

Public Agenda Item #3

Discussion and Training regarding Ethics and Fiduciary Responsibility

December 1, 2016

Paula A. Jones, Deputy Executive Director and General Counsel
Kelley Bender, Chapman and Cutler LLP

Ethics and Fiduciary Responsibility



- ERS works diligently to maintain and promote an ethical work environment
- ERS policy requires employees to perform their duties in an ethical manner

Ethics and Fiduciary Responsibility



- Survey of Employee Engagement reflected staff's belief that:
 - Employees at all levels of ERS are held accountable for adhering to ethical standards
 - Employees feel comfortable reporting ethics violations
 - Employees feel that ERS leadership regularly shows that it cares about ethical issues and concerns
 - Employees demonstrate high ethical standards in their work

Ethics and Fiduciary Responsibility

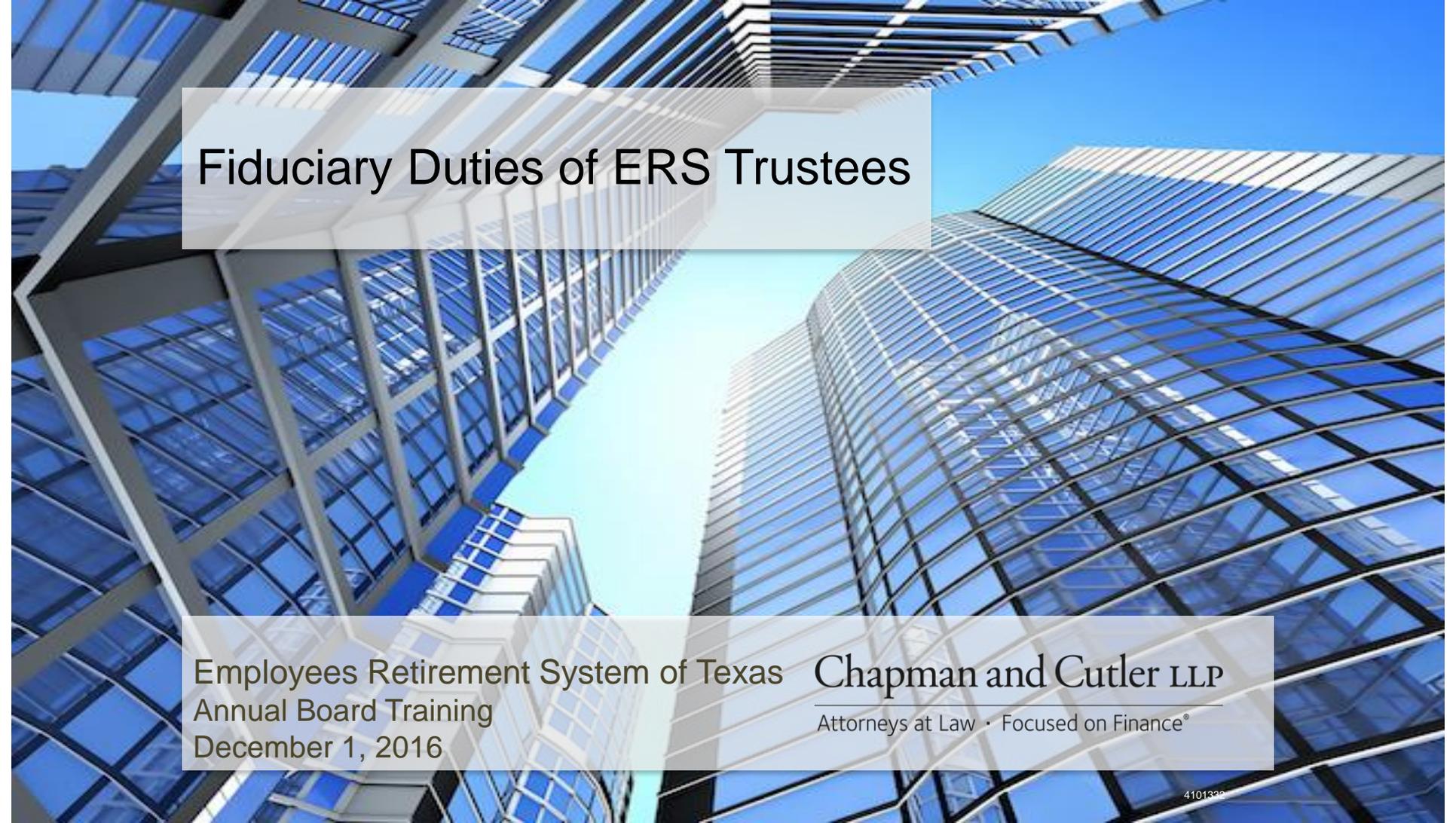


- Employees are encouraged to take ethics-related questions to the Deputy Executive Director and General Counsel (DED&GC) or Director of Human Resources
- Employees may also use ERS' Intranet or external website to anonymously report any alleged ethics violations
- Reports go to DED&GC and Directors of Human Resources and Internal Audit. All reports are investigated

