



# **State Teachers Retirement System of Ohio Fiduciary Responsibility & Governance Training**

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# Agenda

1

**Fiduciary Law**

2

**Key Fiduciary Standards**

3

**Fiduciary Liability**

4

**Common Fiduciary Pitfalls**

5

**Governance**

# Questions to Think About Today

- Why? Why is this session important?
- Who? Who is a fiduciary?
- What? What is required of fiduciaries?
- How? How can I avoid fiduciary liability?

CAVEAT: The purpose of the training today is not to provide legal advice.



# Why Fiduciary Training Is Important

- Even though fiduciary standards are the “**highest known to law**,” fiduciary duties are a frequently misunderstood concept *Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir. 1982).
- Serving as a fiduciary comes with responsibilities of the utmost importance under the law.
- Appreciating the rationale behind the strict fiduciary standards helps with understanding the concept.
- Engaging in ongoing orientation is consistent with “good governance” and a best practice.

# 1

## Fiduciary Law



# Genesis of Fiduciary Standards

- Because funds are held in trust, basic principles of trust law apply.
- Trust law is hundreds of years old, was started in England and was developed by the courts over time. It was applied to family, business, and charitable trusts even before pension funds.
- General trust law contains standards that apply to all trusts and fiduciary law stems from those.
  - Three parties are involved with a trust:
    - Settlor
    - Trustees
    - Beneficiaries



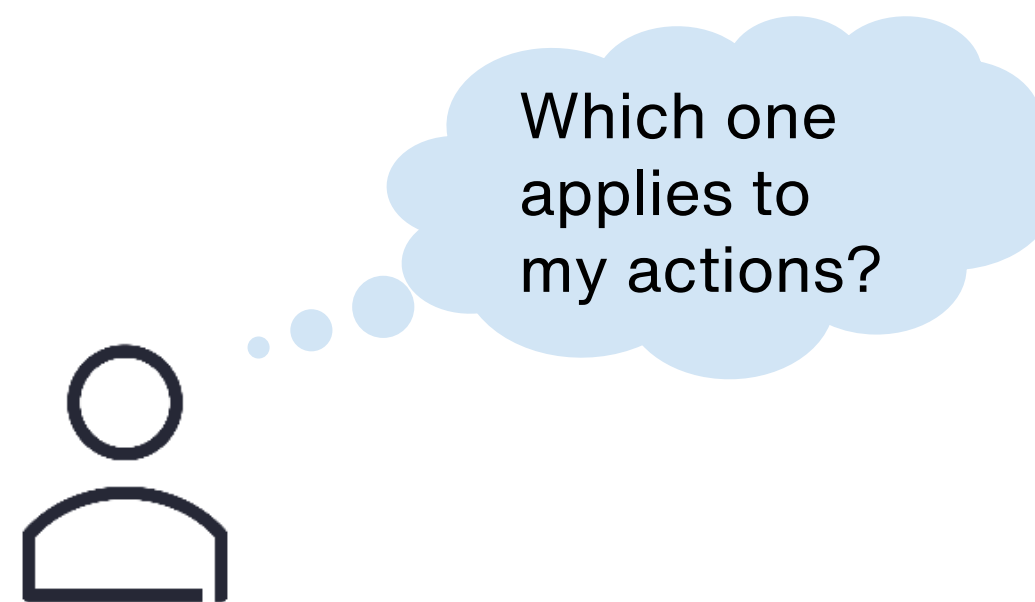
# Sources of Fiduciary Standards

- Ohio Revised Code (R.C.) Ch. 3307
- Employee Retirement Income Security Act (ERISA) of 1974
- Restatement of Trusts 3d: Prudent Investor Rule (1992)
- Uniform Prudent Investor Act (UPIA)
- Internal Revenue Code
- Case law
- Attorney General Opinions



# Prudent Person Rule

- Different prudence standards have emerged and evolved over time.
  - Prudent “reasonable” person
  - Prudent investor
  - Prudent expert
- Prudent “reasonable” person — lower standard, “the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another...” Model Prudent Man Statute.





