4.

Role of the Trustee

4.1-1 Your Fiduciary Duty and Ethics

A **fiduciary** is someone who is legally required to exercise a certain duty of care when acting on behalf of, or in the interest of, another. This duty of care, known as your fiduciary duty, is a significant ethical and legal principle that all trustees must understand and follow.

In basic terms, being a fiduciary is all about trust. It means you control assets that are for the benefit of others. Your specific duties and standard of care are in the laws, regulations, and court decisions that apply to your plan.

As a pension trustee, you have accepted control of your participants' plan. In doing so, you have become a fiduciary, agreeing (you are required) to discharge your trust duties solely in the interests of your plan's participants for the exclusive purpose of providing benefits and defraying reasonable plan administrative expenses.

4.1-2 Your Fiduciary Duty and Ethics

Furthermore, you have accepted control of your plan's assets and the overall administration of the plan itself. Therefore, your fiduciary duties apply to investments and to other aspects of your plan's operations.

For example, you are the fiduciary for benefit administration and disability determinations. You and your fellow trustees are the ones ultimately responsible for seeing that the plan operates in accordance with its governing documents and does not violate any local, state, or federal laws.

Although staff members and consultants may have delegated to them the day-to-day responsibility for plan administration and investment activities, their performance of certain fiduciary roles do not permit you to avoid your trust duties. You cannot simply rely on them as a means of satisfying your obligations as a trustee: You act as a fiduciary for your plan when you hire staff members and consultants, and your fiduciary duties include the active monitoring and review of their performance.

4.1-3 Your Fiduciary Duty and Ethics

In carrying out all of these duties, you must exercise the highest standards of care, such as acting for the exclusive benefit of the plan participants. In addition, other specific rules of conduct often govern the activities of trustees, whether these activities involve the exercise of a specific duty or deal with some other action that relates to the conduct of public officials in general. These rules are often contained in codes of ethics and must be closely followed.

Laws of fiduciary responsibility vary from state to state. They sometimes are similar to the standard set forth in the federal law known as ERISA (Employee Retirement Income Security Act). ERISA does not apply to governmental plans, but the spirit of the ERISA standards is typically mirrored in these state and local laws and regulations. Court decisions and attorney general options may also influence fiduciary obligations in your state.

4.1-4 Your Fiduciary Duty and Ethics

You must take your fiduciary duties seriously. There can be dire consequences for violations. Trustees can be held liable (and even prosecuted if they allegedly engage in criminal activity) for breaches of their fiduciary duties. The same is true for codes of ethics.

Fiduciary Duties mean you have a duty to put another person's interests before your own or those of anybody else. And, you have an obligation to conduct yourself carefully. Generally, pension experts divide fiduciary duties for pension plan trustees into three broad categories:

- **Duty of loyalty – the obligation to act for the exclusive benefit of the plan participants;**
- **Duty of prudence – the obligation to act prudently in exercising power or discretion over the interests that are the subject of the fiduciary relationship; and,**
- **Duty of care – the responsibility to administer the pension plan efficiently and properly.**

4.1-5 Your Fiduciary Duty and Ethics

These duties provide essential guidance, like a road map, to point trustees in the right direction. However, always keep in mind that your fiduciary responsibility is ultimately a legal responsibility. In fact, it is one of the strictest legal duties you will find anywhere in law. Remember, there is also an important fourth duty that a fiduciary has: the duty to ask questions.

Be sure that you ask your legal counsel and executive staff to give you those specific fiduciary rules governing your plan. If you are unclear about any of them, ask for help!

4.1-6 Your Fiduciary Duty and Ethics

You will often hear the duty of loyalty commonly called the

Exclusive Benefit Rule

This means that a fiduciary's loyalty is exclusively to plan participants and no one else. In short, you must put the participants' interests above your own interests and those of any third parties, such as employers, other political bodies, or taxpayers.

4.1-7 Your Fiduciary Duty and Ethics

Exclusive Benefit Rule

In addition, as a fiduciary, you must impartially consider the needs of all plan participants regardless of any individual (such as the governor) or constituents (such as retirees) that were instrumental in your election or appointment to the pension board. This may not make you popular with certain constituents, but it will keep you out of trouble.

The exclusive benefit rule also prohibits you from engaging in acts that would present a conflict between your personal interests and the interests of the plan participants. This is called self-dealing.

For Example…

For example, if you are involved in a decision to authorize the pension plan to sell to, purchase from, or otherwise make a deal with you, a conflict is present. This is because the question would inevitably arise: whose interests – yours or that of the plan's participants – would you favor in reaching a decision on the matter?

4.1-8 Your Fiduciary Duty and Ethics

Exclusive Benefit Rule

This duty not to do business with the plan is one of a trustee's most fundamental duties. Furthermore, a breach of this fiduciary trust can occur whether or not you realize a financial benefit from self-dealing. Therefore, you must be extremely careful to avoid all potential conflicts of interest. For example, participating in a decision that does not directly benefit you, but favors a friend or family member, could present a conflict of interest or the appearance of impropriety.