Ethics and Fiduciary Responsibility - Training



- ERS' personnel policy requires all staff to complete annual ethics training
- ERS' Investment Policy requires all Board and IAC members and certain ERS investment-related staff to receive ethics training annually
- Kelley Bender, partner at Chapman and Cutler LLP, will present fiduciary and ethics training



Fiduciary Duties of ERS Trustees

Employees Retirement System of Texas
Annual Board Training
December 1, 2016

Chapman and Cutler LLP
Attorneys at Law • Focused on Finance®

Areas of Discussion

- What is a fiduciary?
- Who are ERS fiduciaries?
- As an ERS Trustee, what are your fiduciary duties?
- As a fiduciary of ERS, what should you avoid doing?
- What happens if you breach your duties as an ERS fiduciary?
- Application of fiduciary duties in context: Investment of Trust Assets
- Discussion

What is a fiduciary?

- Generally, a person who is required to act for the benefit of another person on all matters within the scope of their relationship
- One who owes to another the duties of good faith, trust, confidence and candor; one who must exercise a high standard of care in managing another's money or property (*Black's Law Dictionary*)
- The identification of a fiduciary and the duties of a fiduciary will vary depending on the law applicable to a specific situation

What is a fiduciary?

- ERISA: A person is a fiduciary of a plan if that person
 - exercises discretionary authority or control over plan management or disposition of plan assets,
 - renders investment advice to the plan for compensation, or
 - has any discretionary authority or responsibility in the administration of the plan.
- Remember that as a governmental plan, ERS and its Board are not subject to ERISA, but its provisions may provide useful guidance

What is a fiduciary?

- Under common law trust principles, a “trust” is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of one or more persons

What is a fiduciary?

- Other types of fiduciary roles with which you may be familiar
 - Director of a corporation
 - Director of a charitable organization
 - Trustee of a family trust
 - Attorney
 - Registered Investment Advisor
- Your role as an ERS fiduciary is different because...

Who are ERS's fiduciaries?

- ERS is a constitutional trust fund administered by the ERS Board of Trustees
- The Texas Constitution and Texas Government Code provide that the Board is the trustee of all ERS assets (trust fund)
- Because the Board holds legal title to the trust fund in trust for the exclusive benefit of all beneficiaries, the Board members are each fiduciaries of the trust fund

Who are ERS's fiduciaries?

- In addition to the members of the Board, the following are fiduciaries of ERS
 - Investment Advisory Committee
 - Executive Director and Deputy Executive Director
 - Staff
 - Those responsible for investing trust assets
 - Others as dictated by their roles and responsibilities
 - Service providers and vendors
 - Some may be fiduciaries by statute
 - Others may agree contractually to owe fiduciary duties

As an ERS Trustee, what are your fiduciary duties?

- Duty to administer the plan in accordance with the “plan documents” (the Texas Constitution, statutes and Texas Administrative Code)
- Duty of prudence/care
- Duty of loyalty
- Other duties
- The sources of duties for ERS fiduciaries are:
 - Texas Constitution
 - Texas statutes and rules
 - Common law (i.e., case law)

As an ERS Trustee, what are your fiduciary duties?

- Duty of Prudence/Care
 - Describes the manner in which fiduciaries carry out their duties
 - Duty to exercise reasonable effort and diligence
 - Texas Constitution (Art. 16, Section 67(a)(3))
 - In making investments, a board shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income therefrom as well as the probably safety of their capital.

As an ERS Trustee, what are your fiduciary duties?

- Duty of Prudence/Care
 - Tex. Gov't Code Ann. § 815.307
 - Prudence with respect to an investment decision must be made taking into consideration the investment of all assets of the trust... rather than considering the prudence of a single investment of the trust
 - Encompasses a duty to seek the advice of experts and consultants, but also related to the duty to delegate where the fiduciary does not have the requisite expertise

As an ERS Trustee, what are your fiduciary duties?