# Prudent Investor Rule

Differences from Prudent Reasonable Person Rule:

- Much higher standard
- A trust account's entire investment portfolio is considered when determining the prudence of an individual investment.
- Diversification is explicitly required as a duty for prudent investing.
- No category or type of investment is deemed inherently imprudent.
- A fiduciary is permitted to delegate investment management and other functions to third parties.



# Prudent Investor

## Prudent Investor Standard of Care

*A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.*

Prudent Investor Act

# ERISA Standards – Why is this important to public pension plans?

**Highest standard under the law.** A fiduciary shall discharge his duties with respect to a plan “with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” ERISA § 404(a)(1)

ERISA is the federal law that governs the operations and administration of private pension plans and welfare benefit plans.

ERISA does not apply to governmental plans, such as STRS.

- State and/or local laws and regulations govern public pension funds.

Fiduciary standards in the law governing public funds are typically modeled after ERISA. This is the case for STRS.

- The language is often virtually the same.
- ERISA reflects relevant trust law, and its “spirit” is typically followed by the courts in the absence of a stated standard.
- ERISA is very influential in providing guidance about how fiduciaries should act.



# Who is a Fiduciary?

The concept is that property is entrusted to a “trustee” on behalf of a beneficiary who receives money from the trust.

There are two ways in which one is a fiduciary under the law:

**1** The “designation” approach where the law or plan documents specifically designate a person as a fiduciary, or

**2** The “functional” approach, where a person is deemed to be a fiduciary by virtue of their discretionary authority and control over plan assets.

- Duties include whether a person has discretion and control over the administration of the plan or the management of plan assets
- Investment managers and investment consultants are fiduciaries
- Certain staff with discretion



# Who is a Fiduciary?

R.C. 3307.01 (K) provides that a fiduciary is a person who:

- *Exercises any discretionary authority or control with respect to the management of the system, or with respect to the management or disposition of its assets;*
- *Renders investment advice for a fee, direct or indirect, with respect to money or property of the system; or*
- *Has any discretionary authority or responsibility in the administration of the system*

# Who is a Fiduciary?

Ohio law also specifically designates the Board as the Trustees and ultimate fiduciaries of the fund.

- *A state teachers retirement system is hereby established for the teachers of the public schools of the state which includes the several funds created and placed under the management a state teachers retirement board... R.C. 3307.03*
- *The general administration and the management of the state teachers retirement system is hereby vested in the state teachers retirement system...R.C. 3307.04*
- *The members of the state teachers retirement board shall be the trustees of the funds...R.C. 3307.15(A)*

# Who is a Fiduciary?

- A person's fiduciary duty is limited to the scope of responsibility delegated to them.
- A fiduciary may not avoid fiduciary status through documentation stating they are not a fiduciary.
- Usually those performing ministerial tasks are not fiduciaries.
- Typically, accountants, attorneys, actuaries and record keepers are not considered to be fiduciaries.

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You don't have to be identified as a fiduciary or accept fiduciary status to be a fiduciary.

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# 2

## Key Fiduciary Standards





# Overview of Fiduciary Standards



## Exclusive Benefit Rule

- Act solely in the interest of the participants
- Reasonable fees/expenses



## Prudent Expert Standard

- Care, skill and diligence
- Prevailing facts and circumstances
- Focus on prudent process



## Diversification

- Diversify to minimize risk unless imprudent to do so



## Follow Plan Documents

- To the extent consistent with applicable law



## Prohibited Transactions

- No self-dealing
- No acting against plan interests
- Limited exceptions

# Duty of Loyalty

*The board and other fiduciaries shall discharge their duties with respect to the funds solely in the interest of the participants and beneficiaries; for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the system...*

R.C. 3307.15(A)

# Duty of Loyalty

## **ERISA Exclusive Benefit Rule:**

A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

for the exclusive purpose of:

- Providing benefits to participants and their beneficiaries
- Defraying reasonable expenses of administering the plan

ERISA § 404(a)(1)

# Duty of Loyalty in Practice



Avoid conflicts; if you cannot, then disclose and recuse



When making decisions, fiduciaries may not balance interests

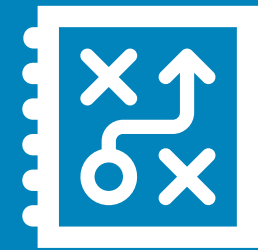


When acting as a fiduciary, you may not put others' interests ahead of the System's interests



