

**New York City
Joint Trustee Orientation –
Fiduciary Basics**

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- **Fiduciaries are subject to the highest standard of conduct known to law.**

A trustee is held to something stricter than the morals of the market place. Not just honesty alone, but the punctilio of an honor the most sensitive.





The basic fiduciary rules are found in the New York State Statutes and Regulations.

These rules are similar in large part to the federal Employee Retirement Income Security Act of 1974 ("ERISA").

For interpretation of these statutes, courts may also turn to trust law.

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The Internal Revenue Code of 1954,

as amended,

imposes a requirement that a pension plan must be established and operated for “ *the exclusive benefit of . . . employees and their beneficiaries* ” in order to be a qualified plan under section 401(a) of the Internal Revenue Code.



FIDUCIARY STANDARDS

In a nutshell:

- Prudence
- Loyalty



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Prudence and Loyalty

Defined slightly differently in NY Estates, Powers and Trusts Law ("EPTL"), in NY Insurance Law (standards issued by State Insurance Department codified in NYC Code ("NYCRR") and in Retirement and Social Security Law ("RSSL") and NY Banking Law.

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Quite a Stew – a Feast Only for Lawyers

All statutes essentially share similar basic ingredients.

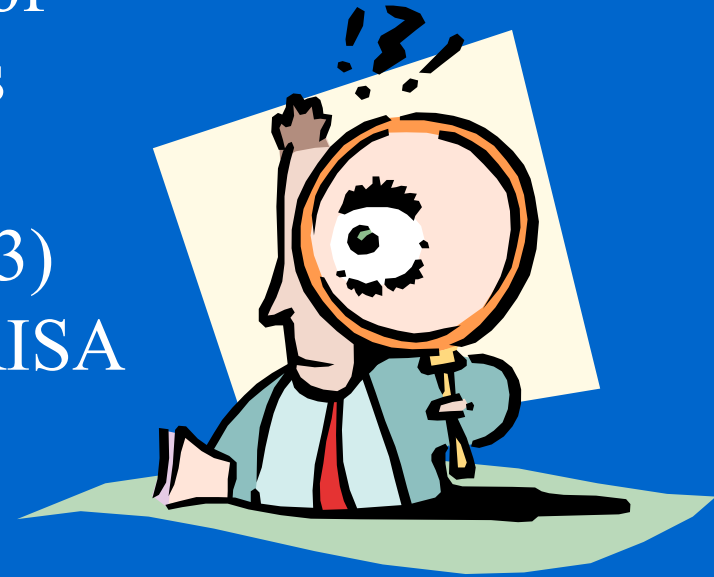


DUTY TO ACT PRUDENTLY

But In the Stew – Two Definitions of Prudence with Different Standards

Prudent Investor Act (EPTL § 11.2.3)
Reflects modern approach taken in ERISA
and recent trust law

Prudent Person Standard (11 NYCRR §136.6) Most closely resembles out of date trust law



Summary of Prudence

Under Prudent Investor Act

- Some Rules Explicit, Others Implicit
- Decisions Judged in Light of Facts at Time, Not in Hindsight
- "Prudent Expert" – "Good Heart, Empty Mind" no Defense – and if you happen to have special skills bar is even higher
- No Investment Inherently Prudent or Imprudent