- Duty of Loyalty
 - Utmost good faith, fair dealing and candor
 - Act only in the interest of members and retirees *as a whole*
 - Exclusive benefit
 - The assets of a system are held in trust for the benefit of members and may not be diverted. (Texas Constitution, Art. 16, Section 67(a)(1))
 - Prohibited from self-dealing or engaging in transactions involving a conflict of interests

As an ERS Trustee, what are your fiduciary duties?

- Duty of Loyalty
 - Hang up any other hats [you] may wear and act solely in the best interest of the collective membership of trust fund members and retirees – not on behalf of individual members or member groups, employers, lawmakers, taxpayers, private businesses or anyone else who might have an interest in the outcome of the decision.

As an ERS Trustee, what are your fiduciary duties?

- Other duties
 - Impartiality; income productivity
 - With respect to co-trustees
 - Furnish information to members and retirees
 - Keep records and provide reports
 - Segregate and identify trust property
- Duty to comply with Code of Ethics
 - As required by statute, the Board has adopted an investment policy that includes a code of ethics

As a fiduciary of ERS, what should you avoid doing?

- Don't act in your own interests or the interests of anyone other than the trust and its beneficiaries
 - May seem obvious, but there is a lot of gray
 - Consider examples from other government pension funds
- Don't violate the ERS Investment Policy
 - This includes the Code of Ethics
- Don't repeatedly neglect your duties to attend to the trust's business
- Don't permit breaches of duties by co-fiduciaries (i.e., other Trustees, Executive Director, staff)

What happens if you breach your duties as an ERS fiduciary?

- Personal liability unless official immunity applies
 - Requires bad faith or actions outside of a Trustee's scope of authority
- Discipline, including reprimand, censure or other measures
- Headline risk
- Note that delegating a duty does not relieve you from all responsibility or liability for breach of that duty

Application of fiduciary duties in context: Investment of Trust Assets

- One of the Board's purposes and responsibilities is the protection and investment of the assets of the trust
- As fiduciaries, each of you is tasked with carrying out the responsibilities of the Board
- How can you carry out the investment authority of the Board consistent with your fiduciary duties?

Application of fiduciary duties in context: Investment of Trust Assets

- The Board may establish advisory committees as it considers necessary to assist it in performing its duties
 - The Board established the Investment Advisory Committee
 - The statute provides that the IAC shall “assist the board of trustees in carrying out the board’s fiduciary duties” with regard to the investment of assets
 - IAC members are also ERS fiduciaries

Application of fiduciary duties in context: Investment of Trust Assets

- The Board may specifically delegate any right, power or duty imposed on the Executive Director to any other person; if not so specifically delegated, then the Executive Director may delegate any such right, power or duty to another member of the staff
 - The Board has delegated its investment authority to the Executive Director and qualified ERS investment staff

Application of fiduciary duties in context: Investment of Trust Assets

- The Board shall develop and implement policies that clearly define the respective responsibilities of the Board and staff
 - The Board approved and adopted the ERS Investment Policy

Application of fiduciary duties in context: Investment of Trust Assets

- The ERS Investment Policy includes the Private Equity Policies and Procedures in Addendum I
- Section I.D.6 sets forth specific lines of responsibility
 - Board
 - IAC
 - Executive Director
 - ERS internal PE Investment Committee
 - ERS PE portfolio management staff
 - PE Non-Discretionary consultant

Application of fiduciary duties in context: Investment of Trust Assets

- ERS internal PE Investment Committee has been granted the following authority:
 - Approving PE portfolio investments recommended by Staff up to the lesser of \$200 million or 0.75% of the trust's assets in the case of partnerships that invest in companies
 - Approving PE portfolio investments recommended by Staff up to the lesser of \$300 million or 1.5% in the case of partnerships that invest in other partnerships (i.e., funds-of-funds)
 - For co-investments with new relationships, the Committee will approve the GP as well as the investment

Application of fiduciary duties in context: Investment of Trust Assets

- As fiduciaries, part of your duty is to assess when changes might be required to existing policies and procedures
 - The Investment Policy is required to be reviewed at least annually by ERS staff, who are also required to recommend changes to the policy
- As part of this assessment, reviewing changes in law and gathering information from peers can help determine prudence of existing policies and procedures.

Questions?