benefits
MAGAZINE

Ethics and Fiduciary Issues for Pension Trustees in a Changing Environment

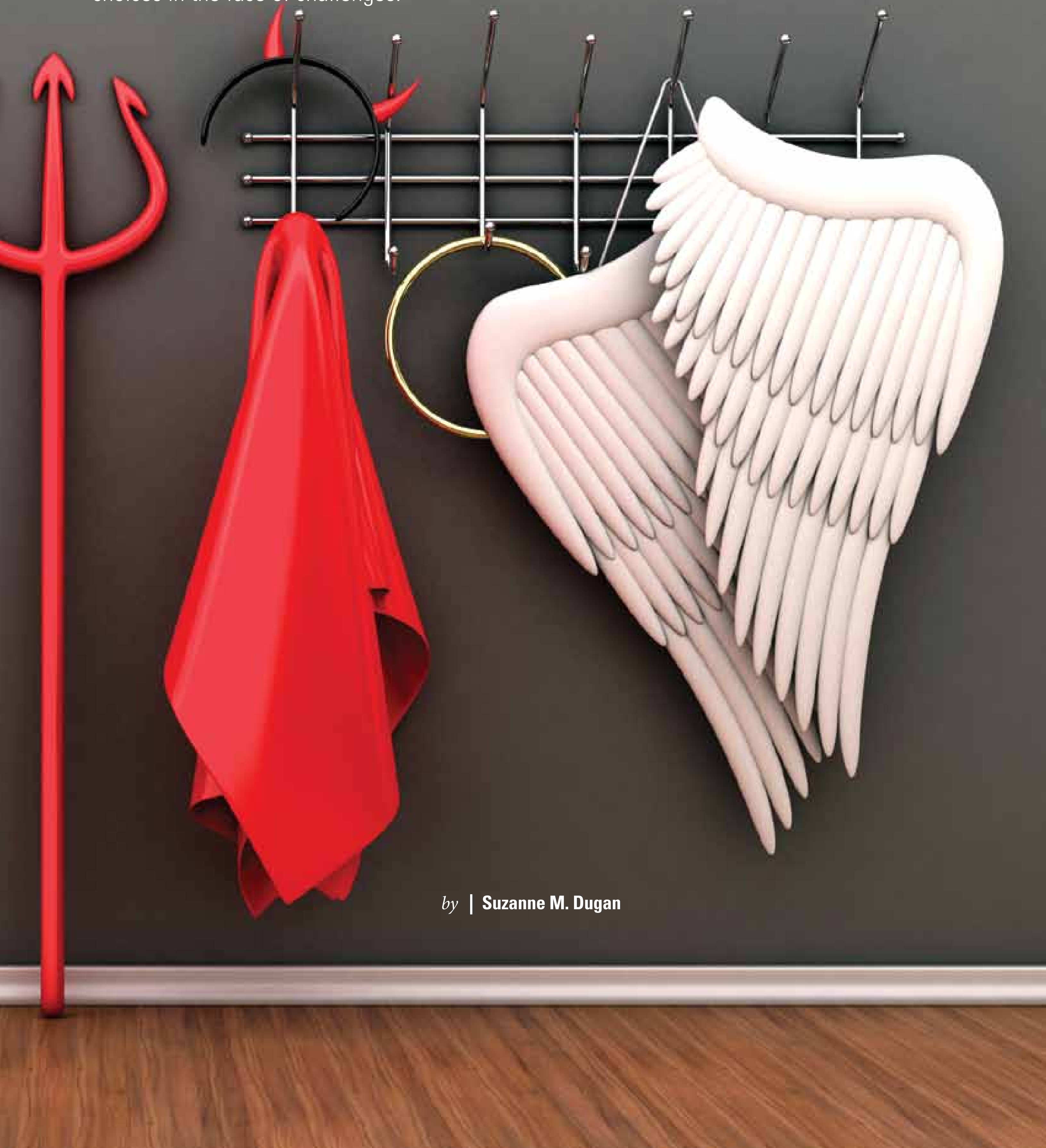
It is an oversimplification to say that trustees have a difficult job. If you do the job right, it is inevitable that some people are going to be upset with you. If you do it wrong, you could be in breach of your fiduciary duty. At a recent conference, a long-time trustee commented that it "isn't fun anymore." I don't know if it was ever "fun," but I do know what he was saying: These are incredibly challenging times, and that makes the already difficult job of a trustee even harder.