Finally, be diligent in considering who benefits from a course of action. If the board is set to decide an issue in which you have an unavoidable conflict of interest, you may want to inform the other board members what that conflict is, or could appear to be, and then abstain from participating when the board deliberates on the matter. If you are unsure whether a conflict is present, ask your executive director or legal counsel for guidance.

4.1-9 Your Fiduciary Duty and Ethics

Duty of Prudence

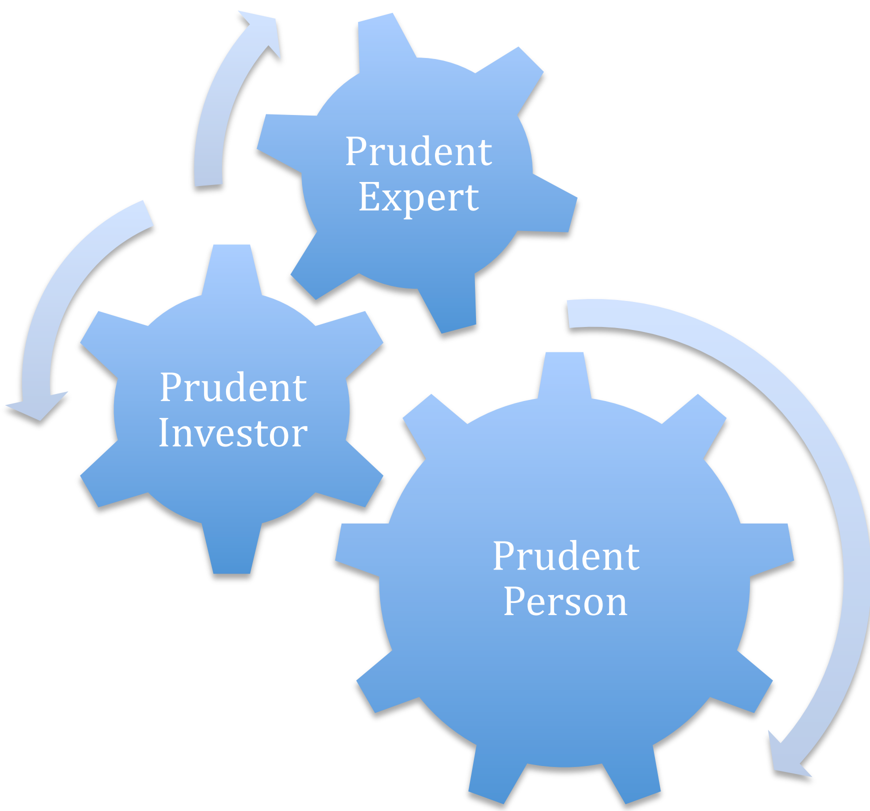
Prudence (that is, being prudent) means to exercise sound judgment, make common-sense decisions, and act with care.

Indeed, prudence is one of the so-called **Seven Holy Virtues** and is associated with wisdom. Simply stated, it is a legal standard that allows a court to compare a trustee's conduct against the conduct of others in similar circumstances. The comparison permits the court to determine whether the trustee acted prudently in a particular situation.

Duty of Prudence

As fiduciaries, trustees have a duty to be prudent, particularly when it comes to handling the plan assets. You must make decisions on behalf of the plan in the same careful manner that you would use in making your own personal retirement decisions. The duty of prudence ultimately focuses not on the outcome on the investment decision but rather on the way in which it was made. One of several standards generally governs this decision-making process.

All of them are variations on the same theme: What would a prudent (1) person, (2) investor, or (3) expert do in the same or similar situation?



4.1-11 Your Fiduciary Duty and Ethics

Prudent Person (Man) Rule

This is the traditional rule and it requires trustees to evaluate each investment independently, rather than as part of a whole investment portfolio. Consequently, because this rule takes a more narrow, investment-by-investment view, it results in less speculation and less risk in making decisions.

Trustees must judge each investment on its own merits. For example, suppose the trustees make an investment that fits within the plan's overall investment strategy. Nevertheless, if the investment, standing alone, is a poor one and produces a loss, the trustees could be held liable.

The emphasis on the prudent person rule is therefore, strongly weighted toward preserving the trust's assets. In some cases, certain investment categories may be viewed as too risky or intrinsically speculative and, therefore, prohibited. In some jurisdictions, the legislature has enacted legal lists of types or amounts of permitted investments.

4.1-12 Your Fiduciary Duty and Ethics

Duty of Care

The duty of care is actually another form of the duty of prudence. However, in this instance, it applies to plan administration and operations beyond investment decision making. Under this duty, the board must, in conjunction with staff, develop, adopt, and implement policies and procedures for the administration of the retirement plan. To fulfill this duty, a trustee must actively participate in the plan's management. This means, for example, attending board meetings, reading reports and minutes, and reviewing staff activities and the performance of consultants. If you lack the time do this, then you will fail to uphold the duty of care that you, as a fiduciary, owe your plan.

