

Fiduciary Duty and the Job of the Board

Presented to SACRS by
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Board  Smart

Overview

- Fiduciary duties
- Fiduciary duty context / global operating environment
- The purpose of a retirement system
- The job of the Board and the Chief Executive
- Lines of Board relationships
- Powers reserved for the Board / challenges and leading practices
 - Conduct
 - Set
 - Oversee
 - Approve
 - Verify
- The future role of Board portals

Fiduciary Duties

Pension fiduciaries are held to the highest of legal standards which requires them to:

- Act solely in the interest of the participants and beneficiaries
 - For the exclusive purpose of providing benefits
 - Pay only reasonable expenses of administration
- Minimize employer costs of providing benefits
- Invest with the care, skill, prudence and diligence used by similar institutional investors
- Diversify investments to minimize the risk of loss and maximize the rate of return, unless clearly not prudent to do so

[Section 17, Article XVI, California State Constitution]

Fiduciary Duty Context

“There are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts.”

“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.”

Trustees should “make diligent and good faith efforts to identify, respect, and balance the various beneficial interests when carrying out the trustees’ fiduciary responsibilities.”

Co-fiduciary liability may be imposed when a trustee enables, conceals, participates in or fails to remedy a breach of duty by a fellow trustee.

[Restatement of Trusts, Third, 1992]

Fiduciary Duties Set the Stage for Effective Governance

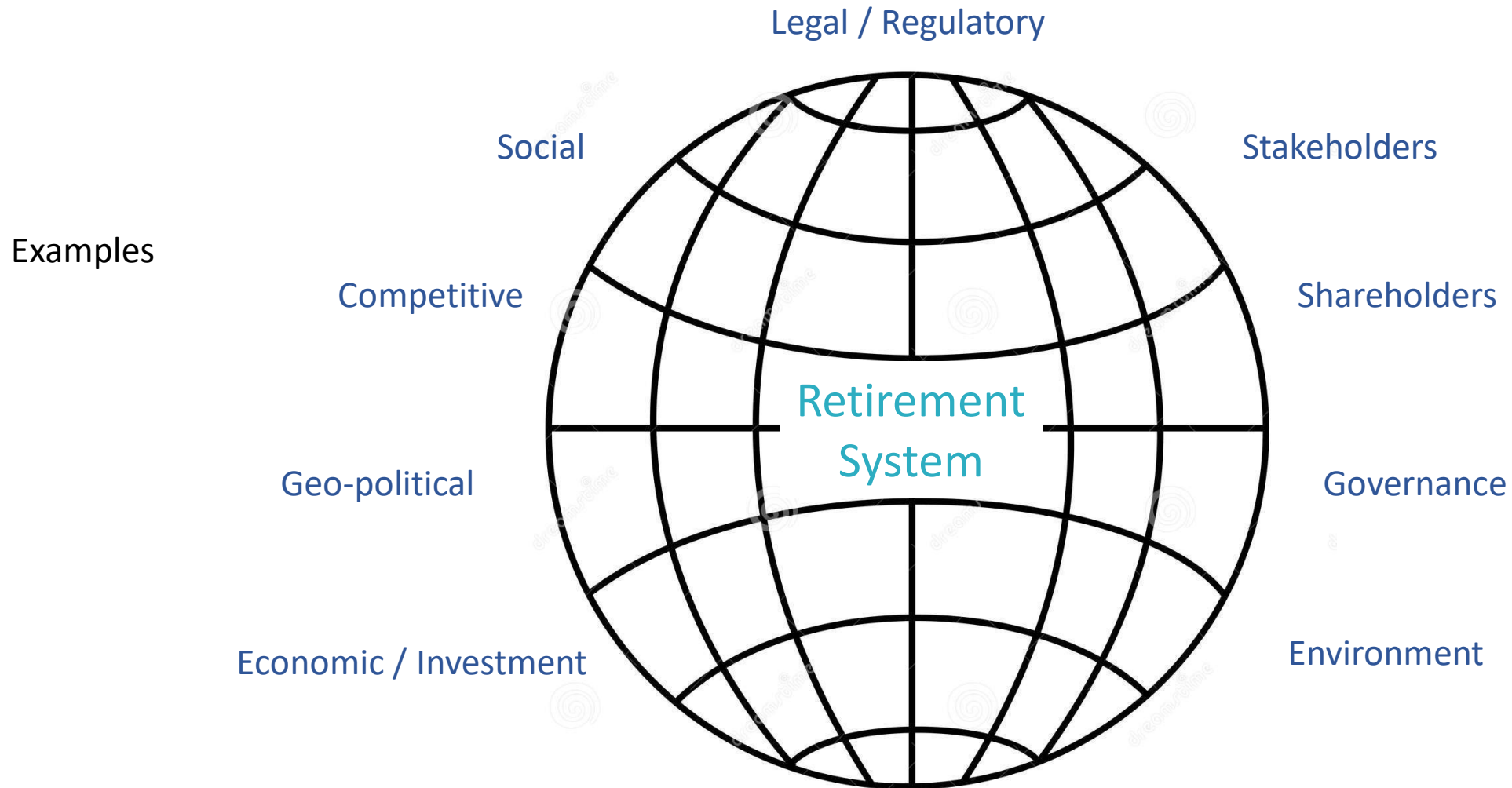
Foundational fiduciary duty principles require:

- Impartial and exclusive loyalty to all participants in delivery of their promised benefits
- Prudent exercise of responsibilities to meet a prudent standard of care which evolves over time
- Reasonable management of costs; minimization of employer costs over time
- Use of diversification to minimize risk exposures

But how does this translate into governance practices?

- What authorities and resources do fiduciary boards have (and need) to get the job done?
- How can they tell if it is working?
- How can they do their job better and improve the performance of the system?

The Global Operating Environment



The purpose of a retirement system is to create, deliver, capture and protect value in the best interests of the members and beneficiaries in a sustainable way.

The job of the fiduciary board is to govern the system i.e., direct and control but not to manage.

