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# Today's Environment: Fiduciary and Ethical Considerations

## Illinois Public Pension Fund Association

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May 14, 2010

## *A Rising Tide...*

- **A rising tide lifts all boats, and in a strong economy errors and outright fraud by investment managers, custodial banks and others may not be apparent.**
- **A falling tide lays bare the truth, and scrutiny of trustees' decisions may increase as the economy sputters.**

## *The Falling Tide*

- **The Madoff fraud unraveled when investors, facing other losses, sought to withdraw capital from Madoff in droves and he was unable to secure new investments to maintain the Ponzi scheme.**
- **Similarly, outsized losses in some securities lending programs at the apex of the financial crisis revealed years of improper management by custodial banks.**

## *Scrutiny Increases as Returns Fall*

- **Media, government officials and beneficiaries focus more closely on performance when the economy is down.**
  - Government facing more pressure on budgets
  - Beneficiaries more dependent upon benefits

## *The Need to Refocus*

- **The recent string of massive frauds by investment advisors has refocused attention on those who trusted these managers.**
  - Madoff: \$50 billion Ponzi scheme, sentenced to 150 years.
  - Stanford: \$8 billion Ponzi scheme.
  - Westridge / WG Trading: Looted client accounts, including public pension funds in California, of more than \$500 million.

*Pension funds were exposed to these frauds through direct investments (Westridge) and fund-of-funds investments (Madoff).*

- **The recent revelations of possible misconduct by custodial banks increased focus on the need to ensure proper oversight:**
  - Securities lending
  - Foreign exchange transactions
  - Claims administration

## *The Need to Refocus*

**At the same time, the media and political leaders have seized upon pay-to-play schemes from New York to California to argue for reform in the relationship between public pension funds and their external investment professionals.**

## *The Need to Refocus*

**In many of these cases, examples have arisen of fiduciaries whose relationships with those managing the assets of their funds may have crossed lines of ethics and the fiduciary duty of loyalty.**

## *The Need to Refocus*

- **There is no silver bullet that will prevent or identify fraud.**
- **These recent examples provide lessons that public pension funds can use to ensure that they are employing the best possible procedures to limit exposure to fraud.**
- **Indeed, the vigilance of public pension fund trustees is a major reason that the primary institutional victims of frauds such as Madoff were private charities and universities rather than public funds.**
- **But, there is always room for improvement...**



## *The Need to Refocus*

- **The response to these examples of fraud by advisors and possible lapses of oversight by some fiduciaries is NOT for Trustees and fund executives to micromanage the day-to-day operations of their funds or investment decisions by outside managers.**
- **The Board's job is to establish policies and procedures that staff can implement to protect the fund and ensure the highest level of services from external advisors.**

## *Foundations of Fiduciary Law*

**No fiduciary relationship is more complete and nearly as absolute as the relationship between a public pension fund trustee and a pension beneficiary.**

## *General Fiduciary Guidelines*

**A Governing Fiduciary such as a trustee seeking to properly fulfill his or her governance duties is charged to act in all matters associated with the trust with:**

- (1) Loyalty**
- (2) Care**
- (3) Prudence**

## *Duty of Loyalty*

**It is critical to ensure that any connections between trustees and potential investment advisors are fully disclosed, and trustees with conflicts recused from relevant discussions.**

- **Madoff scandal revealed that trustees for investment funds (often private charities) personally directed the investment of assets to Madoff based upon their personal relationship.**
- **Ezra Merkin, who operated Madoff feeder funds, is being investigated by the New York Attorney General for his role as trustee for institutions that he placed into Madoff investments.**
- **Recent suit against trustees of a Midwest public pension alleges that certain trustees received political contributions from companies seeking private equity investments from the fund.**
- **In the wake of losses on securities lending, several funds scrutinized the ties between fund staff and the custodial banks managing the lending programs**

## *Duty of Loyalty*

### Illinois Governmental Ethics Act (5 ILCS 420/4A-101(o))

- **Members of a board of any pension fund established under the Illinois Pension Code must annually file a statement of economic interest with the Secretary of State or applicable county clerk.**

# *Duty of Loyalty*

## Illinois Pension Code

- **No monetary gain on investments: no pension board member or employee (or spouse of such member or employee) – shall knowingly have any direct interest in the income, gains, or profits of any investments made on behalf of a pension fund for which the person is a member or employee (Section 1-130).**
  - This new section prohibits such persons from receiving any pay or emolument for services in connection with any investment.
  - May not become “an endorser or surety, or in any manner an obligor for money loaned or borrowed from the pension fund.”
  - Violation of this new section is a Class 3 felony. (40 ILCS 5/1-130)
- **Clarification on gifts from prohibited sources (Section 1-125).**

## *Duty of Loyalty*

### Illinois Pension Code

- **Prohibits anyone from being retained to attempt to influence the outcome of an investment decision or the procurement of investment advice or services of a pension fund for compensation, contingent in whole or in part upon the decision or procurement (Section 1-145).**