There are certain elements of the exercise of the duty of care that can keep you out of trouble. Due diligence is one. This element involves the process of checking and verifying information, as well as ensuring that sufficient analysis has been conducted before making key decisions, including selection of consultants, benefits administration, hiring the plan's chief executive, determining information technology (IT) systems, etc. In short, due diligence is the duty to act on an informed basis.

4.1-13 Your Fiduciary Duty and Ethics

Duty of Care

Another element of satisfying your duty of care is following the law and spirit of the plan's governing statutes, rules, and policies. This is particularly important for the administration of plan benefits, whereby, several laws and regulations apply to benefit eligibility, calculations, and limits. Failing to ensure that these are observed can have serious consequences for plan participants and can influence the plan's ability to maintain its tax-qualified status under the Internal Revenue Code (IRC).

Having a well-written set of operating procedures and diligently following them is an important way in which you can fulfill the overall duty of care. Such procedures would include establishing effective protocols to maintain and protect adequate records and keeping appropriate information confidential. Conducting regular audits and knowing when to pursue appropriate legal action are also important aspects of this duty.

In summary, when fulfilling your fiduciary duties of loyalty, prudence, and care, be sure to remember your duty to ask questions. Find out the specifics of the fiduciary duties that your plan's laws, rules, and policies impose on you as a trustee.

4.1-14 Your Fiduciary Duty and Ethics

Ethics and Codes of Conduct

Living up to a code of ethics goes hand-in-hand with being a fiduciary.

Ethics policies, like fiduciary rules, provide the framework for what is permissible as well as prohibited behavior by pension trustees. Because ethics laws vary from jurisdiction to jurisdiction, it is best to check with your legal counsel or executive staff on the specific ethics policies that apply to your board. However, the primary focus of most codes tends to be on personal conduct and conflicts of interest. Financial disclosure rules and reporting are also typically part of any ethics process. In addition to the rules that mirror the fiduciary duty of loyalty, particularly the exclusive benefit rule and the rule against self-dealing, common categories of activities that ethics policies tend to cover include the following.

4.1-15 Your Fiduciary Duty and Ethics

Ex Parte Communications

Ex parte is a Latin phrase that essentially means without the other party.

Typically used in legal proceedings or settings in which judgments are made, the term refers to a situation in which only one party or side appears before a decision maker. Broadly defined, an ex parte contact for trustees is any written or verbal communication that occurs outside of a regular public meeting between an official with decision-making authority (trustee) and some of the interested parties to a subject matter to be acted on by the pension board.

Such ex parte communications are generally prohibited for pension trustees and senior executive staff. This is because it is important that trustees, as well as those charged with a public trust, be seen by the public as being fair and impartial in their decision-making duties. Restricting ex parte communications helps preserve the integrity of the process by preventing any impropriety or use of off-the-record information that is not fully disclosed to all involved.

Ex Parte Communications

In addition, **the ex parte rule** ensures that all parties involved have a fair shot and an equal say in the matter pending before the board. After all, meeting with only the supporters of a particular position and not their opponents can result in a one-sided view of the matter. Remember, your duty of loyalty is to the plan and all its beneficiaries, not to just one constituency group.

It is also important to remember ex parte restrictions when hiring consultants, awarding contracts, and selecting investments. You must not initiate contacts outside the boardroom with any party who has a financial interest in the transaction or an officer or employee of that party without proper notice and disclosure. Such parties include providers who are bidding to provide the plan with services, such as IT or investment management.

4.1-17 Your Fiduciary Duty and Ethics

Gifts and Travel

As a new trustee, you may suddenly find that you have a lot of new friends.

They may want to give you tickets to sporting events or the theater, offer to take you golfing, treat you to dinner, or bestow on you gifts both large and small. Gifts may be permissible, depending on the ethics rules governing pension trustees in your jurisdiction. In addition to tickets to certain events, meals, and other forms of entertainment, a gift can include money, real or personal property, a service, loan, or even promise of a job down the road. It if is given and accepted without the giver getting back anything of equal or greater value, it will likely qualify as a gift subject to ethics codes in most jurisdictions.

Sometimes gifts can be accepted as long as they are fully disclosed to the pension board or an oversight agency. Some jurisdictions place a dollar limit on gifts so that a trustee may be able to accept a gift less than the designated amount, say $50, without disclosure but may have to disclose larger gifts in a disclosure statement or a report filed with the proper agency or official. Other jurisdictions may simply prohibit gifts of any kind or amount under any circumstances except for family members and long-time friends.

Gifts and Travel

The rules and circumstances surrounding gifts can be confusing. To avoid any doubt about what is or is not allowed, it is your responsibility to learn the rules. Take time to check with your plan's legal counsel or the ethics agency that governs your plan to avoid any appearance of impropriety.