The Board

- represents the owners of the fund or “ship”
- organizes itself to get the job done well
- sets direction, allocates resources and oversees performance
- approves key decisions
- obtains verification of the reliability of the information it receives and reports to others
- hires the captain to run the ship as directed within policy

The CEO / Captain

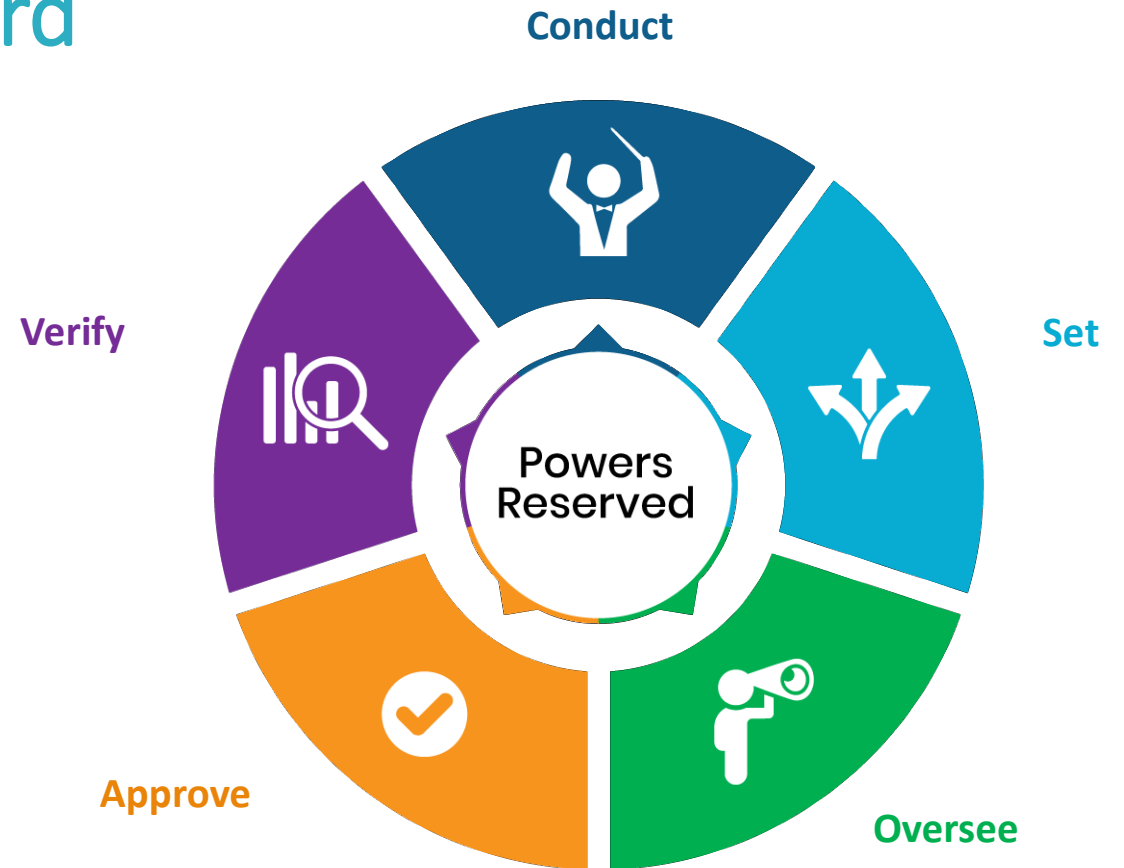
- hires and directs the officers and crew
- captain, officers and crew are responsible for advising the board
- executes the board approved direction within policy
- reports progress and challenges
- identifies / escalates direction and policy implications

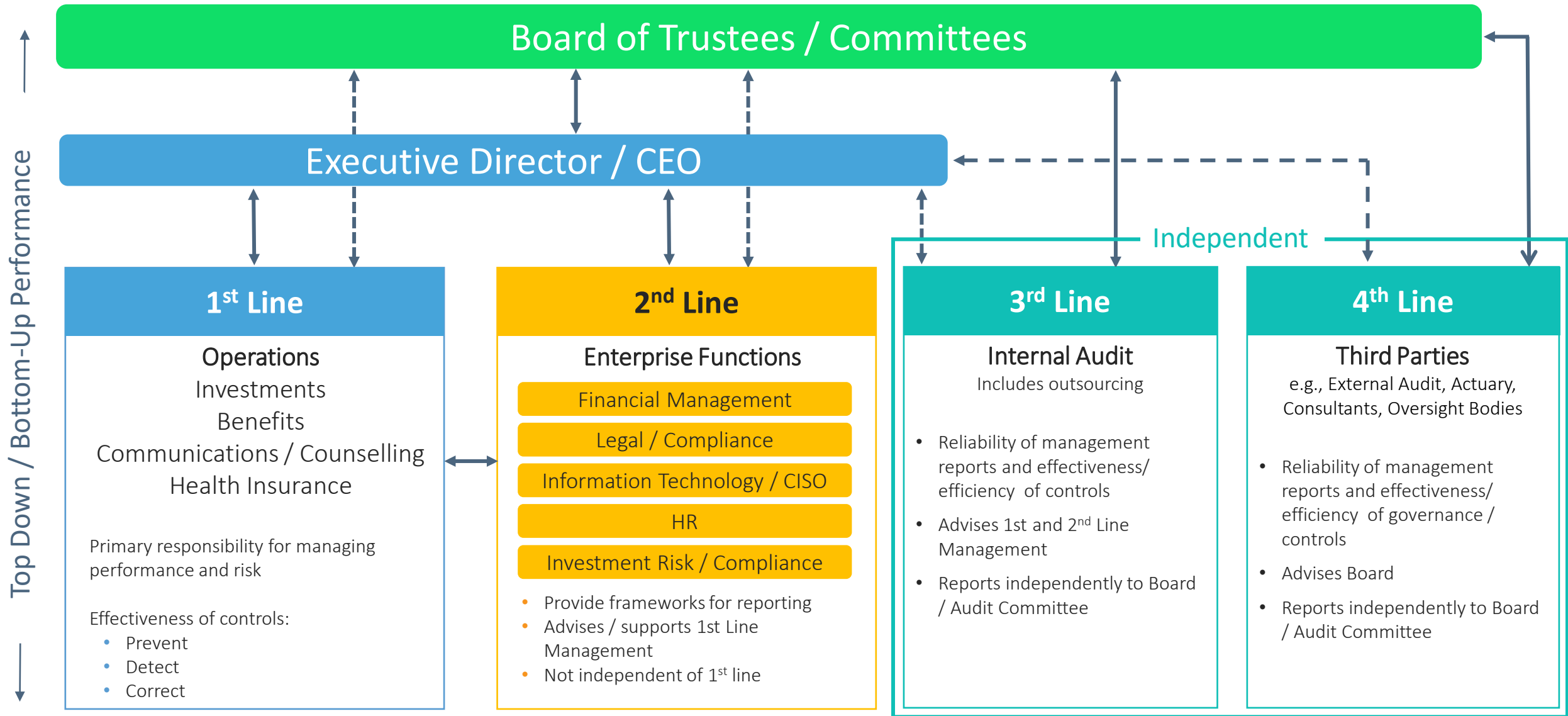


The Job of the Fiduciary Board

In the context of the global operating environment:

- As defined by governing legislation / regulation, articles of incorporation, bylaws, charters, strategies and policies
- Five powers a board can use to direct and control the system to fulfill its duties







Conduct the Business of the Board

- Agenda setting / difficult issues first
- Committees / charters
- Appointments / requirements / staggered terms
- Selection, goal setting, and evaluation of the chief executive director and chief auditor
- Selection and evaluation of board advisors
- Onboarding new directors
- Self-evaluation / development
- Board portal
- Continuing education





Case Example: Conflicts & Perplexity of Wearing Two Hats

Undivided Loyalty to Participants and Beneficiaries

Competing Interests

- Appointing authority
- Election constituency
- Taxpayers
- Personal benefit
- Political parties
- Business associates
- Policy preferences
- My age group

While understanding stakeholder views is important, fiduciary duty applies only to members and beneficiaries.