Pension plans face challenges that reflect the environment in which plans must operate and trustees must do their jobs. These include the financial meltdown of 2008 with its continuing economic effects; government gridlock with all its implications; scandals across the country; claims of underfunded liabilities; moves to restructure plans; federal, state and local budget problems; budget woes blamed on pension and benefit plans; and even the scapegoating of both public and private sector employees. Pension plans are not alone; much has been in the media recently about institutions ranging from universities to government agencies to corporations scrambling to deal with challenges and find a new normal.

As a result, we see a crisis in confidence for many institutions, as some become gridlocked, others fail to meet their obligations and still others engage in scandalous conduct. With regard to pension plans in particular, it's very easy to look for some shortcut; it is much harder to find answers to serious problems that require focus and long-term, innovative strategies and solutions.

The challenges have placed greater demands on plans and trustees as well. There is an increased focus on ethics—not just for pension plans, but also for corporate America, government, nonprofit and academic institutions—certainly more so than when I started in the field of ethics over 20 years ago. Public and media scrutiny is intense, and clients talk to us

A strong ethics program—focusing on core values, processes and procedures—can help create an ethical culture that will help pension fund trustees make the right choices in the face of challenges.



by | **Suzanne M. Dugan**

about the difficulty of operating under a microscope. The focus on ethics further complicates matters for trustees.

Back to Basics

So what should plans do when challenges abound in the midst of increased scrutiny? They should go "back to basics" and invigorate or reinvigorate the organization's ethics program. That means focusing on core values and on process and procedures. But just because these things are basics does not mean that they are easy or automatic.

Numerous studies confirm that the majority of individuals act based on the circumstances of their environment and the standards set by their leaders and peers, even if it means compromising their own morals.[1] This highlights the importance of an organization's culture and of having a good ethics program, which plays a key role in the culture. A seminal study from several years ago, the results of which have since been replicated in additional studies, found that a small portion of employees confronted with an ethical quandary—about 5%—would always do the right thing. An equally small percentage would always do the wrong thing. The vast majority might do the right thing or the wrong thing—i.e., engage in ethical or unethical behavior—depending on the circumstances.

This means that the culture of an organization is critical, and a rigorous ethics program is needed to create and maintain an ethical culture. It seems that we are indeed struggling to create ethical cultures in the workplace—In a 2011 survey by the Ethics Resource Center, 42% of respondents stated that their organizations have weak ethical cultures.[2]

Ethical Culture

Where does an organization's ethical culture begin? First and foremost, it begins with the tone at the top that is shaping the culture of ethics, compliance and risk management. Tone at the top is one of those phrases that can make people roll their eyes, but it is more than jargon. It's what leaders do. They claim leadership on the ethics issues. They elevate ethics within the organization. They communicate the message throughout the organization, speaking frequently about it and integrating the message throughout. It's about articulating the mission and the values of the organization, and not just paying lip service to them.

Case Study

SAC Capital Advisors billed itself as having a "strong culture of compliance" and a rigorous and "cutting edge" compliance program. It boasted that it spent "tens of millions of dollars" on compliance, and employed no fewer than 38 full-time compliance professionals. Moreover, the firm had a continuing training program with prominent outside speakers, such as former Securities and Exchange Commission (SEC) Chair Harvey Pitt. And yet Pitt came away from his visit to SAC unimpressed, saying, "My sense was that it was a check-the-box mentality, not a serious commitment."[3]

SAC affiliates had already paid $616 million in civil penalties to SEC when federal prosecutors in Manhattan announced a plea deal with SAC that would resolve a five-count indictment accusing SAC of permitting a systemic insider trading scheme. Under the agreement, SAC would pay a record-breaking $1.2 billion to the government and the firm would terminate its business of managing money for outside investors. Prosecutors had called SAC "a veritable magnet of market cheaters." Still remaining open are civil charges filed by SEC against Steven A. Cohen, the founder of SAC Capital Advisors, alleging that he ignored "red flags" that should have led him to investigate suspicious insider trading activity at SAC.