Travel is another matter that is typically subject to ethics rules. Pension trustees often have the opportunity to attend educational conferences dealing with matters relevant to their plans. Many pension plans have educational policies in place. Frequently, travel to conferences and educational seminars is permitted, but must be approved in advance. Some boards place limits on the number of travel requests allowed each year. Others have rules governing how many trustees can attend a conference or the total amount each trustee can spend during the year on educational conference attendance.

Check with your staff to find out about the policy for attending educational conferences. In addition, keep in mind that if your travel is paid by an event sponsor or someone other than your plan, then it may constitute a gift and be subject to the ethics restrictions. This will also be true if travel is offered to your spouse to accompany you.

4.1-19 Your Fiduciary Duty and Ethics

Gifts and Travel

Public pension boards are increasingly requiring their consultants to adhere to ethics policies to ensure that the investment advice is fair and impartial. This trend responds to findings by the Securities and Exchange Commission (SEC) that one-half of the consultants it studied also provided services and products to pension plan advisory clients, money managers, and mutual funds. In other words, consultants and others who advise plan trustees often have business dealings with money managers they recommend to the plans. Further, the SEC found that these consultants often have affiliates or subsidiaries of their own that also provide services to pension plans but may not disclose those relationships and the potential conflict of interests.

4.1-20 Your Fiduciary Duty and Ethics

Liability

As a fiduciary you are individually liable and can be held personally responsible for breaches of your fiduciary duty. By personal liability, we mean that your money and property could be at risk. In addition, state and local ethics laws can also impose liability. Therefore, it is important to remember that violations of the governing authority's laws can result in civil or criminal penalties or both. You can be punished with imprisonment, fines, or both. Lawsuits against public pension plan trustees are not common, but they do occur.

Liability

Ethics investigations that involve individual trustees also happen. These investigations are personally painful and reflect badly on the board and your plan. In recent years, the trend has been for pension boards to purchase fiduciary liability insurance to protect the plan, board members, and executive staff members from liability that could arise from various breaches of fiduciary duty. This is more common for boards that have authority over investment decisions. However, recent surveys suggest that less than a majority of public plans have purchased such policies. Furthermore, even when such a policy is in effect, it is important for trustees to understand that dishonest, fraudulent, criminal, or malicious acts are likely excluded from coverage, as are instances of self-dealing.

Your legal counsel and executive staff can explain what protections against liability are in place for board trustees. This is an essential discussion you must have.

4.2-1 Role of the Trustee

Introduction

Like many of your fellow trustees, your decision to seek a position on your plan's board may have been due to your interest in a particular issue or a desire to see that some problem was more effectively addressed by your plan. Or you might have been drafted by your employee organization or others to become a trustee.

Whatever your role, however, however and whatever the reasons that led you to become a trustee, you must be prepared to handle a variety of duties – some of which may be completely new to you. There is a lot to learn at first, but remember you are not alone. It can be a daunting challenge but just keep in mind that many resources are available to help prepare you to become an effective trustee.

4.2-2 Role of the Trustee

Trustees Wear Many Hats

As a trustee you have multiple constituencies and a variety of duties and responsibilities. You represent all of these constituents, regardless of who selected or elected you to serve as a trustee. You ultimately represent them all. Your overriding responsibility is to the pension plan as a whole.

The many roles that a public pension trustee must play, as well as the time requirements they impose on you, will likely be much greater than you had anticipated. Here are some of the many hats you may have to wear as a trustee.

4.2-3 Role of the Trustee

Trustees Wear Many Hats

Fiduciary

A serious legal duty to be responsible for safekeeping the retirement assets of your plan's participants and for managing these assets for the participants' benefit. You always wear this hat, no matter what else you may be doing.

Pension Benefits Administrator

Although your board lacks the authority to actually set benefit formulas, you must ensure the resulting benefits are administered in an efficient, legal, and timely manner.

Investor

Your plan also needs enough money to pay those benefits that you are administering. In most plans the trustees, therefore, decide how to invest the assets of the plan by developing the overall investment strategy.

4.2-4 Role of the Trustee

Trustees Wear Many Hats

Shareholder

Consider yourself a shareholder in the companies whose stocks the plan buys. Investment performance can depend in large part on the behavior of a company's management. Therefore, you may also become involved in corporate governance.

Personnel Manager

Pension boards can spend considerable time reviewing proposals. They also interview and hire consultants for several services, including an array of money managers and investment advisors, actuaries, and outside legal counsel. You may also hire some of the top executive staff members of your pension plan.

Judge

You may act as a judge when considering applications for disability benefits. You many also hear appeals of benefit determinations made by staff with which plan members have disagreed. In such instances, you effectively serve as a judge and issue rulings on these cases.

4.2-5 Role of the Trustee

Trustees Wear Many Hats

Health Benefits Administrator

If your plan administers health care benefits, which some plans do, then it could be your job to help select health insurance plans for your participants. This process also could include deciding on the nature of benefits to be offered, as well as premiums, co-pays, and other terms of coverage.