Conduct the Business of the Board

Importance of Continuing Education

For example:

- Audit committee effectiveness
- Cybersecurity and data governance
- Diversity, equity and inclusion
- Enterprise risk management
- Environmental, social and governance
- Shareholder activism and engagement
- Strategic workforce issues
- Strategy and innovation

“One size fits one”

- Accelerate learning curve
- Reduce information overload
- Customizable to individual needs and styles
- On demand
- Easily accessible
- Plain language ... what every trustee needs to know and ask



Conduct the Business of the Board

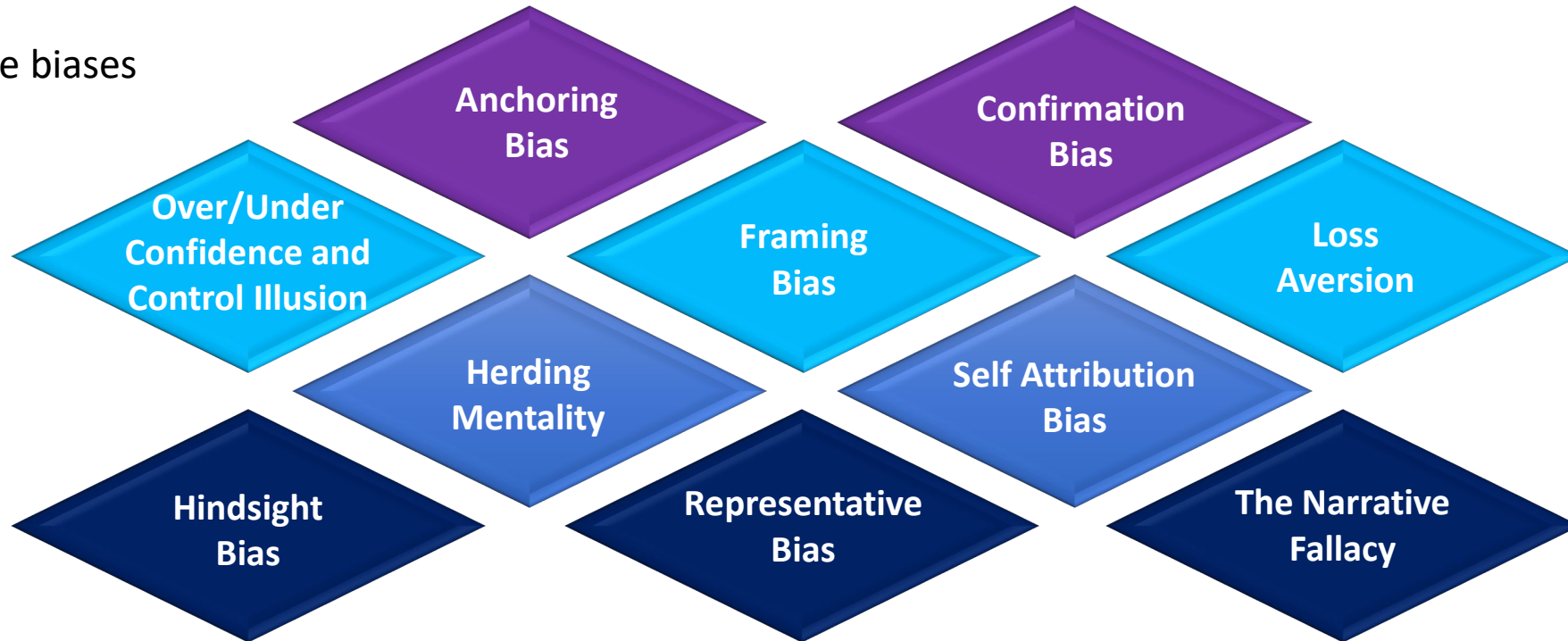
Develop Board Culture

- Role of the chairs / vice chairs
- Officer terms / limits
- Culture / ethics and code of conduct
- Importance of engagement / diversity of opinion
- Board dynamics / split votes
- Signs of function / dysfunction
- Succession planning for the board
- Overcoming behavioral biases



Become Aware of and Try to Neutralize Biases

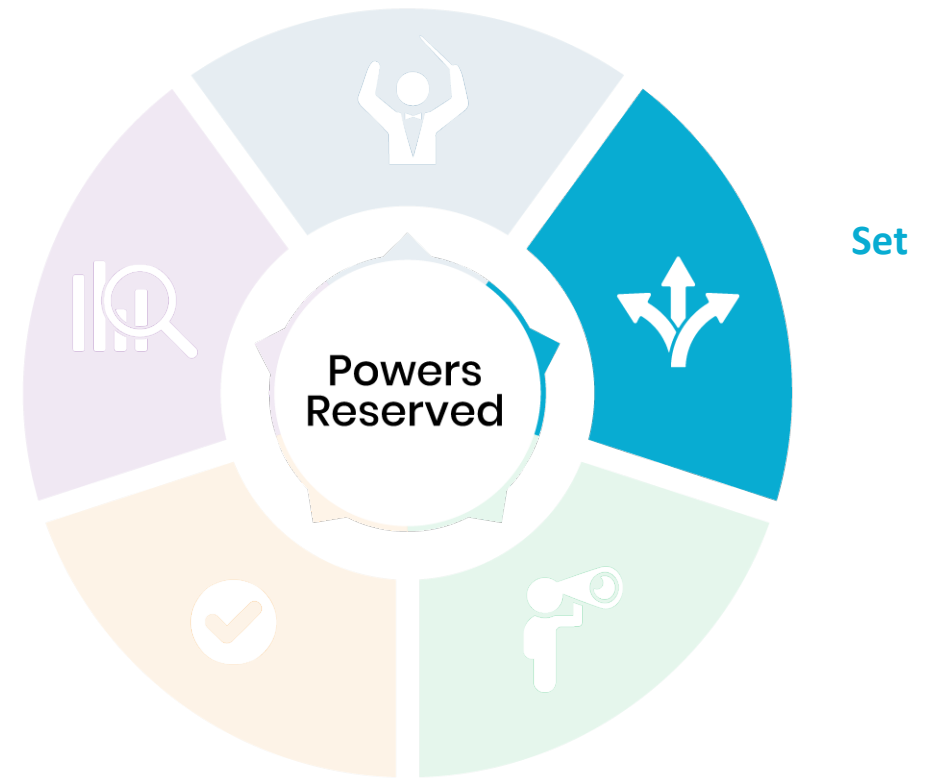
Some example biases



↕ Set Direction and Policy and Prudently Delegate

1. Seek Advice

- Delegate to committees
 - Research / Recommend
- Seek advice from stakeholders
- Seek independent advice
- Seek advice from professional staff
- Understand peer practices

