



City of Falls Church Retirement Board

Fiduciary and Governance Educational Training

September 10, 2020 / Tammy Dixon / Meghan Horn / Julian Regan

| Agenda

Legal

Investment

Actuarial

Who is a fiduciary? Anyone who...

1. Exercises discretionary authority over management of the plan or disposition of plan assets
2. Provides or has the responsibility or authority to provide investment advice for a direct or indirect fee or other compensation
3. Has discretionary authority or responsibility over administration of the plan

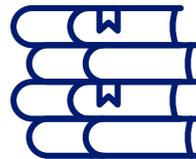
Exercise of discretion is the key

Can include more than just the trustees, such as:

- Retirement Fund staff
 - Board members
 - Investment advisors

Sources of Fiduciary Responsibilities in Governmental Plans

- United States Constitution contracts clause
("No state shall...pass any...law impairing the obligation of contracts...")
- Internal Revenue Code §401(a)(2) exclusive benefit rules and §4975 prohibited transactions
- ERISA can provide guidance even if your plan is not subject to it
- State statutes and municipal codes on plan creation, ethics and conflicts of interest
- Common law and applicable court decisions



Primary Fiduciary Responsibilities

Under ERISA §404(a)(1), affirmative duties are to:

- Act prudently with respect to plan assets and expenses
- Diversify assets to minimize risk of large losses
- Act solely in the interests of beneficiaries for the exclusive purpose of providing plan benefits and paying plan expenses
- Comply with plan provisions and applicable laws
- Select service providers and monitor performance, conflicts of interest
- Communicate with participants about their benefits



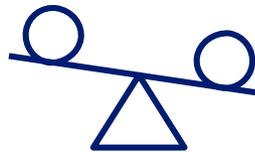
Fiduciary Standards

- Retirement Board (“Board”) has fiduciary responsibilities and the individual Board members are fiduciaries.
- The Board’s fiduciary responsibilities stem from delegated functions as specified in the Code of the City of Falls Church, Virginia.
- The legal standards applied to fiduciaries (duties of prudence and loyalty) are the highest standards under the law and are often difficult to understand.
- Meeting the fiduciary standards requires more than just common sense or a good faith attempt.