Advocate

As a trustee you represent the pension plan before elected officials, taxpayers, and constituency groups. And as a fiduciary, a trustee must always be prepared to defend the plan, particularly if there is controversy over benefit levels, investment policy, or fund solvency.

Visionary

Pension plans are in business for the long haul. One of your most important responsibilities is to ensure that your plan can pay out promised benefits and provide the best form of retirement security for future generations.

4.3-1 Local Agency Ethics

Public Officials – elected or appointed – wield the power of government and serve as stewards of both the public's resources and trust.

For these reasons, the public holds public officials to high standards of ethical conduct.

On the following pages are listed the relevant code sections of ethical issues that apply to trustees who serve as fiduciaries on public pension boards in California. Statute code sections are provided as search tools for additional information.

4.3-2 Local Agency Ethics

Laws Relating to Personal Financial Gain

Bribery
(Penal Code, Section 68)
Bribery involves payment or receipt of anything of value as consideration to alter the outcome of any manner that might come before a public official.

Conflicts of Interest under the Political Reform Act
(Gov. Code section 8100 et seq.)

Material Financial Effect
(Gov. Code Section 87100, 87103)
A government official is prohibited from making, participating in, or in any way attempting to use his/her official position to influence a governmental decision if it is reasonably foreseeable that the decision will have a material financial effect on the official or the official's immediate family.

4.3-3 Local Agency Ethics

Laws Relating to Personal Financial Gain

Public Official – for purposes of the Political Reform Act, includes every member, officer, employee or consultant of any state or local government agency.

Recusal and Leave the Room Rule (Gov. Code Section 87105)
A government official who has a conflict of interest under the Political Reform Act.

4.3-4 Local Agency Ethics

Contractual Conflicts of Interest (Gov. Code Section 1090)

Conflicts of Interest in Campaign Contributions (Gov. Code Section 84308)

Conflicts of Interest when Leaving Office (Gov. Code Section 87406.3)

4.3-5 Local Agency Ethics

Receipt of Gifts (Gov. Code Sections 86203, 89503, 89506)

Honoraria Ban (Gov. Code Section 89502)

Misuse of Public Funds (Penal Code Section 424, Gov. Code Section 8314)

Prohibition Against Gifts of Public Funds (Cal. Const. Art XVI, Section 6)

Mass Mailing Restrictions (Gov. Code Section 89001)

4.3-6 Local Agency Ethics

Government Transparency Laws

Economic Interest Disclosure Under the Political Reform Act (Gov. Code Section 87200)

The Ralph M. Brown Act (Gov. Code Section 54950 et seq.)

Public Records Act (Gov. Code Section 6250)
The meetings of public bodies must be open and public. Actions taken in secret are prohibited except as expressly authorized by law. Any actions taken in violation of the open meetings laws are void.

4.3-7 Local Agency Ethics

Laws Relating to Fair Processes

Common Law Bias Prohibitions
If a public official cannot exercise his/her duties without "disinterested diligence" for the benefit of the public, he/she has conflict and should not participate in the action or decision. (American Canyon Fire Protection Dist. V. County of Napa (1983) 141 Cal.App.3d 100, 103-104)

Due Process Requirements
Due process is a constitutional right to fair treatment in adjudicatory decision-making situations.

Doctrine of Incompatible Public Offices
This doctrine prevents a person from holding two public offices simultaneously if incompatibility exists between the offices.

Competitive Bidding Requirements for Public Contracts (Pub. Contract Code Section 20120)

Anti-Nepotism Policies
Government officials are generally disqualified from participating in decisions that affect family members

4.4-1 Conflict of Interest

Source:
SACRS FIDUCIARY OBLIGATIONS AND CONFLICTS OF INTEREST OF BOARD OF COUNTY RETIREMENTS SYSTEMS

May 4, 1994
Virginia L Gibson; Baker & McKenzie

The board members of a county retirement system are entrusted with the preservation and investment of the county's retirement assets and the administration of the retirement system itself. The board members serve in the same position with respect to county retirement assets that a trustee does with respect to a trust.

Accordingly, the law imposes a number of significant fiduciary obligations on board members, which are designed to steer the board members through the myriad conflicts of interest that they are faced with in their day-to-day duties. These rules and the conflicts they are designed to address are the subject of this outline.

4.4-2 Conflict of Interest

County retirement funds represent a significant pool of assets and an equally large source of temptation for politicians, revenue-hungry counties and local governments, and even the State of California itself. The voters of the State of California recognized this in enacting Proposition 162 in the November 1992 ballot. Proposition 162 states, for example, that

The People of the State of California· hereby find and declare as follows...