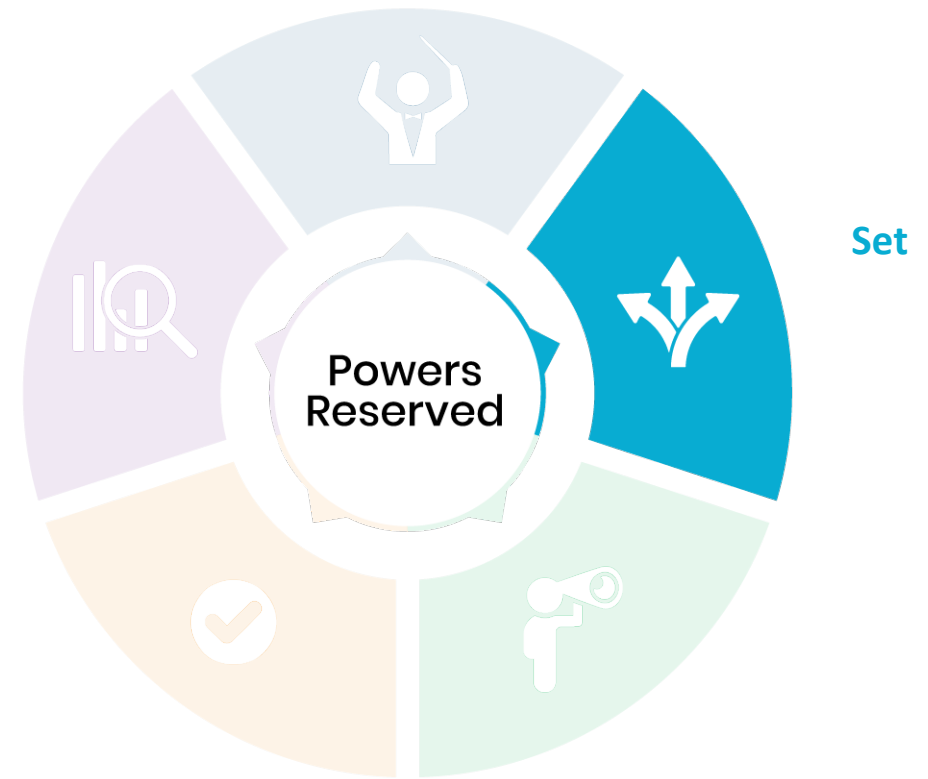


↕ Set Direction and Policy and Prudently Delegate

2. Set Direction

For the entire organization and each of its vital retirement functions:

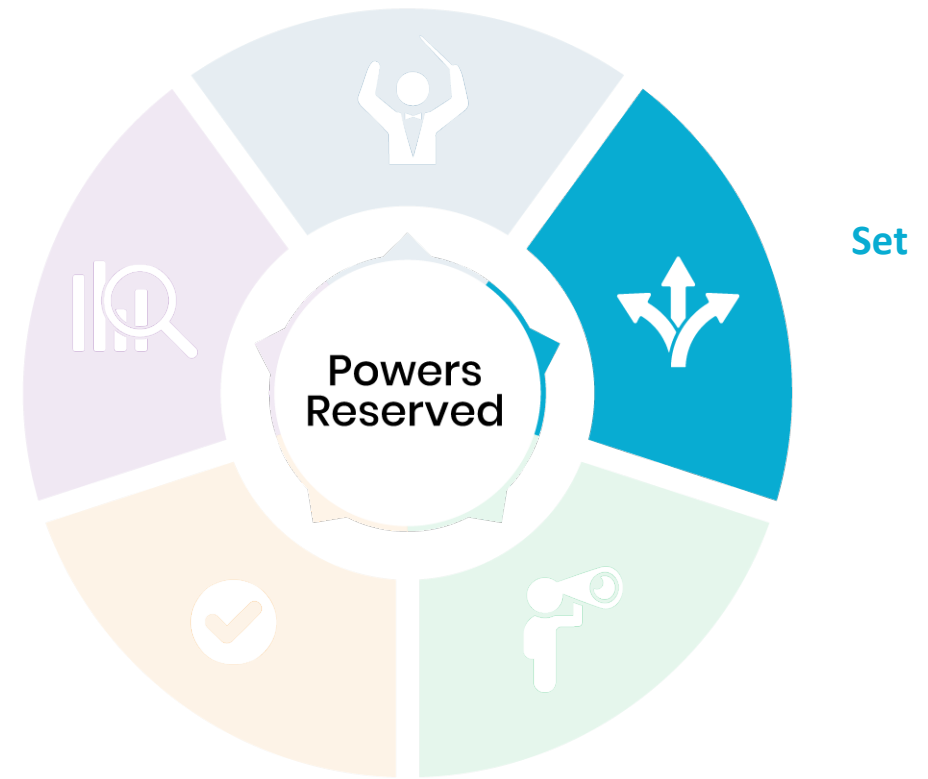
- Think strategically
- Identify essential capabilities needed for the future
- Set overall direction
- Agree on vital signs for vital retirement functions
- Set expected performance targets and define risk appetite
- Set asset allocation matched to risk appetite
- Develop strategic plan