## *Duty of Care*

**A trustee must apply watchful attention to his or her duties. In practical terms this means:**

- **The trustee must ensure the collection of funds and monies due to the plan.**
  - This may include bringing suit to recover monies owed the fund.
- **The trustee must ensure that beneficiaries receive all benefits owed.**
- **The trustee must ensure that the beneficiaries are informed on a periodic basis of the operations of the plan and the financial health of the plan.**
- **The trustee must maintain the fund with up-to-date investments and do his/her best to make the fund financially secure.**
- **The trustee is under a duty to minimize the risk of loss by ensuring the reasonable diversification of investments through asset allocation, except where it is clearly not prudent to diversify.**



## *Duty of Prudence*

**Prudence means the attention and care legally expected or required of a person. For a public pension plan trustee, it means he or she must diligently pay attention to the details of his or her work.**

## *Duty of Prudence*

### **All trustees should, in the pursuit of prudence:**

- **Attend all Board and committee meetings, except in the most extraordinarily personal circumstances.**
- **Prepare studiously for Board and committee meetings.**
- **Read the statutes and internal policy/mission statements concerning your plan, including ethics policy statements.**
- **Read the past three annual reports of your plan as well as the past three audit reports.**
- **Establish a working knowledge of the open records and open meeting laws of your state as well as the ethics laws of your state.**
- **Become familiar with the qualifications and reputation of the plan's auditor, investment consultant and actuary.**
- **Ask the investment officer to explain the current fund asset allocation to you.**

## *Duty of Prudence*

### **All trustees should, in the pursuit of prudence (continued):**

- **Ask to have the various performance benchmarks explained to you.**
  - As a trustee, you must understand the asset allocation system because as a plan trustee, you will be called upon to approve the percentage of assets to be invested in various asset classes.
  - The number of asset classes is expanding with the advent of the global economy, which presents a particular challenge to trustees.
- **Network with other trustees.**
- **Obtain advice from experts (whether legal counsel, investment advisors or others) to answers questions you may have.**

## *The Limits of the Trustee's Role*

**Trustees are charged with establishing the standards and protocols that the fund, its agents and consultants employ when conducting due diligence of asset managers and investment advisors because trustees cannot personally investigate all agents and consultants who handle fund assets.**

## *The Limits of the Trustee's Role*

**Trustees may delegate the actual selection of asset managers and investment advisors to consultants and agents, including “fund-of-funds” managers, but that delegation must be made pursuant to the established standards and protocols for assessing those who will handle the fund’s assets.**

## *The Limits of the Trustee's Role*

- **Trustees are not expected to personally investigate all agents and consultants who handle fund assets.**
- **Trustees establish the standards and protocols that the fund, its staff and consultants must employ when conducting due diligence of asset managers and investment advisors.**

## *Duty to Delegate*

- The trustee has the duty to delegate those tasks the trustee cannot properly do himself or herself.
- But, delegating in and of itself will not relieve a trustee from liability.

## *Duty to Delegate*

- **Whether to delegate has been said to be a question of prudence.**
- **When delegating the following applies:**
  - The duty of care in selecting qualified personnel;
  - The duty to specify the scope of the delegation;
  - The duty to monitor the agent to ensure the delegated duty is carried out in the best interest of beneficiaries; and
  - The duty of loyalty to select an agent on the basis of the interests of the *beneficiaries*.



## *Know Your Advisor*

### **Case Study: Securities Lending**

- Many institutional investors, including pension funds, engage in securities lending through custodial banks.
- Securities lending programs generate nominal returns to offset transaction costs by lending securities and investing the collateral received for those loans in very conservative, short-term investments.
- Some custodial banks invested portions of that collateral in high-risk, long-term investments, including exotic, asset-backed securities, resulting in massive losses.
- Securities lending collateral investment is an investment advisory function, not a ministerial function, which requires rigorous scrutiny that trustees apply to other investment advisors.

## *Know Your Advisor*

- **Even if an advisor’s conduct with your fund is circumspect, misconduct in connection with other funds will impact your relationships.**
- **Recent case of well-regarded advisor who was accused of engaging in “pay-to-play” with select funds**
  - **New York Attorney General is prosecuting.**
- **Disclosure of “pay-to-play” scheme led numerous innocent funds to quickly terminate the advisor and move quickly for replacement.**
  - **Diverts resources**
  - **Increases costs**
  - **Generates criticism**
- **It is fully appropriate to seek disclosures from advisors concerning potential misconduct in other aspects of their business.**

## *Hope for the best...*

### **... but, prepare for the worst.**

- **Investment contracts, including alternative investments such as limited partnerships, hedge funds and funds-of-funds should empower the trustee to terminate the relationship in certain circumstances:**
  - Allegations of fraud or misconduct – without requiring indictment, admission or conviction;
  - Failure to perform adequate diligence of sub-advisors, whether demonstrated by allegations of sub-advisor misconduct, deviation from investment guideline or failure to perform;
  - “Critical man” provisions – ensure that an exit is available if the key personnel who are expected to be managing the fund’s investments are no longer doing so.
  - Several securities lending programs halted all withdrawals, citing liquidity concerns, effectively locking participants into the programs as losses mounted.