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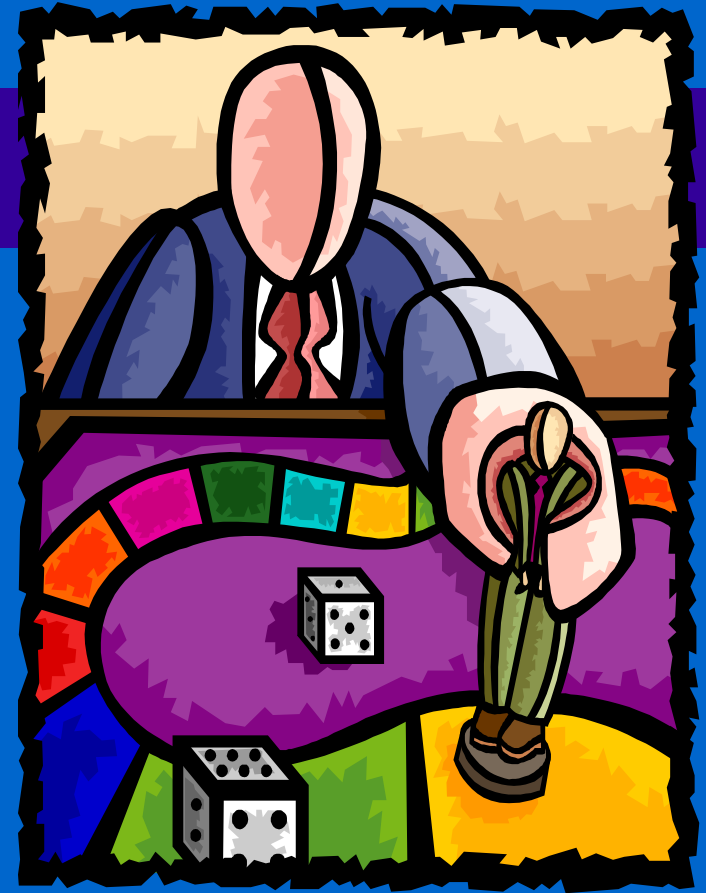
Prudent procedure requires a fiduciary to undertake an appropriate analysis of the proposed course of action. This includes ascertaining the relevant facts, investigating other options and, if needed, obtaining expert advice.



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Substantive Prudence

Under Prudent Investor Act
"Whole Portfolio" theory
requires a fiduciary to invest
and manage not in isolation but
in the context of the fiduciary
assets as a whole and to
implement an overall
investment strategy that
incorporates risk and return
objectives on that basis.



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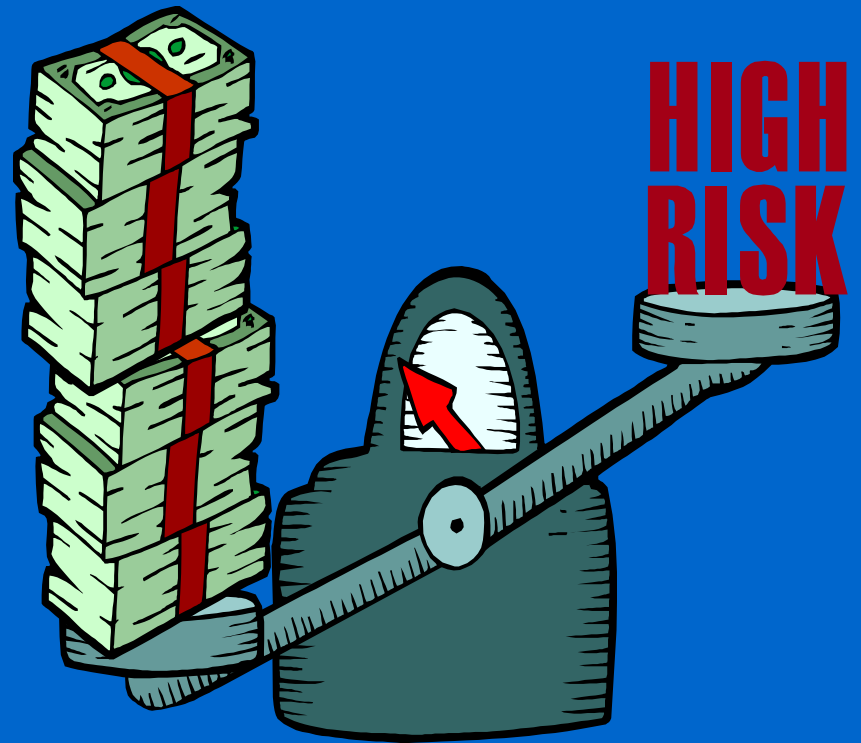
Not an Invitation to Invest in a "Pig in a Poke"

Still Need to Consider the Role that Each Investment or Course of Action Plays Within the Portfolio

Take into Account the Purposes and Terms and Provisions of the Governing Instrument

VIOLATION OF THIS RULE

Investing an "unreasonably large proportion" of plan assets in a single security, a single type of security or various types of securities that depend on the success of one enterprise or upon conditions in one locality.