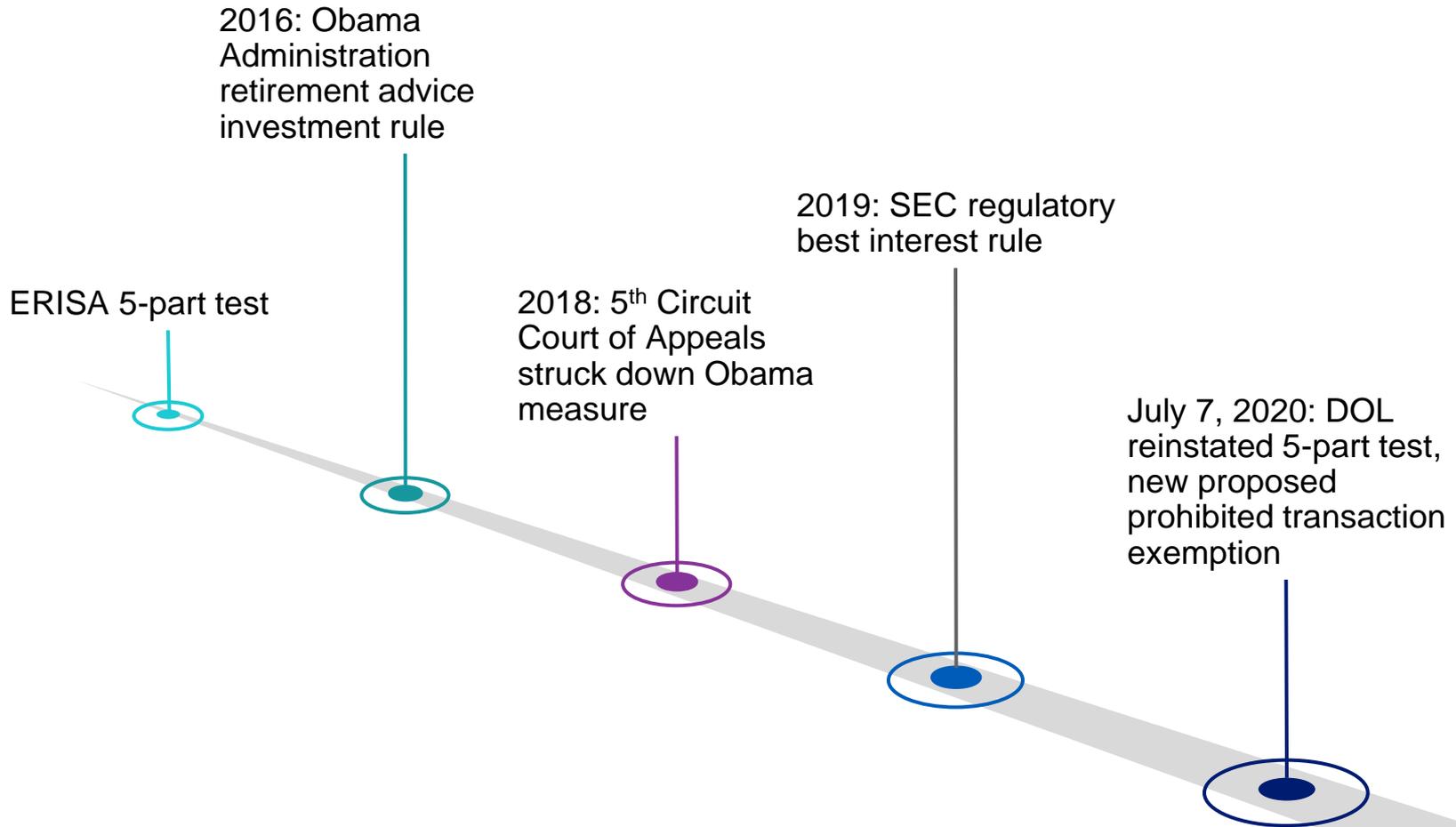


Proposed Rule on ESG Investments

- Whether environmental, social, or governance (ESG) factors impact the pecuniary return or risk of an investment
- If the plan concludes that an ESG factor does impact the pecuniary return or risk, heavy documentation requirements
- Analysis remains risk and return – not “all other things being equal”
- Comment period ended July 30, 2020



History of the DOL Fiduciary Rule



DOL Fiduciary Rule: 2020

- Final rule
 - Reinstates ERISA 5-part test
 - An advisor is a fiduciary if, for direct or indirect compensation, he or she:
 1. Offers advice about buying, selling, or holding investments;
 2. On a regular basis;
 3. Pursuant to an agreement with the plan that
 4. The advice would be the “primary basis” for decisions about investment of plan assets; and
 5. The advice is individualized to the plan’s needs.
- Proposed rule
 - New prohibited transaction exemption: fiduciaries may receive reasonable compensation if they follow the SEC regulatory best interest requirements
 - SEC rule: conflicts of interest are permitted if they are disclosed
 - Withdraws advisory opinion that said the fiduciary rules do not apply to advice to a participant or beneficiary to roll over plan assets to an IRA or another plan
 - Comment period ended August 6, 2020

Thole v. U.S. Bank (June 1, 2020)

- Participants alleged breach of fiduciary duty due to investing heavily in risky assets, giving rise to \$750 million loss. Plan sponsor restored the defined benefit plan's funding.
- **Holding:** defined benefit plan participants that have not failed to receive promised benefits have no Article III standing for breach of fiduciary duty under ERISA
- Substantial increase of risk that plan and employer would fail and be unable to pay promised benefits? **Maybe.**
- The Supreme Court of Kentucky in *Overstreet v. Kentucky Retirement Systems* (July 9, 2020) relied on *Thole* to conclude that participants had no constitutional standing for a breach of fiduciary duty in governance of the state defined benefit plan, because the participants had not themselves incurred a loss



Actuarial Assumptions Litigation

- Series of class action lawsuits alleging that corporate defined benefit plans use “outdated,” and therefore unreasonable, mortality assumptions
- Motions to Dismiss denied in multiple cases: reasonableness of assumptions is not defined and necessitates fact finding
- Motion for Class Certification denied in one case: conflict of interest
- Relevance to governmental plans: litigation contesting reasonableness of assumptions is not gaining traction



Actuarial Standards of Practice

- ASB establishes and improves standards of actuarial practice, and what actuary should consider, document, and disclose when performing actuarial work
- Covers all professional actuarial organizations and practicing actuaries
- Universal – Code of Professional Conduct and ASOP Numbers 1, 41
- Pension ASOP Numbers 4, 27, 35, 44
 - ASOP No. 51 newest standard and covers Risk inherent in pension plans
- OPEB ASOP Numbers 6, 27 35