The duty of loyalty has not evolved — courts strictly interpret

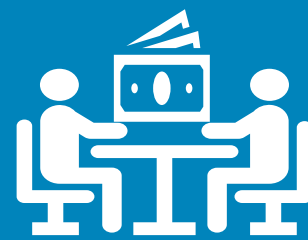
# Examples of Areas Where Duty of Loyalty Comes into Play



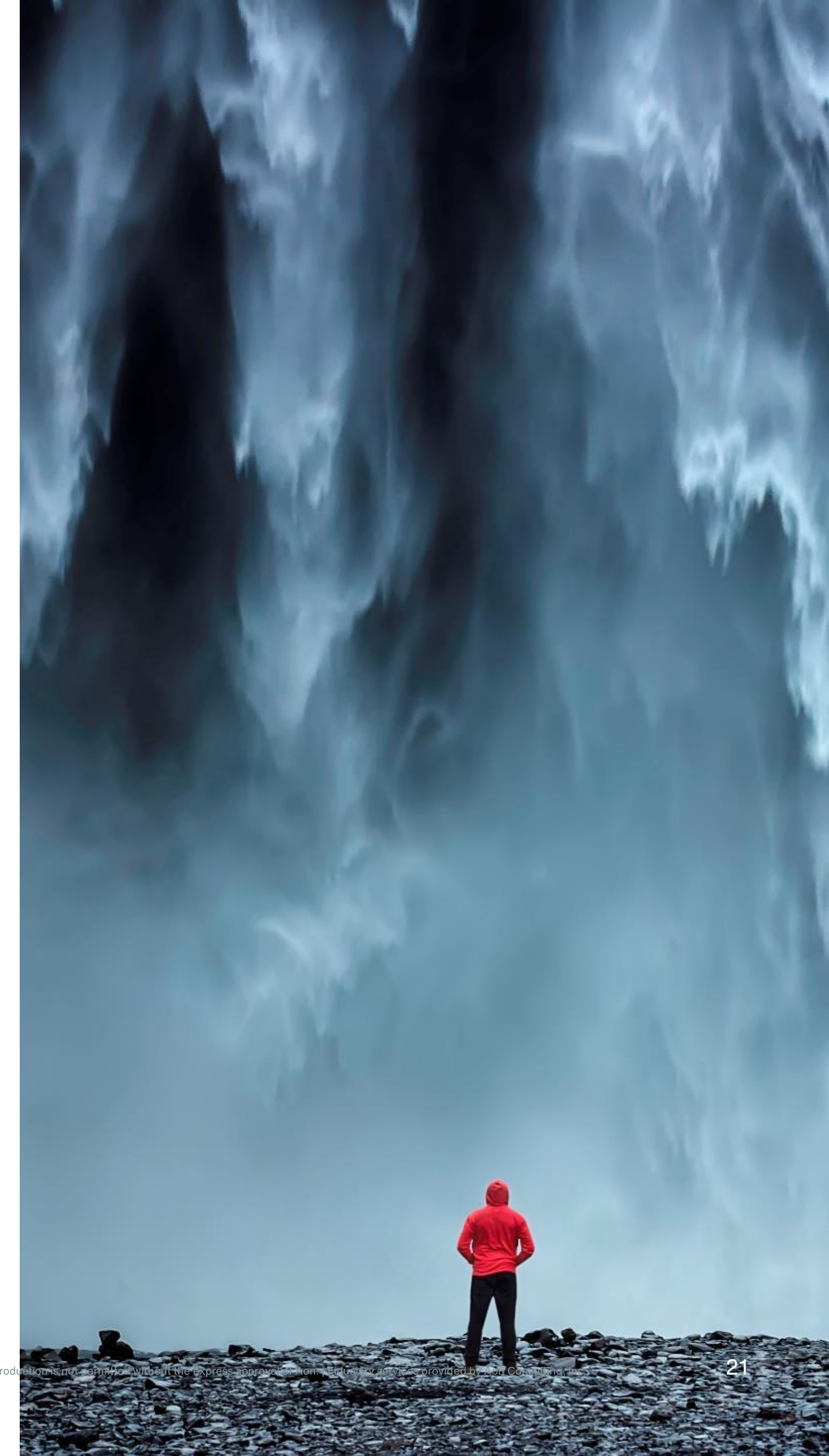
Conflicts of Interest



Acting in your self-interest



Kickbacks from investment managers



# Duty of Prudence

## Prudent Expert

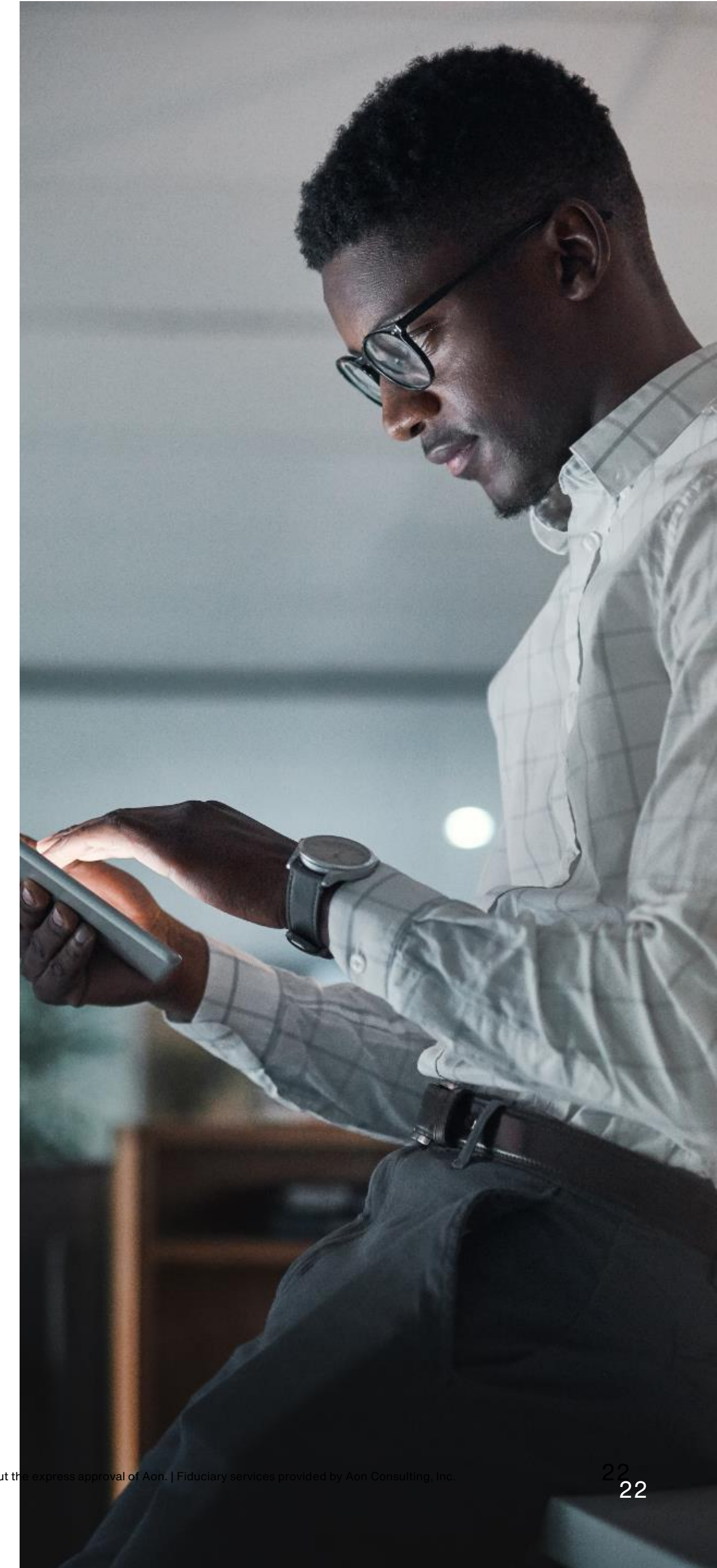
*The board and other fiduciaries shall discharge their duties... with care, skill, prudence, and diligence **under the circumstances** then prevailing that a prudent person **acting in a like capacity** and **familiar these matters** would use in the conduct of an **enterprise of a like character** and with **like aims**...*

R.C. 3307.15(A)

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What would a prudent expert do in a like situation?