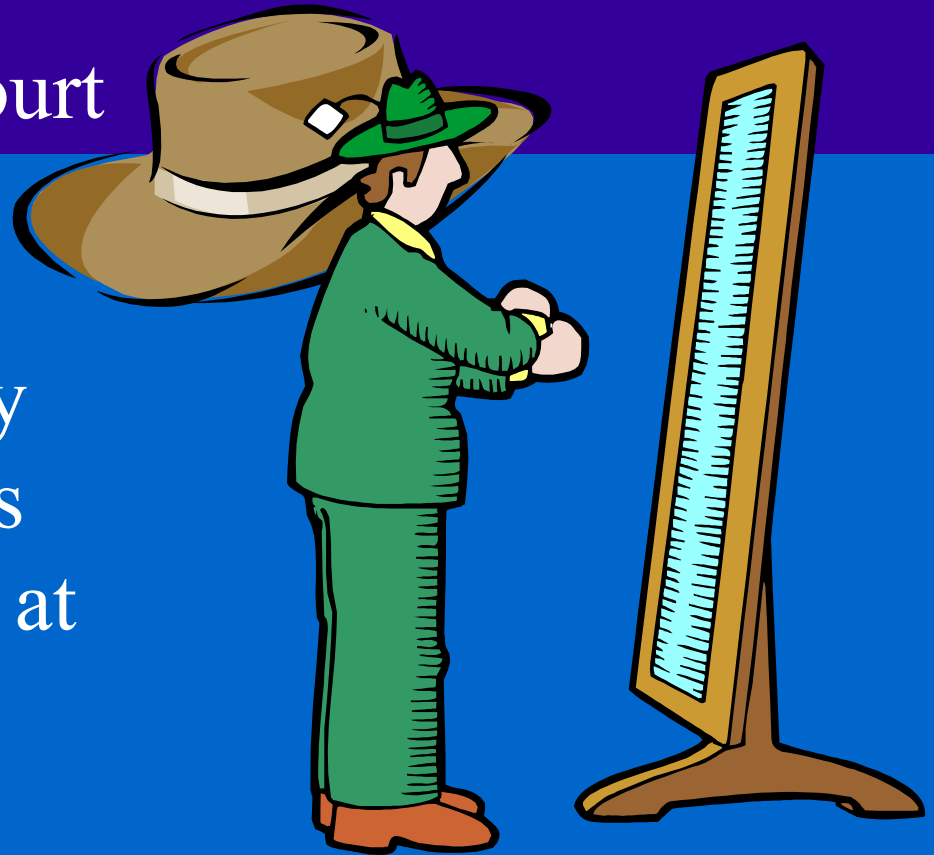
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Duty of Loyalty

...investing funds of the NYC Systems solely in the interest of the members and beneficiaries and for the exclusive purpose of providing them with benefits.



- The U.S. Supreme Court concluded that while performing trust business Trustees may wear only one hat – as trustee – and may not at the same time wear a second hat as a representative of the union or employer that appointed them.





- economic factors exclusively must motivate and
- guide decisions by a statutory fiduciary

- The receipt of “incidental benefits” by a fiduciary, or by a party with an interest in the Board's decision, as a result of a fiduciary decision **will not** violate the exclusive benefit rule.





- any social or non-economic considerations involved in investment decisions may be deemed to result in incidental benefits





The U.S. Department of Labor issued a 1994 ERISA interpretive bulletin regarding investments with corresponding incidental benefits, known as “economically targeted investments,” [“ETIs”]. 29 C.F.R. 2509.94-1



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The Department made clear that the key to making a lawful investment in ETIs requires the performance of due diligence. DOL clarified that “the fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally.”



The U.S. Department of Labor likewise issued a 1994 Interpretive Bulletin Regarding Proxy Voting and Other Corporate Governance Activities.