Note that SAC promoted itself as having a "strong culture of compliance," and what we are talking of here is a culture of ethics. It can be argued that those two cultures are very different, as reflected by the fact that Pitt came away with the impression that SAC had a check-the-box mentality.

Elements of an Effective Ethics Program

What are some of the elements of an effective ethics program?

It's about having an understandable and workable code of ethics and code of conduct that apply to all directors, staff and advisors, top to bottom, and reviewing and revising those codes when necessary so that they remain relevant and robust.

It's also about having an effective ethics training program that is customized or tailored to different positions within the plan. We know that trustees face different issues than employees, and employees face different issues based on their job duties. One-size-fits-all training runs the risk of losing part of that audience.

The ethics program must also have the right internal controls in place, with policies and procedures such as those addressing the roles of trustees, staff and advisors. It is critically important to define those roles clearly. Problems arise when these roles and responsibilities are not clearly delineated.

The decision-making process is another critical area. This process should be well-established, and the decisions made pursuant to that process should be well-documented. It is often said that under fiduciary law, it is the process—not the outcome or results—that demonstrates prudence.

Other key policies and procedures include an investment policy statement, policies on disclosure and transparency, and those implementing applicable laws such as placement agents, political contributions and insider trading. Another example of an important policy is annual disclosure by trustees and other fiduciaries of interests and holdings so that potential conflicts can be recognized and addressed before problems arise. Indeed, a major aspect of an effective ethics program is to identify issues before they turn into problems.

Another important element of an effective ethics program is a resource where officers and employees—especially the 90% of employees cited in the studies discussed above—can get questions answered. It is critically important for individuals to be able to obtain guidance on the application of the rules in specific situations—what might be called a *helpline*. The organization must also provide a resource where people can report wrongdoing and believe that their reports will be taken seriously and treated appropriately. Often called a *hotline*, this may be an actual telephone line but increasingly is an e-mail box or other electronic mechanism for reporting.

Why is all of this important? It's important because an effective ethics program plays an instrumental role in creating an atmosphere in which people are comfortable coming forward for ethical guidance or reporting wrongdoing without fear of retribution—i.e., an ethical culture.

Weak Ethical Culture

What happens when an organization's ethical culture is weak and there isn't an effective ethics program? In a culture where getting the job done is more important than getting the job done in the right way, you wind up with significant negative results: reputational damage (which leads to that crisis of confidence mentioned earlier as one of the challenges facing pension funds); ethics investigations; regulatory enforcement actions; and criminal convictions.

And you wind up with headlines like those we've seen in recent years—and we've seen lots of headlines.

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Pay-to-Play Scandals

Widespread scandals involving political contributions and placement agents occurred across the country, from Connecticut and New York to California and New Mexico, and places in-between such as Ohio and Illinois. SEC concluded that the selection of advisors had been influenced by political contributions and that, as a result, the quality of management service provided to public funds may be negatively affected. According to SEC, contributions sometimes were funneled through placement agents that advisors engage (or believe they must engage) in order to secure an investment from or client relationship with a public pension plan. In such an arrangement, the contribution may be made in the form of a substantial fee for what may constitute no more than an introduction service by a well-connected individual who may use the proceeds of the fee to make political contributions or provide some form of a kickback to an official or his or her family or friends. These scandals resulted in criminal and civil proceedings on the federal, state and local levels. Millions of dollars of fines have been paid, and criminal convictions have brought down several highly placed individuals, including the sole trustee of the country's third largest public pension plan.

Pension Spiking

In a classic example, a park district in a wealthy suburb acknowledged giving three executives nearly $700,000 in bonuses intended, in part, to pad their pensions. The district's executive director was paid more in retirement—$166,000—than he was ordinarily paid to run the agency. For most of his career he was paid approximately $139,000 a year, but at the end his salary was bumped up to $435,000 a year. This raised his pension to $166,000 from about $110,000.[4]

Misrepresentation

SEC in March 2013 charged the state of Illinois with securities fraud for misleading municipal bond investors about the state's approach to funding pension obligations by failing to disclose that its statutory plan significantly underfunded the state's pension obligations. The enforcement action marked the second time that SEC charged a state with violating federal securities laws in its public pension disclosures. In 2010, SEC charged New Jersey with misleading municipal bond investors about the underfunding of its two largest pension plans. The only other governmental entity ever charged by SEC was the city of San Diego, which was sanctioned in 2006 for committing securities fraud by failing to disclose to the investing public important information about its pension and retiree health care obligations in the sale of its municipal bonds in 2002 and 2003.