Insurance

- Fiduciary liability
 - Indemnification and sovereign immunity may not be enough protection
 - Indemnification is conditioned on acting within capacity as a trustee and in good faith; allegations may not be limited to these standards
 - Legal department must review request for indemnification; trustees provide their own defense in the interim
 - Some courts have held that counties and municipalities lack sovereign immunity
 - Who is covered
 - Individual insureds, past, present, and future directors, trustees, officers, employees, board members, and committee members
 - Spousal coverage, heirs and estates
 - Contracted employees
- Cyber liability
 - Ransomware
 - Hacking
 - Social engineering



Best Governance Practices

Provide a Governance Manual to all Board Members

- Governing plan documents (statutes, regulations, plan summaries)
- Organizational chart, role descriptions and summaries of contracts
- Governance policies and procedures, including an Investment Policy Statement
- Relevant rulings and agreements that determine benefits and contribution levels
- Board meeting schedules and rules of procedure

Develop Board Practices

- Develop a strategic investment plan that guides the Retirement Fund toward its goals
- Adopt a fiduciary education program to improve skill sets
- Establish key committees, if appropriate
- Perform periodic audits to evaluate internal controls, performance and risks to fund and its fiduciaries
- Establish actuarial valuation report guidelines
- Consider asset allocation studies to identify asset mixes that meet funding needs



Best Governance Practices *continued*

Make a Strategic Plan

- Set goals and performance measures for key functions
- Long-term investment goals, risk tolerance and diversification objectives
- Multi-year budget needs
- Set service quality goals and process for improving plan compliance

Maintain Written Policies

- Standards of conduct, ethics and conflict of interest rules
- Investment policy that includes goals, monitoring procedures and risk tolerances
- Procurement guidelines that document procedures to select/monitor contractors
- Privacy and information policy

Conduct Risk Oversight

- Ensure governance structure defines risk and accountability
- Assess internal controls and test risk events
- Determine key measures that assess exposure to risk (including financial, operational, reputational)



Governance Policies: *Purpose*

Intent

- Implement plan documents/applicable laws
- Provide governance framework
- Communicate to stakeholders
- Establish historic record

- Provide direction to fiduciaries and their delegates
- Set expectations for Board and individual member conduct

Guidance

Protection

- Set out due diligence processes
- Establish monitoring and reporting processes

Key Governance Policies

Ethics

- Code of Conduct
- Gifts and consideration
- Travel and Expenses

Governance

- Define Board and staff roles
- Implementation of plan rules
- Modification of governing documents, forms

Investment

- Asset conflicts of interest
- Guidance on-class diversity
- Benchmarks
- Avoidance of evaluation and changes

Education

- Describe educational objectives
- Require justification for any educational sessions attended
- Include expense reimbursement rules
- Best practice is annual education session

Communication

- Identify rules for Board to communicate with stakeholders
- Guidelines for trustee communications (with participants, external parties)
- Specify how information is disseminated
- Protect member privacy
- Comply with FOIA laws
- Address security concerns with service providers

COVID-19 Public Health Emergency

- Financial security and retirement savings priorities
 - Consider opportunities to manage risk through tools or revised strategies
 - Consider requesting/preparing updated funding projections
 - Review internal and external processes and protocols for retirement plan operations
- Remote work priorities
 - Technology and security needs
 - Review electronic document management, backup, and storage systems and protocols
 - Assess risk management factors and design policies/strategies for mitigating risks
 - Consider revisiting remote work/telecommuting policies
- IT security and data integrity priorities
 - Potential increased threats of cyber attacks and social engineering fraud
 - Conduct yearly IT security risk assessment
 - Update training and ongoing security protocols



City of Falls Church Retirement Board

Fiduciary Training

September 10, 2020

Contents

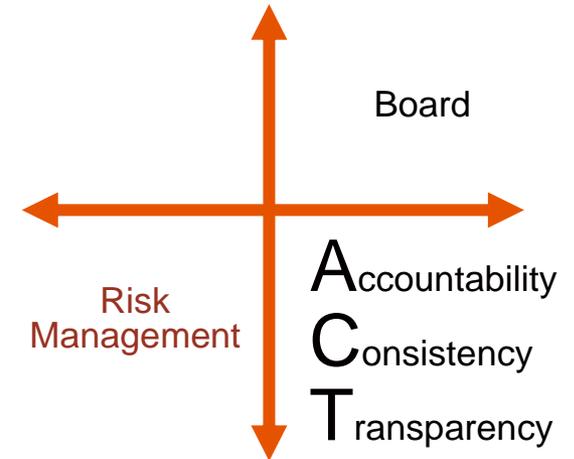
- **Best Governance and Risk Management Practices**
- Asset Allocation and Alternative Investments
- Environmental, Social and Governance (ESG) Investing

Pension Fund Governance: Performance Premium

Why Focus on Governance?