Makes clear that same rules apply as to ordinary Investment decisions 29 C.F.R. 2509.94.-2



Corporate Governance

- A fiduciary who fails to vote or cast a vote without considering the impact of the question, or votes blindly with management, would appear to violate his or her duty to prudently monitor plan assets
- The emergence of "Shareholder Activism"



BASKET CLAUSE

Legal List in "RSSL"
contains permissible
investments

15% leeway for investments
not listed.

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BASKET CLAUSE

Investments governed by
general prudence and loyalty
standards

SPECIAL BASKET CLAUSE RULE

Investments made under the basket clause should benefit the overall economic health of the State of New York "to the extent reasonably possible." Benefits must satisfy the prudence and loyalty requirements, and therefore must be "incidental."



The Duty Not to Engage in
Certain Transactions –
Prohibited Transactions –
Elaborations of the Duty of
Loyalty.



THE INTERNAL REVENUE CODE REQUIRES

That a governmental plan avoid engaging in a "prohibited transaction" in order to maintain the exempt status of the trust.

A prohibited transaction is defined in section 503 of the Code: Loans, purchase of securities from System Sponsor.

This section was enacted to require arm's length dealings between the employer / creator of a trust and the trustee.



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OK, IF

Adequate Security and Reasonable
Rate of Return

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Two 1970's NY Based Decisions Permitted Investment in Sponsor Bonds

Westchester Chapter, Civil Service
Employees, V. Levitt (NY 2nd, 1975) and
Withers v. Teachers Retirement System of
the City of New York, (SDNY 1978 aff'd
2nd Cir, 1979)

Unclear whether would be followed today.

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PROHIBITED TRANSACTIONS

The NY Superintendent of Insurance has issued standards that expressly prohibit the Boards from engaging in certain transactions. These "prohibited transactions" mirror three prohibitions contained in section 406(b) of ERISA.



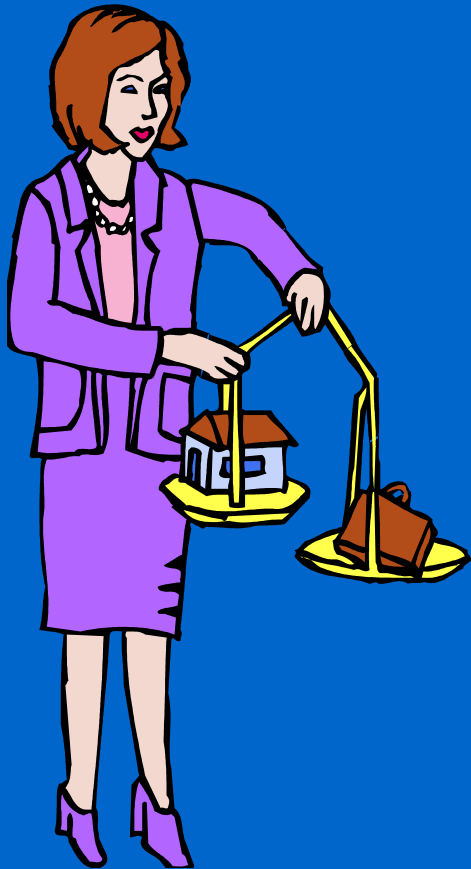
FIDUCIARY PROHIBITIONS

MISUSE OF FIDUCIARY AUTHORITY IN 3 WAYS:

Trustees, consultants, agents and employees shall not act in

- Own interest
- Behalf of adverse party or accept
- “Kick-backs”





A fiduciary may avoid engaging in the first two types of potential misuse by removing himself or herself from the decision-making process and not otherwise exercising fiduciary authority over the decision.

ADVERSE PARTY



- A fiduciary may not act on behalf of a party whose interests are adverse to the plan's, even if he or she receives no personal gain.
- Trustees of two plans who negotiated a loan between the plans engaged in an unlawful transaction because the interests of borrowers and lenders are always adverse.