To protect the financial security of retired Californians, politicians must be prevented from meddling or looting pension funds...

to protect pension systems, retirement board trustees must be free from political meddling and intimidation ... the People must act now to shield the pension funds of this state from abuse, plunder and political corruption

...the People of the State of California hereby declare that their purpose and intent in enacting this measure is as follows...

to ensure that the assets of public pension systems are used exclusively for the purpose of efficiently and promptly providing benefits and services to participants of these systems, and not for other purposes ...

to give the sole and exclusive power over the management and investment of public pension funds to the retirement boards elected or appointed for that purpose, to strictly limit the Legislature's power over funds, and to prohibit the Governor or any executive or legislative body of any political subdivision of the state from tampering with public pension funds.

4.4-3 Conflict of Interest

These are strong words, and they contain several important points.

First, they show a general public awareness of the temptation that retirement funds represent and the potential that exists for misappropriating and diverting these funds to inappropriate uses, especially in times of financial crisis.

Second, they show that the public expects boards of retirement to zealously protect the retirement assets and to stand firm against political pressure to use retirement funds for purposes other than providing retirement benefits.

Finally, they show that the public is concerned about abuses of retirement assets, which means that increased scrutiny is likely to be focusing on retirement boards and individual board members by the Attorney General's office, by the IRS, and by members of the press.

The rules governing fiduciary obligations and conflicts of interest of boards of retirement are contained in the California Constitution, the California Government Code and, to a lesser extent, in the Internal Revenue Code and ERISA.

4.4-4 Conflict of Interest

Proposition 162 added a number of provisions to the California Constitution which are designed to strengthen the position of boards of retirement *vis-a-vis* state and local government, and the Constitution now contains a broad range of provisions dealing with county and other public retirement boards. These provisions supersede all other state laws. They give each board exclusive fiduciary responsibility over its retirement assets, require the board to administer the pension system "in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries" and require the board to ensure that assets are held exclusively for the purpose of providing retirement benefits and defraying reasonable expenses of administration.

The Constitution also requires board members to discharge their duties solely in the interest of and for the exclusive purpose of

(i) **Providing Retirement Benefits**,
(ii) **Minimizing employer contributions**, and
(iii) **Defraying reasonable administrative expenses** of the retirement system, but the duty to participants and beneficiaries takes precedence over all other duties. Board members must act with the care, skill, prudence, and diligence of a prudent person who is familiar with the administration of a retirement system.

Finally, the Constitution makes it clear that only the retirement board has the authority to provide for actuarial services in order to determine whether the retirement system is overfunded or underfunded. This prevents, for example, a local government from interfering in the actuarial assumptions that the retirement board uses in order to lower its obligation to the retirement system.

4.4-5 Conflict of Interest

The provisions of the Constitution are supplemented by provisions in the California Government Code which also provide for penalties if the rules are broken. The Government Code contains detailed provisions governing conflicts of interest of board members. These provisions prohibit board members from being financially interested in any contract that they make in an official capacity, from engaging in any activity for compensation that is in conflict with board duties, and from using their positions to influence a decision in which they have a financial or personal interest.

The Internal Revenue Code ("Code") is relevant also, because many county retirement systems derive their tax-exempt status from Code section 401(a). As a condition to receiving this tax-exempt status, the Code imposes a number of conditions, including a requirement that the retirement systems must use their assets for the "exclusive benefit" of the retirement plan beneficiaries. Over the years this exclusive benefit rule has been interpreted and extended by the Internal Revenue Service ("IRS") to require retirement plan fiduciaries to consider only the financial interests of plan beneficiaries in discharging their fiduciary duties (as opposed to any other nonfinancial considerations which might nonetheless benefit the beneficiaries, such as investing in certain projects that are designed to improve the quality of life of citizens in general within a county).

4.4-6 Conflict of Interest

The IRS has also in some cases interpreted the exclusive benefit rule in light of the precedents that have been developed under the Employee Retirement Income Security Act of 1974 (-ERISA-). ERISA is the primary statute governing private pension plans, and contains detailed rules about fiduciary duties, obligations and conflicts of interest. A great deal of case law has built up around ERISA, and as a result ERISA often provides precedents where they are lacking in other areas of trust and fiduciary law. Accordingly, the IRS in interpreting the exclusive benefit rule has incorporated some of the developments of case law and rulings under ERISA. This phenomenon of "creeping ERISA" makes it necessary to sometimes consult ERISA's rules even when ERISA is not directly applicable. Thus, even in the case of a county retirement system which is not subject to ERISA, ERISA can provide guidance which is sometimes indirectly applicable and often useful.

4.4-7 Conflict of Interest

The most common situations where conflicts of interest arise and where the rules of fiduciary conduct are likely to be broken by county retirement boards are as follows:

1: Service Providers

Selecting and retaining service providers, such as investment managers, consultants, legal advisors and others, raises issues of prudence and loyalty. For example, board members must act prudently in selecting service providers who are best able to serve the retirement system, and must act in the best interests of the retirement system by selecting providers based on their performance rather than any personal or financial connection that the board members have with the service providers. Thus, selecting a service provider because he or she is a friend or because he or she is providing financial benefit to a board member would be a violation of the board members' fiduciary duties.