- Effective governance practices may significantly impact performance
- Public pension funds and other leading investors are continuing to place emphasis on strengthening governance
- Effective governance provides a structure for managing market, liquidity, operational and other risks.

Best Governance Practices



“The top CEO score funds outperformed the bottom ones by an average 2.4% per annum...”

—*Rotman International Journal of Pension Management*, Fall 2008

“Instituting governance best practices will provide the company with an internal effectiveness structure and a tool to manage corporate risk.”

—*The Conference Board*

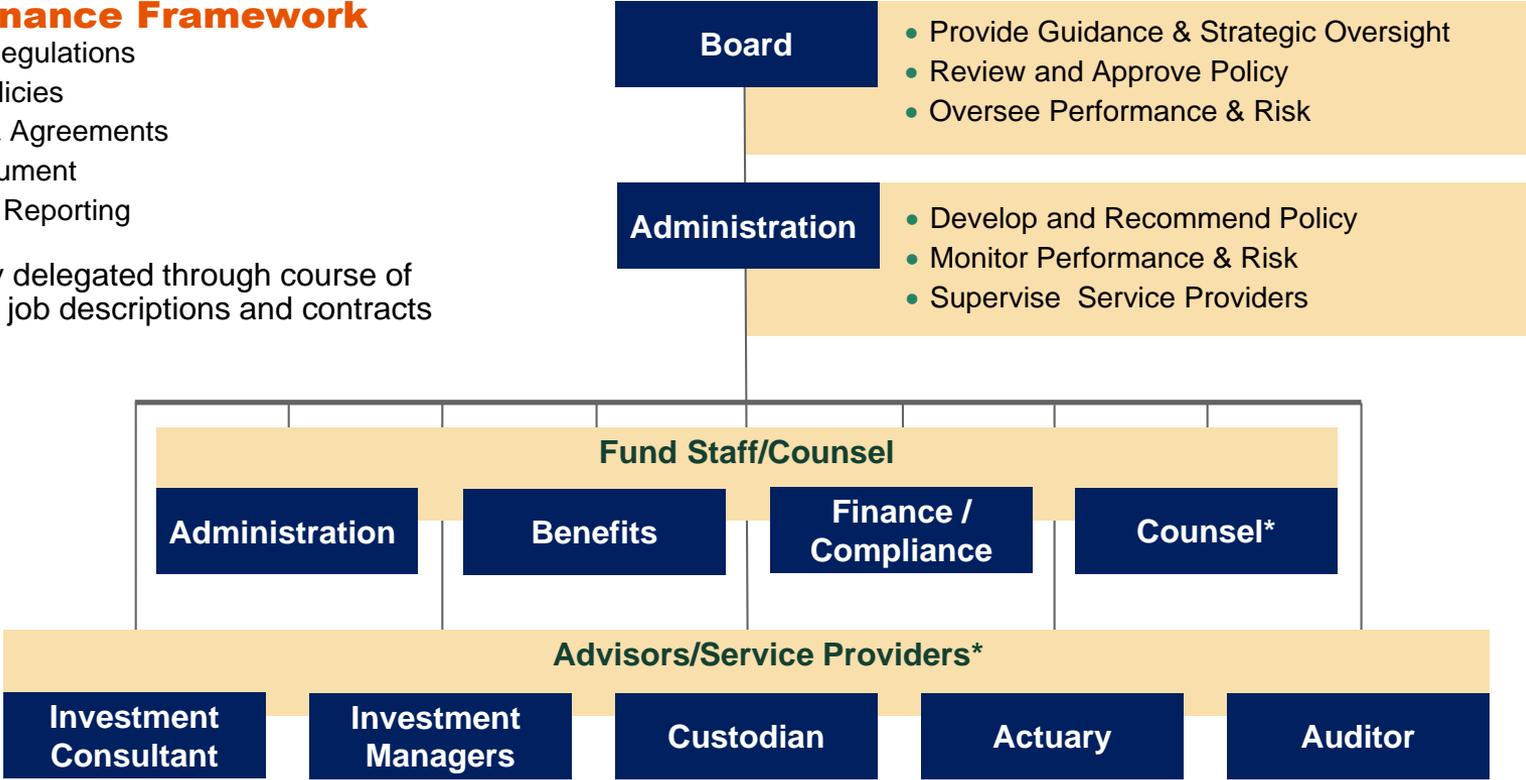
Retirement System Governance Structure & Oversight Roles