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# Duty of Prudence

**Fiduciaries are judged by the prudence of their process.**

“The test of prudence is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investment succeeded or failed.”

*Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5<sup>th</sup> Cir.1983)

# Duty of Prudence

- A good process is more important than a good outcome and is the best defense to potential liability.
  - **Written documentation is critical** in order to demonstrate that you acted prudently. Hard to prove your conduct or process if it is not documented.
- The law requires prudence, not perfection.
- Contemplates comparison to peers.
- It is judged on an objective standard — prudent fiduciary behaves as other similarly situated fiduciaries would behave.



# Examples of Areas Where Duty of Prudence Usually Comes into Play



**1**

**Setting the Asset Allocation**



**2**

**Documentation of Processes**



**3**

**Retaining Expert Assistance**



**4**

**Reviewing Performance**



**5**

**Managing Risk**



**6**

**Delegation of Authority**

# Standards of Prudence Evolve

## **Prudence standards evolve over time.**

- As prudence standards evolve over time, fiduciaries need to keep up.
- Due diligence practices of the past may not be enough.
- Investments with the potential for high returns are often higher risk and require more due diligence.

## **Decisions should be made using contemporary standards of prudent experts**

- More specialized advice from independent consultants/service providers.
- More written opinions rather than verbal “off the cuff” comments.

# Duty of Prudence in Practice

## **Collect and understand information before making a decision.**

- Consult with knowledgeable, independent outside external and/or internal experts (other staff).
- Review information on what others are doing, i.e., your peers.
- Decisions should be consistent with information and policy.
- Decisions should be made using contemporary standards of prudent experts — remember the duty of prudence evolves over time.

**Document, document, document steps taken in the deliberative decision-making process (evidence of prudent process).**

# Duty of Prudence — Delegation

A trustee has a duty personally to perform the responsibilities of trustee except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances. Restatement of Trusts 3rd

- Delegation is allowed and even encouraged by the Prudent Investor Act and ERISA.
- Failure to delegate may be a fiduciary breach.
- To be prudent, when delegating the following generally applies:
  - Duty of prudence in selecting qualified professionals
  - Duty to specify the scope of the delegation
  - Duty to monitor the professionals to ensure the delegation is carried out in a manner consistent with the delegation, and the delegation continues to be prudent
- Board members may delegate but they cannot abdicate their fiduciary responsibility.

# Duty to Follow Plan Documents

- A fiduciary shall discharge his or her duties with respect to the plan in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of the law. ERISA § 404(a)(1)(D)
  - Plan document can include multiple documents (By-laws, Statement of Investment Objectives and Policy, policies adopted by the Board)
- Fiduciaries cannot be arbitrary and capricious in their application of applicable law(s) or plan.
- Familiarity with plan documents is essential.



# Duty to Monitor

U.S. Supreme court opinion held fiduciaries have a continuing duty — separate and apart from the duty to exercise prudence in selecting investments at the outset — to monitor and remove imprudent investment options. *Tibble v. Edison International*, 135 S.Ct. 1823 (2015), *Hughes v. Northwestern Univ.*, 595 U.S. \_\_ (2022).



The board's role is to establish policies and procedures that staff can implement to protect the fund and ensure the highest level of services from external advisors.

Adequate reporting is necessary for prudent monitoring.

Trust but verify.

# Duty to Diversify

The duty to diversify emanates from the duty of prudence.

Modern Portfolio Theory typically applies:

1

Consider each investment within the context of the entire portfolio.

2

Create an “optimal” portfolio given the board’s risk/return preferences.