4.4-8 Conflict of Interest

2: Social Investing and Economically Targeted Investments ("ETIs")

Selecting investments based on their social benefit or based on criteria other than purely financial concerns, raises issues of prudence, duty of loyalty and diversification. Board members must be sure that the primary purpose for selecting an investment is its ability to perform financially. Boards must also be sure that investments are not too concentrated in one geographic area, so that the retirement system diversifies its financial risk. In some cases, however, economically targeted investments can work if the primary financial and diversification concerns are satisfied. Many boards are either in the process of developing or have already adopted ETI guidelines governing when an ETI will be deemed an acceptable investment.

4.4-9 Conflict of Interest

3. Board Members with Dual Responsibilities

Serving in dual roles raises issues of conflicts of interest and incompatibility of office under the Government Code. Board members who serve in dual roles, for example as both board members and county officials, must be careful to separate their duties to the retirement system and their duties to their other employer. While acting as board members, the members must act in the best interests of the retirement system notwithstanding their duties to the county or other employer. If the duties toward the other employer conflict with board duties, board members must consider abstaining on votes when conflicts of interest arise.

4. Campaign Contributions

Board members in political office who solicit campaign contributions for their own political campaigns from service providers to the retirement system raise duty of loyalty in conflict of interest issues. Soliciting campaign contributions not only raises the appearance of impropriety, but it can create a conflict of interest in that if a service provider complies with the request, board members' judgment in deciding whether to retain the service provider could become biased. Also, the service provider may believe that providing campaign contributions is a substitute for doing the best job that he or she can for the retirement system.

4.4-11 Conflict of Interest

5. Board Member Expenses

Excessive board member expenses raise issues of duty of loyalty, and conflict with the duty to minimize employer contributions to the retirement system and to defray reasonable expenses.

6. Actuarial Assumptions or Funding Methods

Under the California Constitution, board members have sole responsibility for providing for actuarial services for the retirement system. There is often political pressure to use actuarial assumptions that reduce the county's obligation to pay into the retirement system. Board members should exercise care, since their primary duty is to ensure that the retirement system is adequately funded to provide benefits for the participants. Again, issues of prudence and duty of loyalty are at stake.

7. Pension Obligation Bonds

When counties decide to make up pension underfunding through the issuance of pension obligation bonds, there is often pressure on the board to freeze its actuarial assumptions or otherwise make commitments to ease the bond underwriting. Again, duty of loyalty and prudence require the board to put the retirement system's interests first, and not commit to policies that could impair the adequacy of the retirement system assets.

8. Loans and Investments for the Benefit of the County

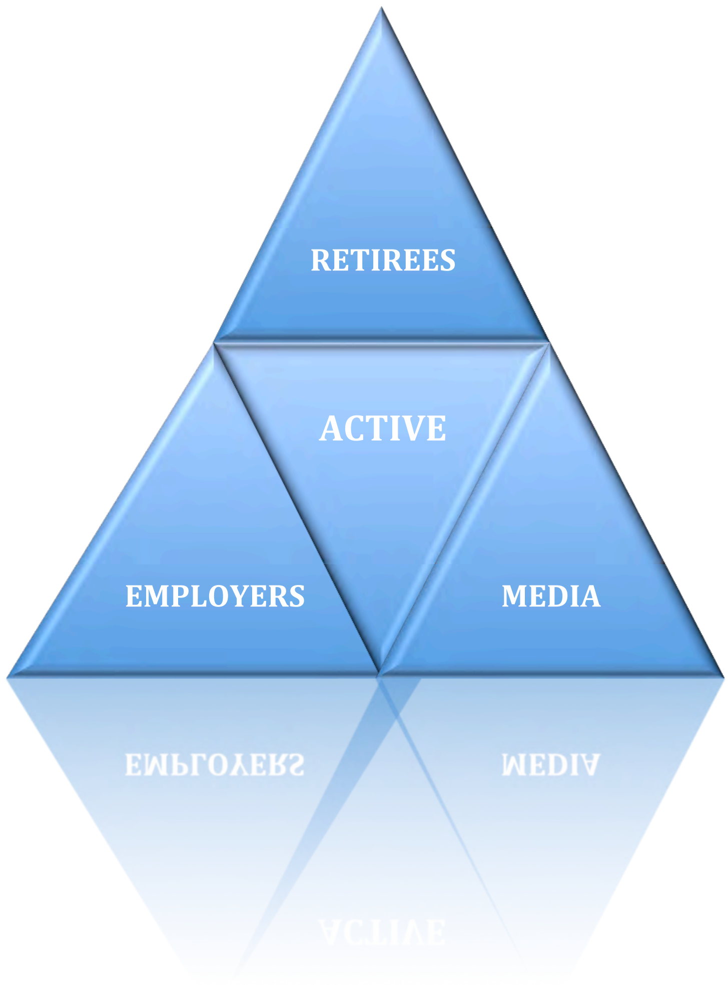
Prudence and the duty of loyalty require any proposed loans to the county or investments that benefit the county to be evaluated on the same basis as other investments, despite any pressures to give favorable treatment to the county.