➤ Boards delegate performance of administrative, investment, compliance and other functions to staff and specialist groups who are responsible for managing risk within the span of their operations.

Governance Framework

- Laws & Regulations
- Board Policies
- Rulings & Agreements
- Plan Document
- Required Reporting

Authority delegated through course of conduct, job descriptions and contracts



• Sample for illustrative purposes. Example does not include Committees of the Board.

Risk Governance: Defining and Managing Risk

- By breaking risk into distinct categories an organization can more effectively measure and manage risk toward the end of reducing the probability and severity of losses.

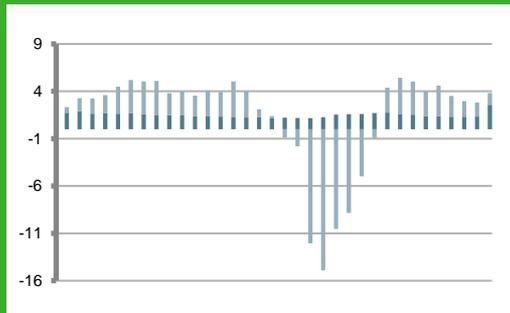
Market Risk*

- Risk related to adverse movement in market factors such as asset prices, exchange rates or interest rates.

Liquidity Risk

- Risk of loss resulting from an asset owner's inability to sell an asset in a timely manner and for its actual value.

Market



Operational Risk

- Risk resulting from inadequate or failed internal processes, people and systems or from external events.

Credit Risk

- Risk of loss due to failure of obligors (e.g. bond issuers, tenants) to honor their payments.

* Note: Sample for Illustrative Purposes. Market risk types include, but are not limited to equity, inflation, currency and interest rate risk.
Asset / Liability Risk: Risk that liquidity will not be adequate to meet operational requirements or financial obligations.

NCPERS Best Governance Practices

Governance Manual

- Statutes, Rules
- Mission Statement
- Organization Chart
- Policies, Charters

Risk Oversight

- Risk Governance
- Risk Assessments
- Key Risk Measures
- Reporting

Communications

- Mission Statement
- Participant Surveys
- Reports to Members (CAFR)
- Governance Principles

Board Practices

- Strategic Planning
- Fiduciary Education
- Actuarial Studies
- Corporate Governance

Strategic Planning

- Multi-Year Plan
- Measurable Goals & Objectives
- Multi-Year Budget
- Succession Planning

Board Policies

- Standards of Conduct
- Investment Policy
- Privacy, Data Security
- Procurement

Measures & Metrics

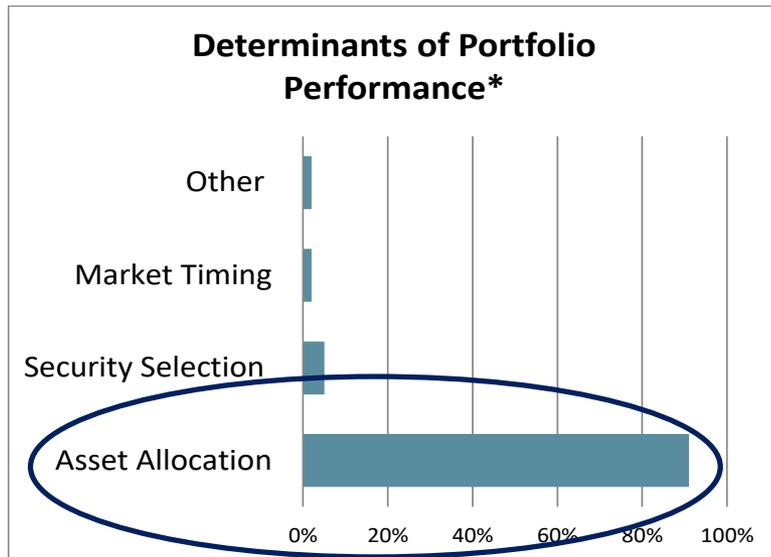
- Key Performance Measures
- Key Risk Measures
- Member Satisfaction
- Balanced Scorecard

