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Ethics and Fiduciary Issues for Public Pension Plans: Lessons Learned

BY SUZANNE M. DUGAN

One need only look at the headlines on any given day to find a story involving ethical misconduct. The settings of these stories range from corporate board rooms to athletic playing fields to government agencies on the federal, state, and local level—and pension funds are certainly not immune.

In April, a former member of the board of the California Public Employees' Retirement System (CalPERS) pleaded not guilty to conspiring with the former chief executive officer of CalPERS to commit fraud in connection with $3 billion in investments that resulted in placement fees in excess of $20 million, which involved allegedly fabricated documents. A federal grand jury in San Francisco had indicted the two individuals in March (55 PBD, 3/21/13; 40 BPR 781, 3/26/13). The criminal case is the final leg in a trifecta involving the alleged "pay-to-play" scheme, civil litigation having previously been brought by the Securities and Exchange Commission in April 2012 for violations of federal securities law, and by California's then-Attorney General Jerry Brown in May 2010.

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This follows on the heels of last month's news that SEC charged the State of Illinois with securities fraud for misleading municipal bond investors about the state's approach to funding its pension obligations. SEC's enforcement action marks the second time that SEC has a charged a state with violating federal securities law; in 2010, SEC found that New Jersey misled municipal bond investors about its underfunding of the state's two largest pension plans (160 PBD, 8/20/10; 37 BPR 1887, 8/24/10).

Headlines from late 2012 reported that former New York State comptroller and sole trustee of the $150 billion Common Retirement Fund, Alan Hevesi, would be released from prison just before Christmas. Hevesi admitted accepting more than $1 million in benefits in exchange for directing state pension investments to associates, after previously having been convicted of another felony for using a state employee as a chauffeur for his ailing wife, now reportedly in a nursing home. His son, a member of the New York State Assembly, issued a statement at the time of his father's release saying that his father has accepted responsibility for his actions: "My father has publicly acknowledged that he willfully allowed himself to become unbelievably arrogant, entitled, and personally corrupt.. . . He let corruption flourish around him by intentionally denying what was happening in his office. . . . My dad has owned and taken responsibility for his actions, and has been extensively punished for them, and now he and my entire family are closing the book on this part of our lives."[1]

Another scandal that garnered much attention was first revealed in an investigative series published by the *New York Times* revealing that almost every career employee of the Long Island Rail Road (LIRR) applied for and received disability payments after retirement—as many as 97 percent in one year. Ultimately 32 people were charged with participating in the massive scheme, including former LIRR employees, two doctors, a medical office manager, a former union president, and a former pension agency employee who assisted the workers in filing claims (55 PBD, 3/24/10; 37 BPR 689, 3/30/10). Among the red flags that went unaddressed: the disability rate was three to four times that of other railroads, the board went nearly two years without for-

[1] Gannon, Michael, and Mastrosimone, Peter C., "Alan Hevesi to be Released from Jail in December," *Queens Chronicle*, Nov. 21, 2012.

mally meeting, and the inspector general operated from his home in Florida—until he retired on disability.[2]

Great attention is devoted to news involving ethical missteps and stories concerning public pension plans often draw even greater attention. Any tale involving large sums of money—and other people's money, no less—can make for sexy reading. Spend too much time reading too many of these articles and one begins to understand why we have a crisis in confidence in public pension plans. The lesson of paying attention to ethics duties and fiduciary responsibilities should be clear by now. Yet too often it is not, and lessons are learned the hard way, by dealing with the fallout from a scandal.

Lessons Learned

The questions then become: What is the appropriate response going forward and what are the lessons that have been learned from these ethics scandals? Examining the context in which hard lessons have been learned and applied demonstrates how to avoid issues in the first place by instituting necessary policies, processes and procedures, and paying careful attention to ethics duties and fiduciary duties.

It is fair to say that public pension plans—indeed, all pension plans—are operating in a time of great disruption. In today's changing environment, public pension systems are facing greater challenges than ever. The continuing economic effects of the Great Recession, government gridlock, demeaning of public and union employees, unfairly targeting pension plans as the cause of budget difficulties—all these have combined with ethical scandals to feed the crisis in confidence in pension plans. As concerns regarding underfunded liabilities grow and cost pressures continue to rise, ethics and fiduciary issues for pension plans will be at the forefront.

It is often the case—previously observed in the public sector and the private sector and now in the public pension world—that scandal drives reform. Follow one of these stories in the headlines, and you'll find an organization scrambling to establish a fraud hotline, create a watchdog, mandate ethics training, and institute internal controls. These are all basic elements of an effective ethics program. And that's exactly what pension plans should do in challenging times—go back to basics to avoid the scandals.

Back to Basics

What does it mean to go ''back to basics''? This means focusing on core values, and on process and procedures, and invigorating the ethics program. Although these may be the ''basics,'' it does not mean that they are easy to implement. Yet these steps are so much easier when done in the calm of ordinary activity than in the midst of scandal.

Studies find that individuals act based on the standards set by their leaders and peers, even if it means compromising their own morals. This highlights the importance of an organization's culture. And a robust ethics program is needed to create or maintain an ethical culture.

[2] Bogdanich, Walt, and Phillips, Nicholas, ''The Disability Board That Couldn't Say No,'' *New York Times*, Dec. 14, 2008.

The ethical culture begins with governance, the basic organizational features of the enterprise. ''Tone at the top'' is more than just jargon—it's what leaders do. They claim ownership of the ethics issues. They elevate ethics within the organization, implement a plan, and communicate the message throughout the organization. They articulate the message through words and action, not just paying lip service. The importance of ethics has to permeate the organization for the ethics program to be successful. The ethics program must create an environment in which people are comfortable coming forward for ethical guidance or to report wrongdoing without fear of retribution.