TRANSACTIONS INVOLVING KICKBACKS



A fiduciary charged with violating the anti-kickback rule must prove by "clear and convincing evidence" that compensation he or she received was for some service other than a transaction involving plan assets.

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FIDUCIARY PROHIBITIONS

May not own or maintain
any indicia of
ownership or personal
interest in any assets of
a System other than an
interest
as a beneficiary.



11 NY ADC 136.6(h)(4)

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RECENT LOYALTY ISSUES



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“Gravy Train”

Acceptance of Gratuities – Civil and criminal law violations.

State of Ohio “zero tolerance” policy – trustees indicted, staffs investigated under criminal law.

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United States of America v.
Dean Kirkland, Gary Kirkland
and Robert Legmo (No. CR02-
350-BR) (D. Oregon 2004).

- ERISA based criminal decision
- Court convicted vendors for bribing trustees with free travel – trustees on the “gravy train”



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U.S. Labor Department has developed body of law with regulations, rulings and lawsuits.

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Relevant considerations whether a gratuity permissible:

- Could the Plan itself pay for it?
- Does the Plan have a written policy?
- Is it authorized by the Plan?
- Is the gratuity disclosed?
- Are detailed records maintained?
- Is the cost extravagant?
- Evidence of intent to influence a decision?



• • • **Gratuities that should be avoided:**

- Free or discounted services or goods.
- Cash awards, retiree parties or gifts of more than normal value, charitable contributions in connection with a plan sponsor event.
- Expenses of family or friends.
- Personal expenses while on travel.
- Purely recreational activities.
- Expense paid overseas trips.

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Gratuities that may be acceptable:

- Meals in conjunction with meetings
- Reasonable hotel, reception travel expenses for educational conferences.
- Seminar fees.

Pension Power – Uses and Abuses

- Divestment – South Africa, Tobacco, Sudan
- Pro-investment – Affordable Housing, High Labor Standard Countries.

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AFL-CIO recently pushed the envelope in connection with efforts to stymie Social Security privatization – use of governmental plan assets to “educate” the members and the public, use of threats to put pressure on vendors.

U.S. DOL announced investigation and shortly thereafter issued strongly worded letters challenging the legality of the former and issuing a “strict scrutiny” warning regarding the latter (Letter to AFL-CIO, May 3, 2005.)

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Hiring Vendors

Targeted Hiring.

Ohio Legislation requires State Funds to “consider” home-grown and minority and women owned investment brokers. Has led to criminal investigation of the Bureau of Workers Compensation.

Trustees interpreted goals to be directives.

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Consultant Abuses

The SEC conducted an inquiry into the potential conflicts engaged in by investment consultants and issued a May 2, 2005 Staff Report highlighting its findings of significant undisclosed conflicts of interest.

The U.S. DOL in an August 19, 2005 fact sheet listed 10 questions that Plans must ask consultants. www.dol.gov/ebsa

Free Speech

- Trustees often discuss Plan matters with members, union or employer sponsors and the media.
- Rules are unclear as to the legalities of such discussions.
- Trustees should be careful not to disclose:
 - Confidential information.
 - Information that might harm Plan investments.
 - Misleading or erroneous information

DELEGATION OF AUTHORITY

Statutes Authorize Trustees to Delegate Investment and Management Functions if Act consistent with Fiduciary Requirements in Selection and Monitoring.

Delegatee Accepts Fiduciary Responsibility, as well.



LIABILITY FOR FIDUCIARY BREACH BY:

- Trustees
- Staff
- Contractors



LIABILITY FOR TRUSTEES AND STAFF:

- Negligence and malfeasance under general municipal law, willful violation of insurance standards under insurance law.
- Defense and indemnity available, but limits – acting within the scope of employment and not in violation of any rule or regulation of the Agency.
- Indemnity unavailable if damage resulted from intentional wrongdoing or recklessness.
- Insurance mentioned, but not specifically authorized.



No provision explicitly relieving trustees or staff of liability where delegate authority, but contractor held liable under EPTL in 2003 decision Scalp & Blade v. Advest (N.Y. A.D. Fourth Department)



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