Contents

- Best Governance and Risk Management Practices
- **Asset Allocation and Alternative Investments**
- Environmental, Social and Governance (ESG) Investing

The Importance of Asset Allocation

- Asset allocation is a primary driver of investment returns.
- Key inputs into setting an asset allocation structure include:
 - The long-term investment objectives (return assumption).
 - Board risk tolerances, cash expenditures, adequacy of assets to cover expenditures
 - Capital market assumptions for risk, return and correlations across asset classes.



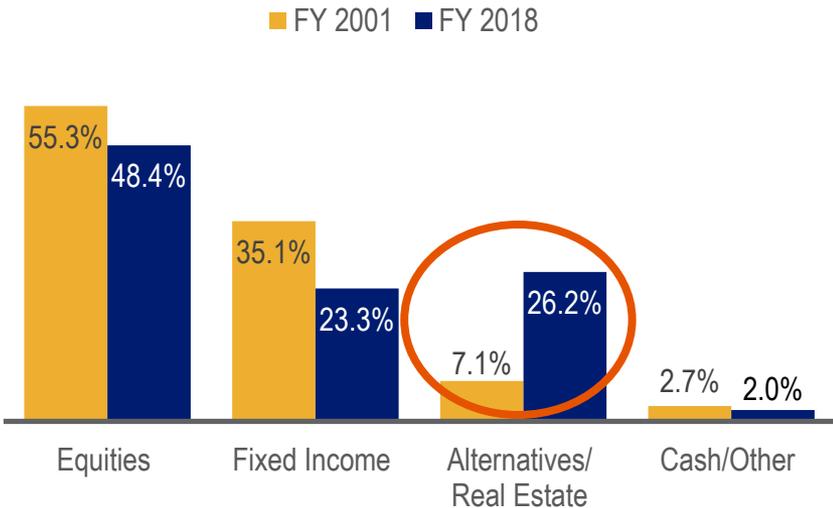
Characteristics to Consider



*Source: Brinson et al: "Determinants of Portfolio Performance," Financial Analyst Journal, May-June 1991.

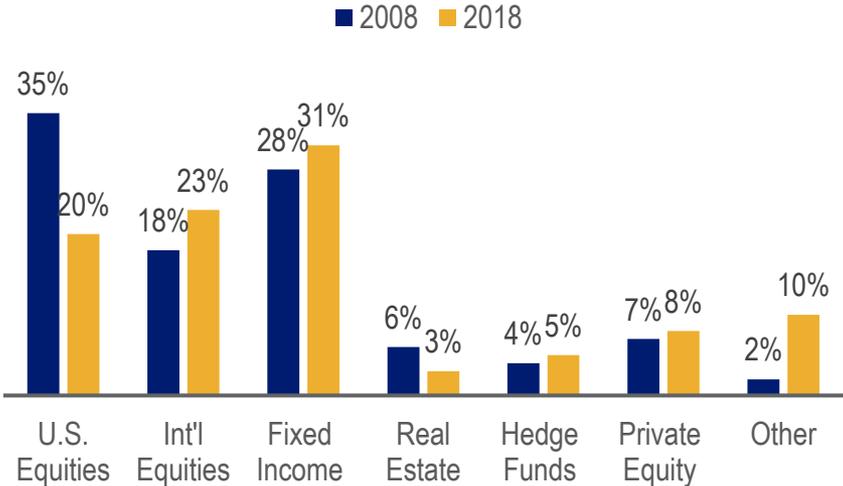
Asset Allocation: Changing Risk Exposures