An organization needs a vigorous and robust ethics program to create an ethical culture or maintain an existing ethical culture. Elements of an effective ethics program include:

- an understandable **code of ethics**, with examples of conflicts of interest and situations that create appearances of conflicts, reviewed and revised regularly to remain relevant and robust;
- a comprehensive **ethics and fiduciary training program**, customized for trustees and staff and the respective issues faced;
- a **resource** for employees **to obtain guidance** on the application of the rules in specific situations;
- **internal controls** addressing such topics as the roles of trustees, staff, and advisers; the decisionmaking process; and disclosure and transparency issues;
- a **hotline** for people to report wrongdoing, with confidence their reports will be treated appropriately; and
- **enhanced transparency** to provide appropriate disclosure of investments and transactions, as well as funding in order to address the crisis in confidence in pension systems.

The director of SEC's Office of Compliance Inspections and Examinations has stated that ethical cultural objectives should be central to an effective regulatory compliance program, and outlined 10 elements for an effective ethics and compliance program (reflecting the Federal Sentencing Guidelines for Organizations that explicitly integrate ethics into elements of an effective compliance program that would be considered as a mitigating factor in determining criminal sentences for corporations):[3]

- *Governance*—the tone at the top that is shaping the culture of compliance, ethics, and risk management.
- *Culture and values*—leadership promoting integrity and ethical values in decisionmaking and requiring accountability.
- *Incentives and rewards*—incorporating integrity and ethical values into performance management systems and compensation.
- *Risk management*—ensuring effective processes to identify and mitigate risk.

[3] Speech by Carlo V. di Florio, director, Office of Compliance Inspections and Examinations, *The Role of Compliance and Ethics in Risk Management*, http://www.sec.gov/news/speech/2011/spch101700cvd.htm .

■ *Policies and procedures*—establishing, maintaining, and updating tailored policies and procedures.

■ *Communication and training*—customized to specific business, risk, and regulatory requirements.

■ *Monitoring and reporting*—monitoring and reporting critical issues to management and the board.

■ *Escalation, investigation, and discipline*—processes through which employees can raise concerns anonymously or confidentially without fear of retaliation and matters are effectively investigated and resolved fairly.

■ *Issues management*—root cause analysis is done with respect to issues that are identified so remediation can occur.

■ *Ongoing improvement process*—a culture of continuous improvement.

Trends

Of course, not all pension plans are waiting for a scandal to be the impetus, but rather are being proactive in addressing ethics and fiduciary issues. As those of us who have worked in and with public pension plans can attest, the vast majority of trustees and employees of pension plans are honest, hardworking, and dedicated. They take very seriously the exercise of their fiduciary obligation to act in the best interests of the members and beneficiaries of their pension systems.

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. The duty of prudence requires a standard of conduct, not a particular outcome or performance. Prudence is reflected in the process that is followed by fiduciaries.

So, too, prudence must be reflected in the review and implementation of the ethics program. It should begin with an ethics review: an assessment of the structure, operations, and processes of the pension plan conducted from an ethics and governance perspective.

The implementation of the ethics program must then be pervasive, reflecting the all-important culture of the organization, which must start at the top and filter throughout the organization. It must reach all primary areas that affect the operations of the enterprise, such as investment processes, benefits administration, recordkeeping, transparency and disclosure, compliance, procurement process, and vendor monitoring.

In today's world, scrutiny by the public and the media is intense. In this kind of environment, it is crucial for an institution to have someone who is specifically dedicated to ethics. The focus on ethics is too great and the field has become too specialized. In fact, there are organizations that are designed to provide much needed support to the burgeoning field of ethics officer—there are multiple organizations for corporate ethics officers[4], and an organization for government ethics officers[5], and perhaps what is needed today is an organization of pension-fund ethics officers.

There is a saying that you hire consultants to tell you the things you don't want to hear. This is true of ethics officers as well. Norman L. Eisen, who was President Obama's ethics officer until December 2010, when he became ambassador to the Czech Republic, was known among his colleagues as the "fun sponge." Eisen is quoted as saying: "Sometimes my job is to scare the bejesus out of everybody."[6] Eisen's colleagues also referred to him by his nickname, "Mr. No." No one likes to hear "no"—but so much better for them to hear it in advance than to suffer the consequences. And we have seen what the consequences are—ethics investigations, criminal convictions, regulatory enforcement actions, and reputational damage. Fortunately, the lessons learned from these consequences have resonated with pension plans, which are going back to basics so they can avoid repeating past mistakes in order to restore confidence in pension funds.

Conclusion

Public pension plans are learning that, in a time when challenges abound, the right course of action is to go back to basics and reinvigorate the organization's ethics program. This is a lesson that now, with abundant examples of crises, should be very easy to learn. Smart fiduciaries know that a focus on core values and on process and procedures can serve to protect their funds. And there is nothing more fundamental and basic for pension funds than to ensure sound and effective attention to ethics duties and fiduciary responsibility.

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[4] One such organization is the Ethics and Compliance Officer Association, for individuals responsible for their organization's ethics, compliance, and business conduct programs. Another organization is the Society of Corporate Compliance and Ethics, which provides resources for ethics and compliance professionals from various industries and helps individuals become Certified Compliance and Ethics Professionals.

[5] COGEL, the Conference of Government Ethics Laws, is a professional organization for government agencies, organizations, and individuals with responsibilities or interest in government ethics, election, campaign finance, lobbying laws, and freedom of information.

[6] Saslow, Eli, "White House Ethics? 'Mr. No' Knows," *The Washington Post*, March 13, 2009.