## *Trust, but verify*

- **Methods of verification vary for different external advisors (pension consultants, asset managers, fund-of-fund managers)**
- **Identify the critical facts important to your selection of each external advisor and require staff to verify to the level that provides comfort and resolves open questions.**
- **Reliance upon reputation alone, however sterling, is insufficient**

## *Trust, but verify*

### Examples of verifiable facts when staff is assessing external advisors:

- **Confirm references**
- **Review ADV Forms**
- **Documentation concerning investment methodology**
- **Site visits by staff or consultants**
- **Identify the professional firms (custodians, auditors, etc.) that provide services to the fund's external advisors, and act as "gatekeepers"**
  - **Lack of gatekeepers was critical to success of Madoff and Bayou**
- **Submit specific questions:**
  - **Terminations by other clients**
  - **Regulatory censure**
  - **Client complaints to regulators**
  - **Severance of former employees**

## *Trust, but verify*

**When delegating responsibility for the ultimate investment to an external advisor or fund-of-funds, the Board, through fund staff, must retain oversight:**

- **Staff should learn the identity of all individual managers within the fund-of-funds.**
- **Staff should create due diligence checklist to ensure that consultants and funds-of-funds perform when selecting managers for the fund-of-funds and require verification that all requirements have been satisfied.**
- **Staff should verify that consultant or fund-of-funds will continue to supervise fund-of-funds managers, including specifics such as frequency of audits and site visits.**

## *Hope for the Best...*

- **Remember the “headline” risk, and be sure that you can terminate an agent even if the misconduct at issue arose in connection with a fund other than your own.**
- **Consider providing prior authorization to retain outside counsel to advise on complex transactions.**

## *The SEC is NOT Your Proxy*

- **SEC cannot and does not investigate all indications of fraud**
- **Registration by an investment advisor does not guarantee:**
  - Experience
  - Expertise
  - Honesty
  - or even full disclosure.
- **Massive Ponzi schemes such as Stanford and Madoff demonstrate that the SEC cannot be relied upon to identify or prevent fraud.**
- **The SEC and state regulators do not serve as proxies for trustees in conducting adequate diligence of investment advisors.**



## *Process, Process, Process*

### How do trustees protect themselves and the fund from liability for losses?

- Trustees should ensure that the fund has established procedures and policies for all vital plan functions.
- Trustees should ensure that such procedures are followed in an orderly fashion. The processes and procedures the Board has in place are the best defense to potential liability.
- Boards should consider purchasing insurance coverage for officers' and directors' liability.

**A trustee is liable for a loss resulting from his or her failure to use the care and skill required of a trustee.**

## *Common Sense*

- **Use your common sense in approaching decisions. While common sense alone is never enough on which to base fiduciary decisions, if a deal looks too good to be true – often it is.**
- **Don't allow yourself to be pressured into making a decision.**
- **Don't ever be afraid to ask questions. What you don't know, can hurt you in the trustee arena.**
- **Always remember that you are acting in a public capacity.**

## *Common Sense*

**The “front page test” should be one of your everyday benchmarks.**

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**“If we take this action, am I comfortable with it being described on the front page of the local newspaper read by my family and friends?”**

## *Common Sense*

- **Do not lose sight of the fact that the ultimate responsibility for the fund lies with the Board. Thus, the buck stops with you.**
- **If you believe a staff member or money manager is not properly serving the fund, you have an affirmative obligation to address the problem.**
- **If you do not understand an investment after careful examination and consideration, you should not approve that investment.**
- **If your gut feeling is that there is some problem, follow through on your feeling. Trustees are just as liable for doing nothing as they are for doing the wrong thing.**

## *Common Sense*

- **Do not settle for jargon from your staff, consultants and attorneys. Demand plain English. All too often, professionals hide behind jargon to avoid the difficult task of communicating clearly.**
- **Know what you don't know. Hire competent professionals to fill in the gaps.**
- **Embrace excellence. Your beneficiaries deserve it.**



### Avi Josefson

Mr. Josefson prosecutes securities litigation for the firm's institutional investor clients, and has participated in many of the firm's significant successes, including *In re SCOR Holding (Switzerland) AG Securities Litigation*, which resulted in a recovery worth in excess of \$143 million for investors. He was also a member of the team that litigated the *In re OM Group, Inc. Securities Litigation*, which resulted in a settlement of \$92.4 million. As a member of the firm's new matter department, he counsels institutional clients on potential legal claims.

A member of the firm's subprime litigation team, he is currently involved in the securities fraud action arising from the collapse of subprime mortgage lender American Home Mortgage and the actions against Lehman Brothers, Citigroup and Merrill Lynch, arising from those banks' multi-billion dollar losses from mortgage-backed investments. Mr. Josefson is also actively involved in the corporate governance litigation practice, and represented shareholders in the litigation arising from the proposed acquisitions of Ceridian Corporation and Anheuser-Busch. He has presented argument in several federal and state courts, including an appeal he argued before the Delaware Supreme Court.

Mr. Josefson received his J.D., from the Northwestern University School of Law, and currently resides in Chicago.