Public Pension Funds: Average Asset Allocation



Source: NASRA

Institutional Investors' Asset Mix

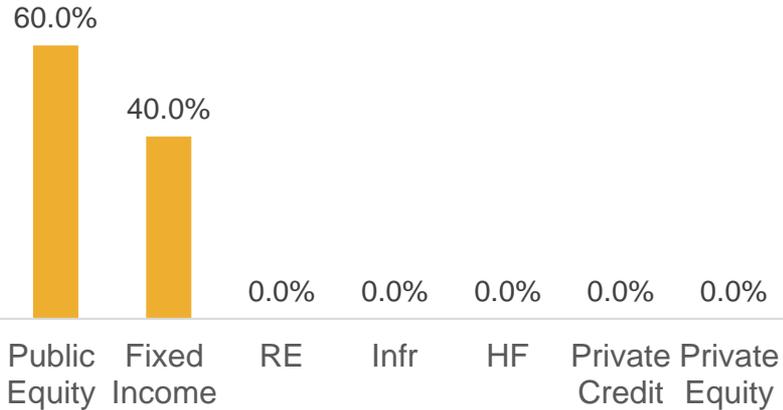


Source: Greenwich Associates

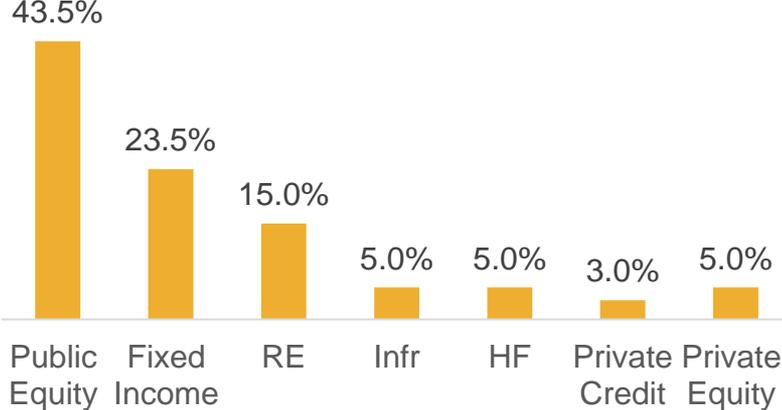
- Institutional investor allocations to alternative investments and real estate have increased significantly of the past 15 – 20 years.
- Allocations to alternative investments may increase expected return, while reducing volatility and improving portfolio efficiency.
- An effective alternative investment program requires an enhanced framework to manage market, liquidity, operational and credit risks not captured in traditional modeling.

Asset Allocation: The Role of Alternative Investments

Sample Asset Mix #1



Sample Asset Mix #2



	60/40 Portfolio	Add Real Estate	Add Infrastructure	Add Hedge Funds	Add Private Credit	Add Private Equity
20 Year Expected Return (A)*	6.6	6.7	6.8	6.8	6.9	7.2
20 Year Expected Return (G)*	6.1	6.3	6.4	6.4	6.5	6.8
Standard Deviation	10.7	9.8	9.9	9.7	9.5	9.8
Sharpe Ratio	0.32	0.36	0.37	0.38	0.40	.41

* Note: Scenarios are for illustrative purposes only. Not all inclusive. "A" – arithmetic. "G" – geometric.

- Adding real asset investments and hedge funds may increase expected return, while reducing volatility and improving efficiency.
- A successful alternative investment program requires a framework and tools for managing risks that are unique to alternative investments.

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- **Environmental, Social and Governance (ESG) Investing**

Environmental, Social, Governance Investing Defined

➤ Environmental, social and governance (ESG) investing encompasses factors outside the scope of traditional financial measures that may impact company performance.



Environmental

- water scarcity
- climate change
- energy efficiency
- pollution



Social

- labor relations
- human capital management
- health and safety
- supply chain
- human rights
- corruption
- ethical business practices