# Duty to Diversify

- “...fiduciaries shall discharge their duties...by diversifying the investments of the system so as to minimize the risk of large losses.” R.C. 3307.15(A)
- ERISA requires diversification so as to minimize the risk of a large loss, unless under the circumstances it is clearly prudent not to do so.
- The duty to diversify emanates from the duty of prudence.
- For DB plans, Modern Portfolio Theory:
  - Diversify plan assets unless it has been reasonably determined that the trust is better served by not diversifying.
  - Consider each investment within the context of the entire portfolio.
  - Create an “optimal” portfolio given the Board’s risk/return preferences.
- For DC plans, participants must be able to choose among alternatives which are diversified and have materially different risk and return characteristics.
  - Offer an adequate number of investment options and communicate risk/return characteristics with plan participants.
  - ERISA requires at least three. More investment options are not necessarily better.





# 3

## Fiduciary Liability



# Fiduciary Liability

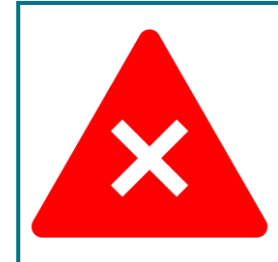
- The laws governing public fund fiduciaries typically impose liability for a breach of duty. Under Ohio law, if a member of a state retirement board breaches the member's fiduciary duty to the retirement system, the attorney general may bring action against the board member for harm resulting from the breach. The attorney general may recover damages or be granted injunctive relief, which shall include the enjoinder of specified activities and the removal of the member from the board. Any awarded damages are paid to the retirement system. R.C. 109.98
- R.C.3307.181 (E), provides that "each fiduciary of the system shall be bonded or insured to an amount of not less than *one million dollars* for loss by reasons of fraud or dishonesty".
- R.C. 3307.10(B) states that "the Board may secure insurance coverage designed to indemnify board members and employees for their actions or conduct in the performance of official duties and may pay required premiums for such coverage from the expense fund"
- STRS has obtained fiduciary liability insurance coverage that covers breaches, and there is no recourse against those covered by the coverage

# Co-Fiduciary Liability Concept

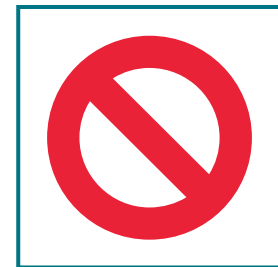
- Co-fiduciary liability means “you are your brother’s keeper.”
- Ohio law and ERISA impose co-fiduciary liability on any fiduciary who participates “knowingly in, or knowingly undertakes to conceal. . . [a breach] knowing [it] is a breach”. R.C. 3307.181
  - A fiduciary has a duty to prevent or halt a co-fiduciary’s breach
  - A fiduciary is liable for a co-fiduciary’s breach of their duties if the fiduciary knowingly participates in, conceals, or enables the co-fiduciary’s breach
  - If you know of another’s fiduciary breach and you do nothing about it, you are breaching your fiduciary duty
  - A fiduciary’s inaction or failure to act promptly to halt another fiduciary’s breach can give rise to co-fiduciary liability
  - For liability to attach, you must have **actual** knowledge of an action **you know to be a breach**
- The courts have said that fiduciaries have a duty to speak up and take **reasonable efforts** to prevent or remedy the breach.
  - Resignation from your position is typically not sufficient
  - Steps might include obtaining an injunction



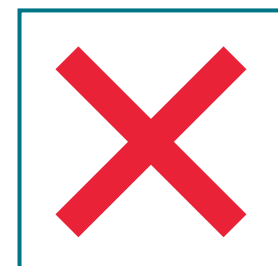
# Prohibited Transactions



**Prohibited Transactions = Conflicts of Interest**



Conflicts of interest can arise if personal financial gain impairs objective decision-making



Ohio law and ERISA bar fiduciaries from engaging in certain transactions to avoid conflicts, including self-dealing

# 4

## Common Fiduciary Pitfalls



# Examples of Fiduciary Pitfalls

Failing to operate the System prudently and for the exclusive benefit of participants	Failure to document decisions	Failure to periodically review policies	Failure to engage in ongoing education
Failure to engage in succession planning	Inconsistent actions	Failure to identify problems and act when needed	Failure to follow the plan documents (unless inconsistent with law)
Overreaction to recent information	Failure to have a strategic plan and/or follow it	Failure to properly select and monitor service providers	Operating in a vacuum, not knowing what the industry and your peers are doing