↕ Set Direction and Policy and Prudently Delegate

3. Set Policy

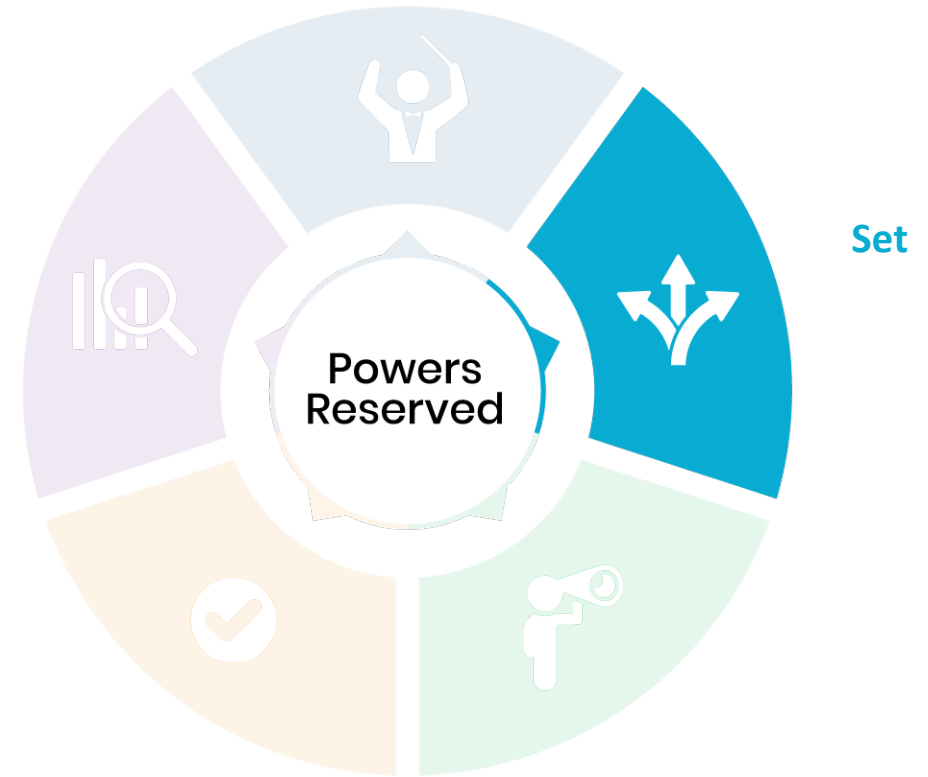
- Define performance and risk
- Agree on the meaning of risk
- Set risk tolerances / investment policy
- Develop a strategic policy calendar
- Identify policy options
- Summarize the options and implications
- Make informed choices
- Keep it evergreen



↕ Set Direction and Policy and Prudently Delegate

4. Prudently Delegate

- Standard of care
- Delegations to professional staff
- Delegated authority and resources



Case Example: Trustees are expected to delegate

“[T]rustees would have not only authority but a duty to delegate management activities in some reasonable fashion unless the trustees personally possess both the necessary expertise and the necessary time (even with the use of advisers) to manage the program themselves with the requisite degree of care, skill and caution.” [Emphasis added]

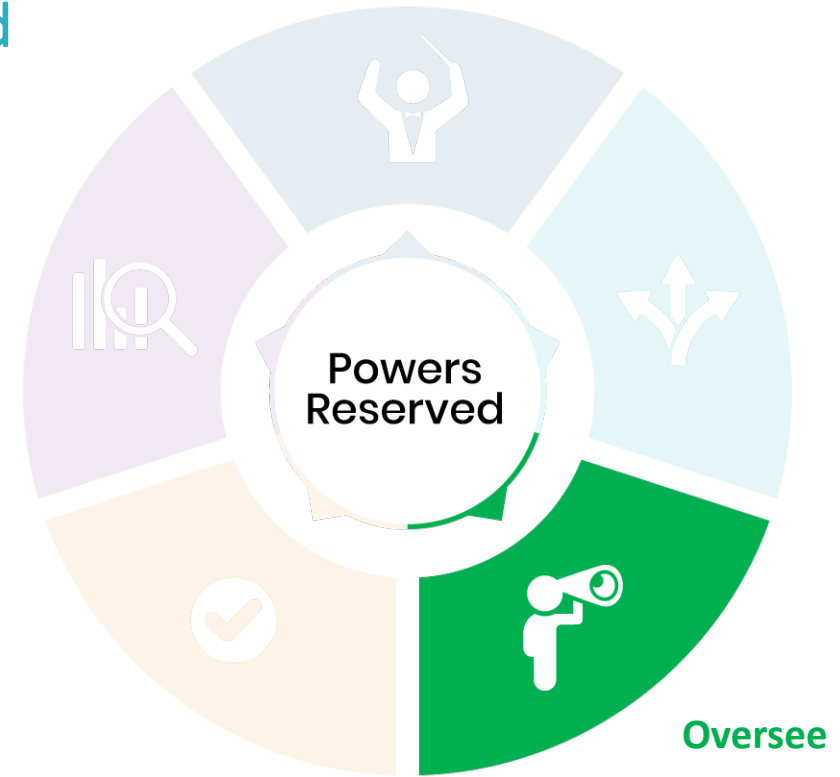
[Restatement (Third) of Trusts, Illustration 23 to Section 90, regarding venture capital investments]



Oversee the Execution of Direction Within Policy

Are Enterprise Performance and Risk Managed Within Policy?

- Insight for oversight
 - Reduce data overload / improve line of sight
 - Exception reporting
 - Expected vs. actual
 - Acceptable / unacceptable variation?
 - Dashboards / scorecards
- Oversight role of board committees



Case Example: Oversight process fiduciary duties

“[A] trustee’s duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved.”

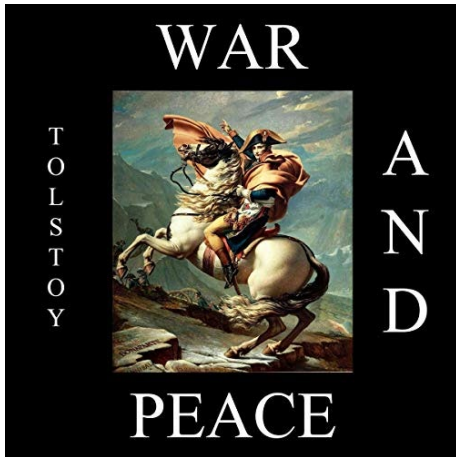
[Restatement (Third) of Trusts, Section 90, Comment b]



Oversight

1. To watch over and direct but not closely supervise or manage
or
2. An unintentional failure to notice or do something

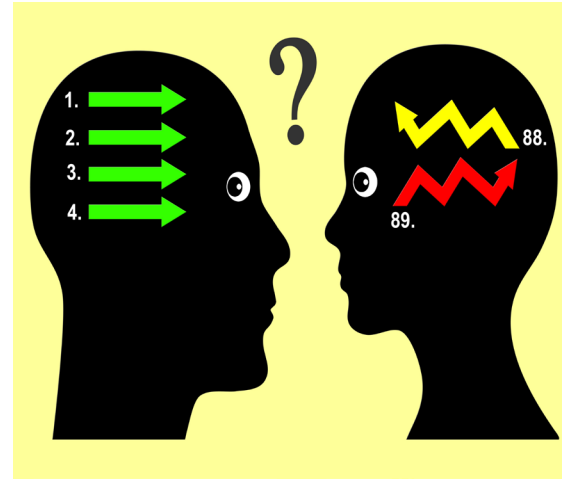
Insight for Oversight Challenges



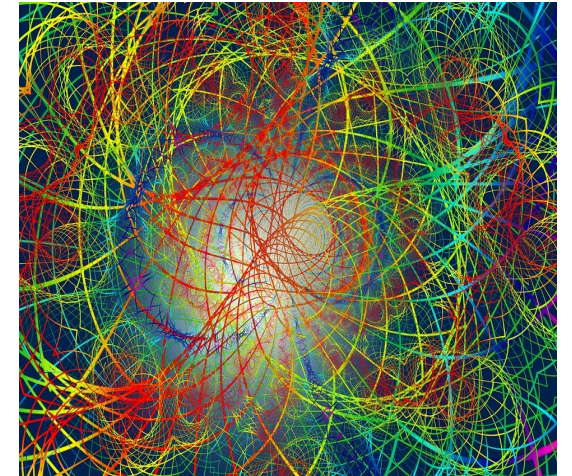
1225 pages
560 main characters



Individual appetites
for detail?