Improper Disability Awards

In 2008, the *New York Times* published a series of articles calling attention to a scandal at the Long Island Rail Road (LIRR) involving disability pensions. The numbers are shocking—Between 2000 and 2008, the disability rate for LIRR retired career employees was between 93% and 97%. Two doctors allegedly were paid up to $1,200 per diagnosis in addition to the thousands that they billed insurance companies, with one doctor reportedly earning more than $2 million. Twenty-four individuals have pled guilty, criminal charges are pending against another eight, and the Federal Bureau of Investigation continues its investigation. The disability benefits of over 600 retirees have been revoked, although individuals can reapply and submit new medical evidence.[5]

Reforms—Going Back to Basics

After a scandal, such as that of the LIRR case, we often see reforms being instituted that reflect the back-to-basics theme. The entity will announce that, in order to curb abuse, it is establishing a watchdog, mandating ethics training, creating a fraud hotline—all basic elements of an ethics program. And we typically see these reforms following the scandal. This highlights the need in the pension area to be proactive—to get out in front in order to create ethical cultures in organizations and institute the basic elements of an effective ethics program noted above before any scandals arise.

Red Flags and Fiduciary Duty

SEC used the phrase *red flags* in its order instituting administrative proceedings against Steven A. Cohen, alleging he ignored red flags that should have led him to investigate suspicious trading activity at SAC Capital Advisors. In the LIRR case, there were many red flags: All examinations were by the same doctors, and no independent medical evaluations were required; applicants had the same ailments; the ailment rate was far out of line with comparable entities in the industry (three to four times the industry average); and the percentage of applications granted was an astounding 93% to 97% every year between 2000 and 2008.

These red flags require a prudent fiduciary to investigate further. We know that a fiduciary has an obligation to discharge his or her duties with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person 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. That's the duty of prudence, one of the basic fiduciary duties that a trustee has. Fiduciaries must be adequately informed to meet this standard.

Just as a fiduciary would undertake due diligence with regard to investments, due diligence also must be undertaken with regard to the plan's ethics program. And remember that fiduciary responsibility extends to both investment activity and non-investment-related activities such as selection of providers, administration of plans, allocation of expenses and preparation of reports. It is important to be aware that if fiduciaries are asleep at the switch and allow an unethical environment to jeopardize pension benefits, it can be argued that they are breaching their fiduciary duty.

Bottom Line

In a time when challenges abound, pension plans should go "back to basics." This means invigorating or reinvigorating the plan's ethics program. As a trustee, you protect your fund when you focus on core values, and on process and procedure. And there is nothing more fundamental for pension plans than sound and effective attention to fiduciary responsibilities and ethics duties.

takeaways >>

- Public and media scrutiny of many institutions, including pension funds, has become more intense.
- Problems arise when the roles of trustees, staff and advisors are not clearly delineated.
- A major aspect of an effective ethics program is to identify issues before they turn into problems.
- The lack of an ethical culture can result in a damaged reputation, regulatory enforcement actions and criminal convictions.
- A prudent fiduciary will investigate red flags that may indicate a problem.
- Fiduciary responsibility extends to both investment and non-investment-related activities such as selection of providers, administration of plans, allocation of expenses and preparation of reports.

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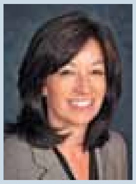

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Endnotes

1. Ethics Resource Center, 2009 National Business Ethics Survey, *The Importance of Ethical Culture: Increasing Trust and Driving Down Risks,* available at www.ethics.org.
2. Ethics Resource Center, 2011 National Business Ethics Survey, *Workplace Ethics in Transition,* available at www.ethics.org.
3. James B. Stewart, "Rules Compliance with an 'Edge.'" *New York Times,* July 26, 2013.
4. Joseph Ryan, "Park District Pension Play Pays Off Handsomely." *Chicago Tribune,* July 31, 2010.
5. Walt Bogdanich and Nicholas Phillips, "The Disability Board That Couldn't Say No." *New York Times,* December 14, 2008.