clients on private equity due diligence, co-investments, U.S. Regulatory developments, custody and securities lending matters, secondary transactions, sustainability, and corporate governance matters.

Tiffany has been legal advisor to numerous Funston Advisory Services fiduciary and governance reviews, including two for the ORSC: the Ohio Police & Fire Pension Plan (2022), the State Teacher Retirement System (2022). She is also a member of the Board Smart faculty and has developed the Talk entitled "Governance Policies."

Tiffany previously served as the chief legal officer and deputy executive director for a $12 billion defined benefit public employee retirement fund. While serving as the fund's chief legal officer, she was responsible for a variety of investment matters including negotiation and review of private equity, private real estate and public market investments. She is a member of the National Association of Public Pension Attorneys (NAPPA), where she is a member of the Investment Committee and Co-Chair of the ESG Working Group. She is also a member of the Council of Institutional Investors.

Tiffany is a member of the bar in Illinois, Minnesota, Texas, and Wisconsin. She earned her JD from the University of Oregon Law School, as well as an MA from Northwestern University and a BA from the University of Oregon.