Ways to communicate
/ learn?



Loss of situational
awareness?



Situational Awareness

Knowing what's going on around you

Common causes of loss of situational awareness:

- Information overload
- Selective attention / fixation
- Loss of focus / distraction
- Complacency / fatigue
- Biases
- Failure to see emerging patterns (threats / opportunities)
- Failure to understand implications

Improving Situational Awareness

Benefits

- Improves knowing what's going on around you
- Improves ability to watch over and direct
- Improves
 - Resilience
 - Agility
- Reduces / avoids unintentional failure to notice or do something

What's important, what's changed, what does it mean?

- Signal Detection
 - Exception reporting – good / poor
- Pattern recognition
 - Trend
- Direction and Policy Implications
 - Threat / Opportunity
 - Response Hierarchy – Maintain options
- Escalation criteria / process
 - Multiple channels
 - Chain of command
 - By-pass (whistleblower)

Oversight Tools

Vital signs for vital functions / goals

- Performance and risk are inseparable
 - Risk is potential for unacceptable performance
- Expected (target) and actual
 - Tolerances / Benchmarks
 - Approved by Board
- Measures
 - Strategic choices
 - Leading / Lagging

Heads Up Displays / Alerts / Exception Reporting

- Color-coded
- Automated inputs
- Links to underlying data
- Dashboards
- Scorecards
- Process calibration by management / reliability
- Independent verification of reliability
 - Green is really green



Line of Sight
Execution of
Direction and Policy



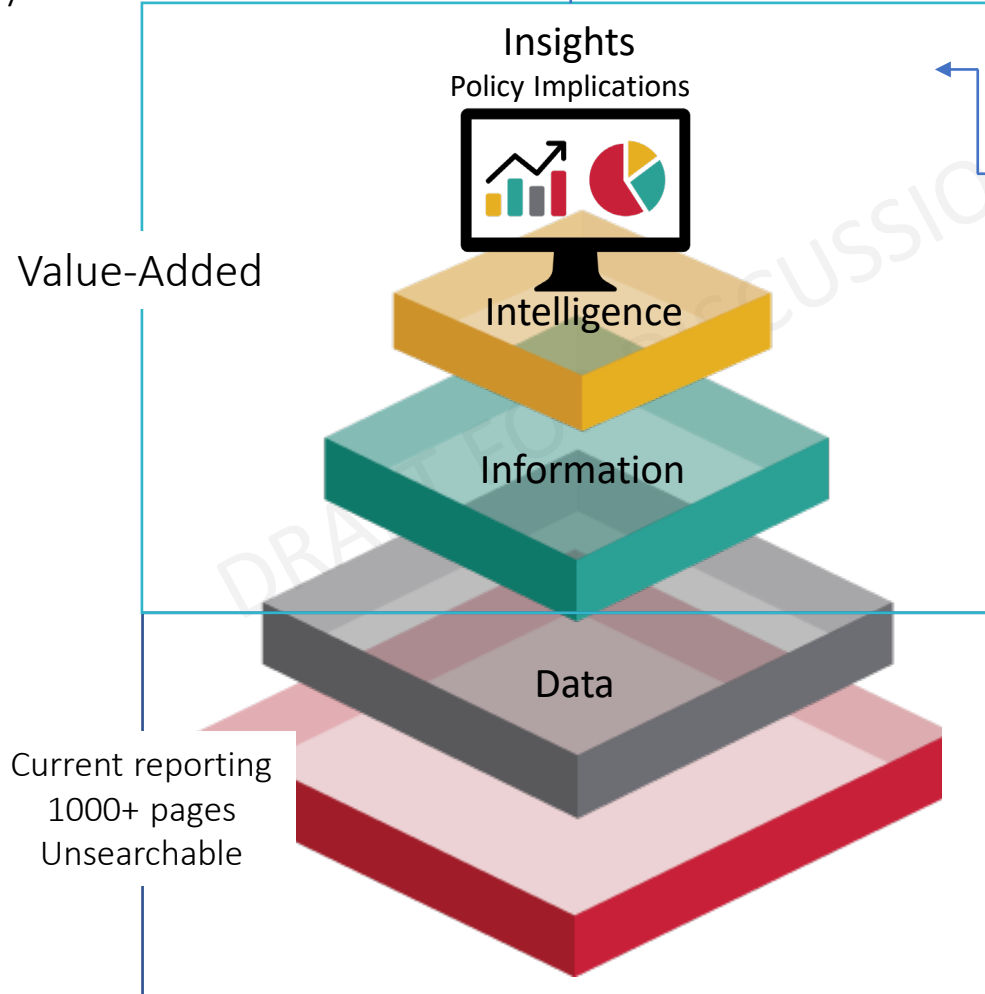
Drill down
and roll up

Searchable



Verify

Trustee / Committee of the Board / Board



Exception-based reporting:

- Improves efficient access to information
- Improves insight for oversight
- Improves situational awareness

[Link](#)

Management actions / Escalation process

[Link](#)

Exception-based dashboards / scorecards

[Link](#)

Vital Retirement Functions / Vital Signs

[Link](#)

Supporting Operational Information

[Link](#)

Transactional Level Data



Enterprise Performance

✔ Complete ✖ Off-Target (Complete) ● On Target ■ Off Target * Pending Refresh ** Data Not Available ▲ At Risk □ Under Development ⓘ Informational 🔍 Under Review

FY 2020-21 Quarter 2 Report

December 31, 2020

Executive Summary

Strategic Plan Alignment Map

Enterprise Operations Map

STRATEGIC MEASURES

Fund Sustainability	FISCAL YEAR 19/20				FISCAL YEAR 20/21			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Funded Status	■	*	*	*	■	*		
Projected Funded Status	●	*	*	*	●	*		
1-year total expected fund volatility	●	*	*	*	■	*		
Annualized (5-year) excess investment returns relative to Total Fund policy benchmark	■	*	*	*	■	*		
Stakeholder assessment survey – risk	*	*	*	●	*	*		
Investment managers policies and procedures for environmental, social and governance (ESG) factor integration	●	*	*	*	●	*		