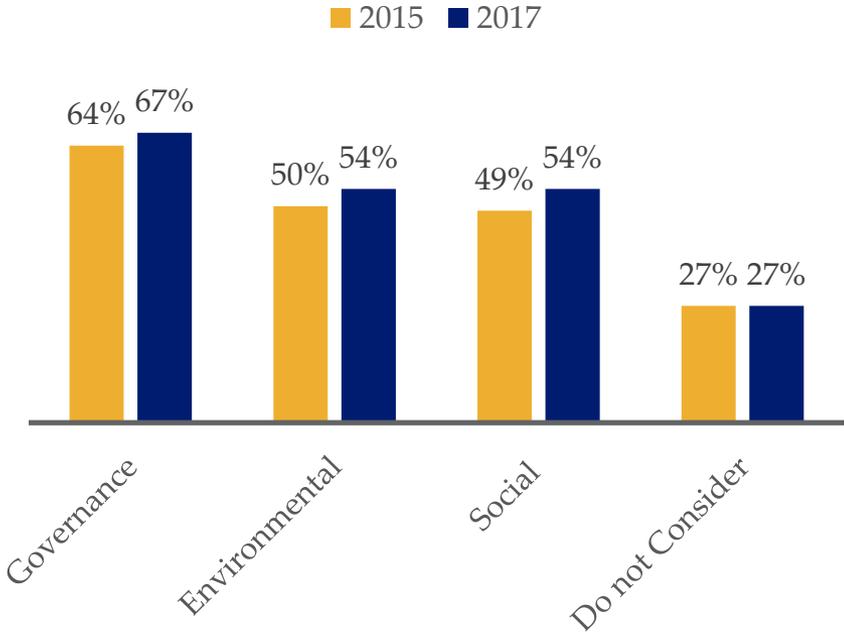
Governance

- board composition
- board structure
- board accountability
- executive compensation
- shareholder rights
- transparency
- ethical conduct

Environmental, Social and Governance Adoption

➤ ESG adoption is evidenced by increasing incorporation of ESG factors into investment decision making and analysis.

ESG Factors Considered in Investment Analysis or Decisions



Source: CFA Institute ESG Survey, 2017

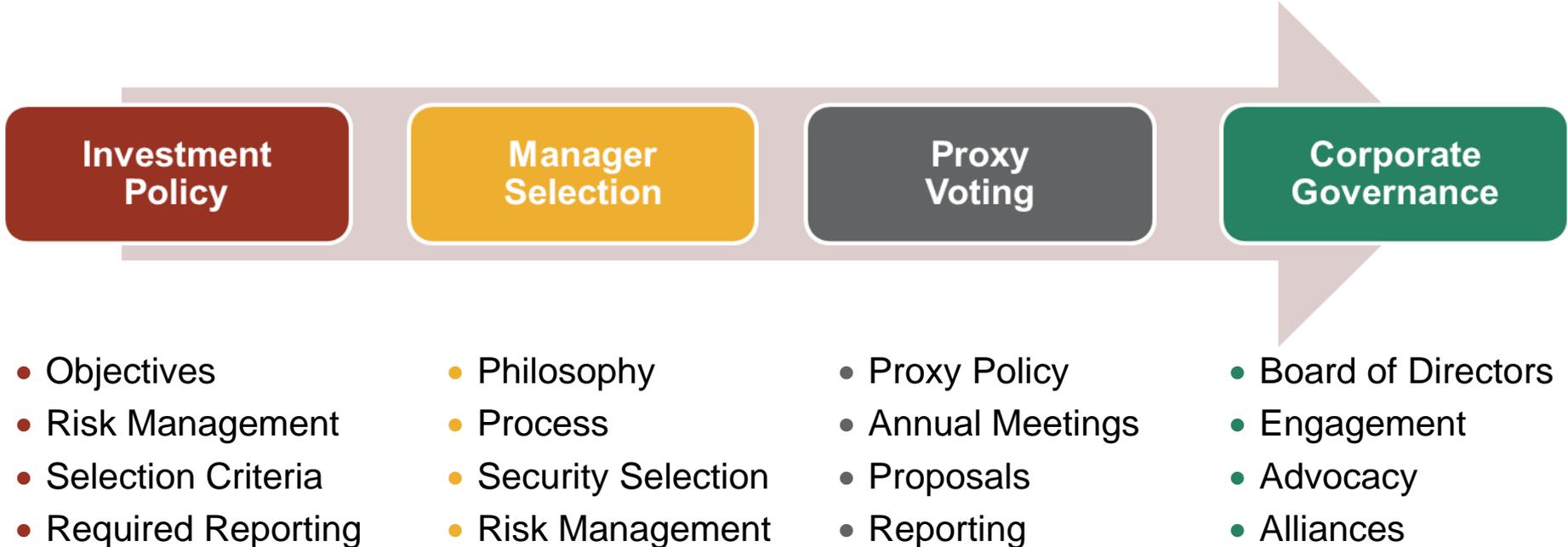
ESG Incorporation Reported by Institutional Investors (Billions)



* Source: US SIF Foundation

ESG Investment Program Implementation Tools

➤ Investors may implement ESG investing through a number of investment program mechanisms, including the investment policy, selection of investment managers, proxy voting and corporate governance engagement.



“ESG investing is now becoming embedded in the investment process of many institutional investors.” — Barclays Bank PLC, 2016

Questions?