9. Spiking

The temptation for board members to use their superior understanding of the retirement system to manipulate their compensation in the final years of employment so that they receive a higher pension raises issues of duty of loyalty, and also creates the appearance of impropriety which should be avoided. The risks involved in violating the fiduciary obligations imposed on board members range from the loss of tax-exempt status for the entire retirement system, which could have catastrophic financial consequences, to removal of board members by action of the Attorney General. Extreme violations could even result in criminal sanctions. Finally, board members should bear in mind that even borderline or "grey area" activities can result in extremely damaging negative publicity.

4.5-1 Your Constituents

A **Constituent** is a person or group of interest you represent in your role as a plan trustee. Although you should certainly listen closely to your specific constituents, you should also be aware of the concerns of others with interests in the plan.



4.5-2 Your Constituents

Active Workers

Pension Plans typically administer benefits for several classes of workers employed by the plan sponsor.

All active employees have the same question when it comes to their retirement plan: Will it provide me with an adequate income that I can count on when I retire, at a price I can afford to pay today? Because benefit formulas and employee contribution rates tend to be fixed, they are unlikely to be active employees' most pressing concern when it comes to retirement benefits. Instead, other benefit changes are probably going to be of more interest, and these are also where you as a trustee may have a role to play. For instance, the plan's retirement ages will always be of great interest to active workers. Changes in these ages are increasingly the focus of attention as labor markets continue to change.

Other issues affecting retirement benefits that are typically of great interest to active employees include changes to the average salary component of the benefit formula. Also, any considerable modifications in the overall benefits delivery system will spark interest from active workers.

4.5-3 Your Constituents

Retirees

Retirees and the organizations that represent them may be the constituency you hear from the most. This is predictable because retirees are already receiving pension payments. They are keenly aware of their pension benefits because they receive them every month. Retirees also tend to have more time to become involved in matters involving their pension benefits and retiree health care benefits, when those are offered. Remember, because retirees are on a fixed income, any change in their monthly income and/or expenses can be painful.

Retirees will be particularly interested in your staff and its ability to get retirement benefits processed in an accurate and timely manner. Your plan's publications should be easy for retirees to understand, particularly the materials about benefits. The nature of your educational programs will also be of concern to them. Retirees will also be interested in your investments and their performance levels because over two-thirds of all public retiree benefit payments on average come from investment returns.

4.5-4 Your Constituents

Employers

Although the focus of active and retired plan participants is on benefits, one of the employers' chief interests is likely to be the contribution rate to the plan. In other words, how much is it and how much does it vary from year to year? In a DB plan, the employer contributions, when combined with employee contributions and investment earnings, are insufficient to pay future retirement benefits, there will be a shortfall.

The technical term for a shortfall is unfunded liability, something the employer must address. A shortfall can lead to an increase in the overall employer contribution rate, which makes employers unhappy. When dealing with the employer as a constituent, remember that, although the employer may be the plan's sponsor, the plan itself, and the decisions that you must make as a trustee of the plan, must always be directed exclusively for the benefit of the plan's participants.

4.5-5 Your Constituents

The Media

The media come in many shapes and sizes. Pension plans often find themselves a topic of comment in all of these venues. There is one important policy issue to address when it comes to media relations and that every new trustee should learn: Who among plan officials is allowed to talk with reporter? Who is prohibited from talking to reporters? Experienced trustees have mixed views of the press.

Although the media can be helpful in setting the record straight when plan's critics are propagating misinformation, reporters can ask uninformed questions about things over which you have no control. However, the press often provides the primary means by which your pension plan is viewed and judged by the public. The press is also one of the chief sources of information about your plan for your constituents.

4.6-1 Prudent Expert

TEN RESOLVES FOR THE PRUDENT FIDUCIARY

In order to maximize the potential for our plan to achieve investment success, I will do the following:

1	**Identify the most appropriate planning horizon when constructing the investment portfolio for our plan**
2	**Recognize that managing the risk of the portfolio is more effectively achieved by property structuring the investments instead of continually hiring and firing managers**
3	**Adequately diversify the portfolio in recognition of the new globally integrated economic environment**
4	**Resist the temptation to make decisions that will have an impact on future return predicated upon the returns most recently achieved by the asset classes**
5	**Decide what is best for our portfolio rather than being influenced by the actions others are taking as they supervise their portfolios**
6	**Recognize that to invest in long bonds, stocks and equity real estate requires successfully enduring the bear markets as well as the bull markets**
7	**Adopt policies in the long-term best interest of the portfolio in the aggregate rather than by being unduly influenced by any one portfolio component**
8	**Increase my understanding of the historical risk/reward tradeoffs in order that our fund may benefit from an insightful exploitation of risk**
9	**Recognize the importance of the income component of long term total return**
10	**Preserve objectivity in the process of making decisions about investments**