High-Quality Affordable Health Care	FISCAL YEAR 19/20				FISCAL YEAR 20/21			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chronic disease prevention and management	New for FY 20/21				*	*		
Behavioral health quality	New for FY 20/21				□	□		
Measuring access to care	*	*	*	●	*	*		
Member experience	New for FY 20/21				*	*		
Health care premium affordability	New for FY 20/21				□	□		

INPRS Working Balanced Scorecard

Date: April 22, 2021

Reporting Period: March 2021

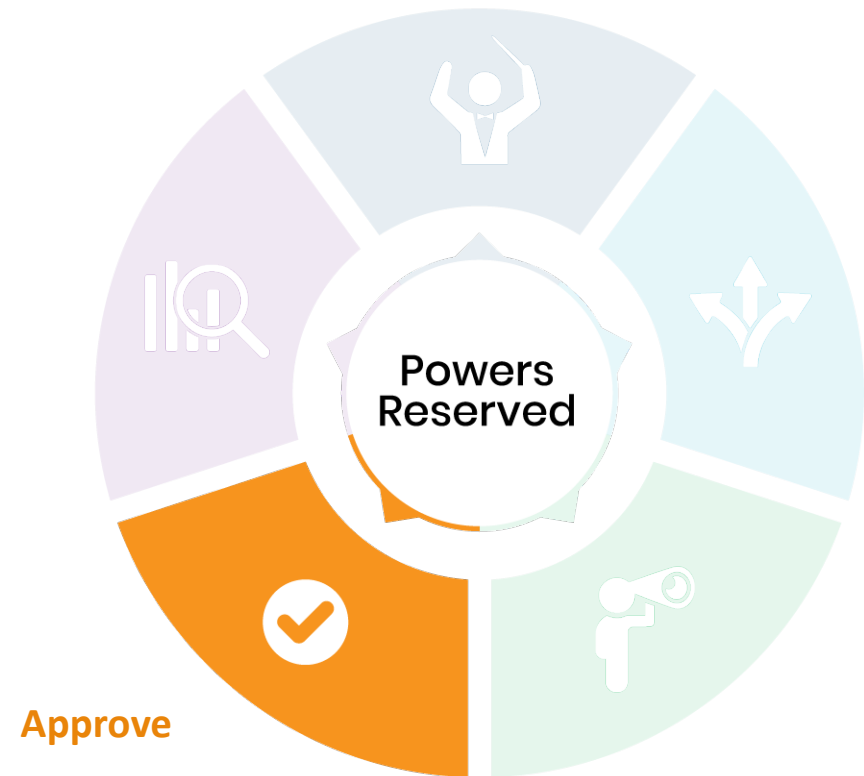
Strategic Goal	E-Staff Champion	Type	Measure	Target	Actual & Escalation Status	Trend (Last 3 Reporting Periods)	FYE 2020	FYE 2019	FYE 2018	Update Frequency
Customer										
We're Trusted to Pay	D. Grotz	Lag	Funded Status -- Prefunded Plans	Positive Trend & ≥ 80%	90.6%		90.6%	88.1%	88.3%	Annually
Goal 2: Deliver a quality member experience.	J. Hutson	Lag	Member Satisfaction: Call Center	>76.1	76.8%		81.6%	78.4%	--	Monthly
	J. Hutson	Lag	Member Satisfaction: Recent Retiree	>74.8	79.5%		75.1%	74.0%	--	Monthly
	J. Hutson	Lag	Member Satisfaction: Website	>83.2	90.4%		92.1%	89.3%	--	Monthly
	J. Hutson	Lag	Member Satisfaction: Counseling	>93.3	98.2%		96.1%	96.3%	--	Monthly
	J. Hutson	Lag	Member Satisfaction: Workshops	>90.0	90.2%		90.0%	95.8%	--	Monthly
Goal 3: Engage members through effective communication, education and collaborative relationships.	J. Hutson	Lag	CEM Member Engagement Survey	Top 1/3 of participating peers	5.46	new metric	--	--	--	Biannually



✓ Approve Key Decisions

1. Due Diligence for Recurring Decisions: e.g.,

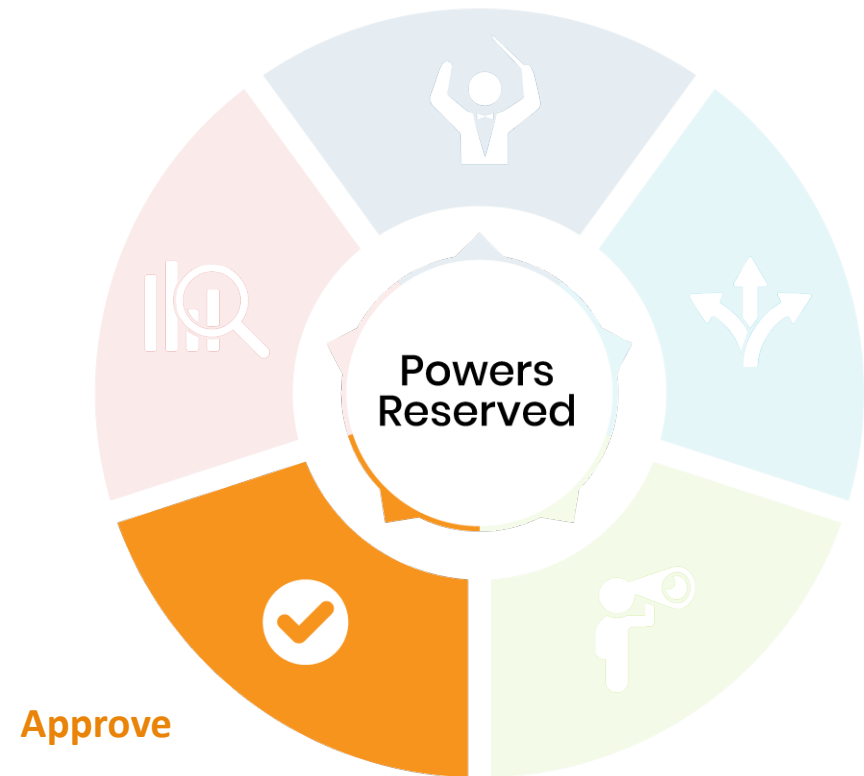
- Budget requests (annual)
- Financial statements and ratification of payments (annual)
- Actuarial valuation, including actuarial factors, assumptions, and methodologies (annual)
- Five-year actuarial experience review (5-year)
- Actuarial audit (5 years)
- Medical plan benefit changes and premium rates (annual)
- DC Plan Document adoption and changes (ad hoc)
- Third Party Administrator and other provider contracts
- Designated signatory changes (ad hoc)
- Acceptance of third-party reports (e.g., Internal Audit)
- Other third-party contracts (e.g., cyber insurance)