# Ways to Mitigate Fiduciary Liability

A thorough orientation and continuing education on fiduciary responsibility

A good understanding of common scenarios where fiduciary duties come into play

A thorough decision-making process with clear documentation of actions and rationale

Obtain expert advice from the staff, legal counsel, and others when needed

Prudent delegation and diligent oversight — understand what authority has been delegated and what authority has been retained

Good governance policies including clear accountability and a commitment to ongoing oversight activities

# 5

## Governance





# Why is Good Governance Important?



## Fulfill Fiduciary Responsibilities

Good governance policies and practices can help fiduciaries meet their fiduciary responsibilities.



## Prevent Fiduciary Breaches

Good governance helps to prevent fiduciary breaches and minimize risk.



## Add Value

Good governance adds value:

- Studies have shown that “good governance” is associated with increased returns.
- It can reduce the likelihood of litigation.
- Good governance fosters stakeholder confidence.

# Elements of Good Governance



# What is Governance

Good governance begins with a clear understanding of fiduciary duty.

- Unless all Board Members share the same understanding, governance problems could arise.
- Governance is not:
  - Day-to-day operations
  - Tactical decisions
  - Staff functions
  - “How to do it”
  - Policy implementation

# Independence

- It is important for a pension fund to be independent.
- Independence is often measured by evidence of a pension fund's:
  - Procurement authority
  - Budgetary authority
  - Personnel authority — hire, evaluate, compensate, and terminate staff
- If non-fiduciaries are able to exert control over pension fund fiduciaries, the duties of loyalty and prudence could be compromised.
- The duty of loyalty demands independence from:
  - The appointing body
  - The plan sponsor
  - Taxpayers
  - The public
  - Sub-groups of the participants

# Board/Committee Meetings

Meetings are where the work gets done.

Good meetings facilitate good decisions.

Act as a single board and not as individual members in carrying out your duties.

## Questions to consider:

- Does STRS have the right number of meetings to accomplish its work?
- Is there good attendance at the meetings?
- Are agendas established appropriately?
- Is there a proper allocation of time to address issues?
- Are meeting materials useful and provided in advance?
- Are different points of view allowed to be heard?
- Are discussions kept focused on the issue at hand?
- Are all relevant factors considered in decision-making?
- Are you trying to balance multiple roles, when the duty of loyalty requires an undivided loyalty?



# Why Board Minutes Are Important

- Ohio law requires that public bodies must keep full and accurate meeting minutes-not a verbatim transcript, but enough facts and information to permit the public to understand and appreciate the rationale behind the public body's decisions.
- The fundamental role of minutes is to preserve an accurate and official record of the proceedings of a meeting.
- Well-kept minutes:
  - Reflect individual member dissent where appropriate
  - Offer guidance for future STRS action
  - Serve as a valuable source of contemporaneous evidence in regulatory or judicial proceedings
  - Reduce misunderstanding as to the intent of STRS
  - Serve as evidence of the process the fiduciaries followed
- Fiduciaries are judged by the prudence of their process.
- Minutes serve as documentation of the deliberative process and are essential to establishing that STRS has acted consistently with its fiduciary duties.



# Common & Best Practices for Boards

- Setting mission & vision.
- Establishing SIOP (Statement of Investment Objectives and Policy) and performance benchmarks, monitor risks and returns.
- Ensure effective organizational planning.
- Require orientation and continuing Board member education.
- Annually assess Board's performance.
- Ensure adherence to legal standards and ethical norms.
- Engage and monitor independent expert advice-investment consultants and outside service providers.
- Provide proper financial oversight and ensure STRS has sufficient resources and staff to further the funds' goals.

# Common & Best Practices for Individual Board Members

- Be informed about mission and policies.
- Attend and be prepared for meetings.
- Participate in orientation and continuing education
- Serve on committees.
- Have a mentor.
- Keep up to date on developments in pension and public fund arena.
- Follow conflict of interest, disclosure & confidentiality policies.
- Focus on what you must do, what you may do, and what you cannot do.
- Act in good faith.



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