✓ Approve Key Decisions

2. Key Decision Diligence Standards:

- Identify all decisions requiring board approval
- Set decision diligence standards for each one
 - Policies for most critical decisions
 - Defined decision-making processes, e.g.:
 - Timing of the decision
 - Roles and responsibilities
 - Policies that govern
 - Comparisons with prior performance and approvals
 - Explanations of variances from or differences with prior requested approvals.
 - Requirements for advisor concurrence, if applicable
- Link decision timing to continuing education

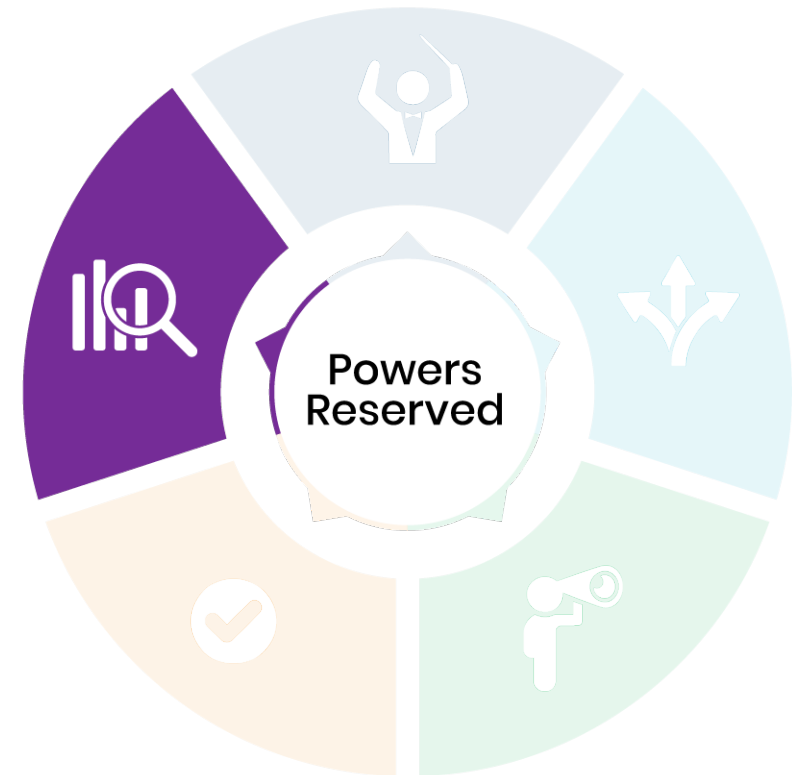


Verify Then Trust

“Trust, like reputation, is gained in inches per year and lost in feet per second.”

- Reasonable assurance by executives
- Independent reassurance / verification by others
 - Is green really green?
- Benchmarking / third party reviews
- Four lines of value creation and defense / lines of Board relationships

Verify





The Role of Portals

- Need a way to access and understand highly complex information in uncertainty
- Need insight for effective oversight of delegated direction within policy
- Understand trends in direction and policy implications
 - Stay the course?
 - Adjust?
 - Change course?



Board Portals

Current State

- Secure meeting materials
- Focus primarily on “Conduct”
- Rigid / flat files
- Non-searchable / lacks glossary
- Hard to print selections
- Seen as clerical responsibility

Future State

- Secure meeting materials
- Support exercise of all powers
- Flexible
- Searchable / glossary
- Easy to print selections
- Seen as strategic board interface



Enhance the Board Portal

Enable all Powers Reserved

Improve Insight and Access to information



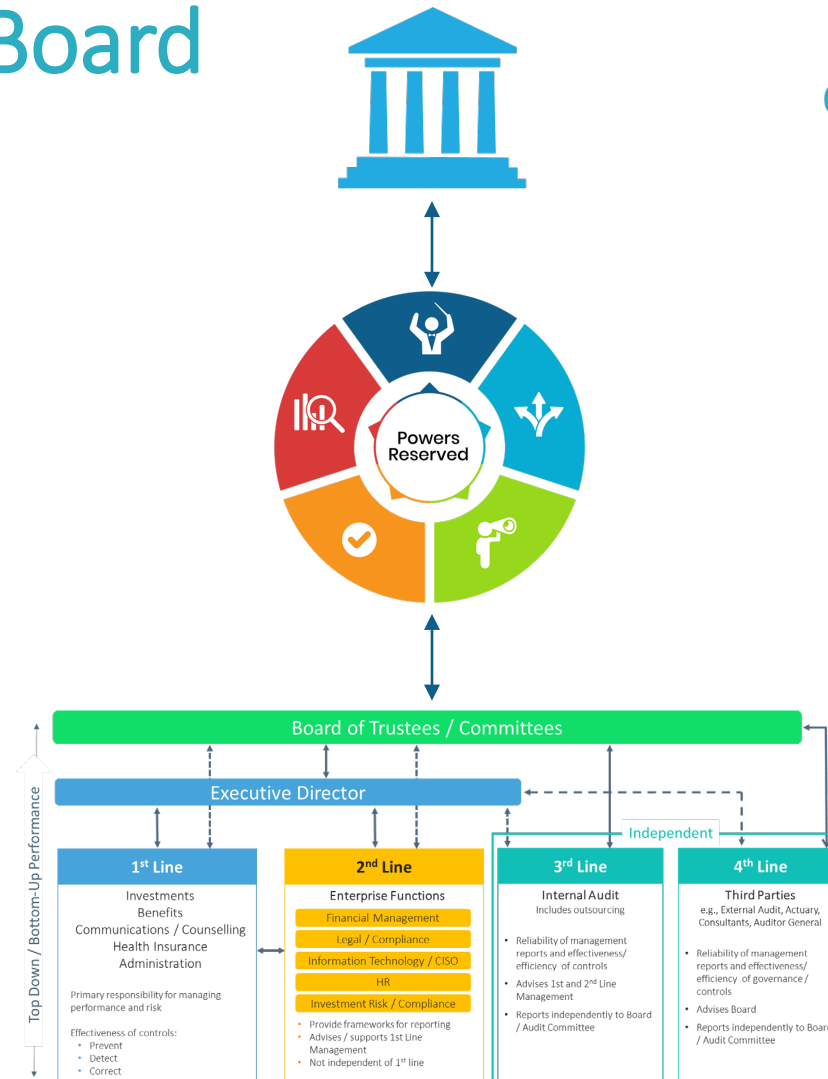
Searchable
Drill Down / Aggregate

- Policy Agenda / Minutes / Charters
- Strategic Plan
- Dashboards
- Performance / Risk Exception reports
- Policies
- Policy Option Summaries
- Audit reports
- Education resources
- Subject Matter Indexes
- Glossaries

Job of the Fiduciary Board Summary

Govern: Direct and Control
 Organization Performance and Risk
 With Loyalty, Prudence and Care

Powers reserved
 exclusively for the Board



Lines of relationship
 with the Board

For further information

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