

California ABLE Act Board

Fiduciary and Governance Training

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Section 1

Foundations of the Board's Duties

Sources of Fiduciary Duties

- Fiduciaries are held to extremely high standards of conduct
- A variety of sources together establish the fiduciary duties of Board members and otherwise provide guidance:

State Law

Common Law

Federal Law

Program Documents

- CalABLE Code Sections (Qualified ABLE Program Act)
- CalABLE Regulations

- Restatement of Trusts

- Internal Revenue Code

- Program Disclosure Statement and Participation Agreement

Fiduciary Sources

- **California Code Sections authorizing and establishing CalABLE are primary sources**
- **Additional sources**
 - **Fiduciary law is based on common law of trusts**
 - **Created hundreds of years ago and developed over time by case law**
 - **General Trust Law**
 - **Trust Components**
 - **Settlor creates the trust**
 - **Trustees govern the operations of the trust**
 - **Beneficiary receives benefits (usually money) from the trust**
 - **Restatement of Trusts**
 - **Incorporates the Prudent Investor Rule (1992)**

Common Law Underpinnings

- **Common Law**
 - **Duty of Care**
 - Act in good faith, in the best interest of the entity
 - Standard: ordinarily prudent person acting under similar circumstances
 - **Duty of Loyalty**
 - Put entity's interests ahead of personal interests
 - Act solely for the benefit of participants and beneficiaries
 - **Duty of Obedience**
 - Follow governing documents and the entity's mission
 - Comply with the law
 - Seek professional assistance where necessary
- **Duties Derived from Common Law**
 - **Duty of Prudence**
 - **Duty of Loyalty**
 - **Diversification**
 - **Adherence to Program Documents (Duty of Obedience)**
 - **Prohibited Transactions**

Federal Guidance on Fiduciaries

- **ABLE Plans may look at other Federal laws for Guidance:**
 - **Public retirement plans rely upon ERISA for fiduciary standards**
 - **Unregistered funds and separate accounts may look to the Investment Company Act of 1940 standards for governance**
 - **A combination of both may provide appropriate governance guidance for the CalABLE Board**
- **ERISA on Fiduciaries:**
 - **Fiduciary status is based on the *functions performed for the plan, not just a person's title.***
 - **Fiduciaries are held to a “prudent expert standard”:**
 - **“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 like character and with like aims...” ***
 - **Fiduciaries include the trustee, investment advisers, municipal advisors and any individuals exercising discretion in plan administration**
 - **Attorneys, accountants and actuaries are not fiduciaries when acting in their professional capacity**

* ERISA 404(a)(I)(B) (*Emphasis added*)

Investment Company Act of 1940 Governance Standards

- **Directors of investment companies and public companies generally share common responsibilities**
- **Examples of duties specific to investment company directors:**
 - **Approve timing of Net Asset Value calculations and procedures for valuation of securities**
 - **Approve trading practices and procedures**
 - **Approve investment objectives and policies**
 - **Monitor credit quality and valuation of money markets**
 - **Approve distribution plan of open-ended funds pursuant to Rule 12b-1**

Federal Securities Law Foundation

- **California's Qualified ABLE Program Act establishes the Board as the creator of a municipal trust:**
 - CalABLE participants open ABLE accounts
 - Contributions to CalABLE accounts are invested in units of the trust, which units are "municipal securities"
- **Securities Act of 1933:**
 - Municipal securities are exempt from registration
- **Securities Exchange Act of 1934:**
 - Municipal securities are exempt from most reporting requirements
- **Trust Indenture Act of 1939:**
 - Provisions do not apply to municipal securities

Federal Securities Law Foundation, cont'd

- **Investment Company Act of 1940 and Investment Advisers Act of 1940:**
 - Provisions do not apply to instrumentalities of a State or agents “acting in the course of official duty”
- **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:**
 - Advisers to municipal entities are subject to varying degrees of oversight by FINRA, the MSRB and applicable Bank Regulators

Importance of the '33 and '34 Acts Together

- An exempt issuer does not have to register securities or sales of securities
 - Interests issued by municipal trusts are exempt from registration
- BUT anti-fraud provisions of both Acts *always* apply:
 - Section 17(a) – Fraudulent Interstate Transactions ('33 Act)
 - Section 10(b) – Manipulative and Deceptive Devices ('34 Act)
 - Rule 10b-5 – Employment of Manipulative and Deceptive Devices ('34 Act)
- “10b-5” Anti-Fraud Standard:
 - “It is unlawful to make *any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading*”

Section 2

Fundamentals of Fiduciary Duties

Who is a Fiduciary?

- **Board members are the highest level fiduciaries with the broadest responsibility**
- **Others may be fiduciaries, too, by contract or by virtue of the work they perform**
- **Some internal (executive) staff are fiduciaries**
- **Test is whether they have discretion**
- **Investment managers and consultants are usually fiduciaries but not all outside service providers such as auditors and attorneys**
- **Test is whether a person has discretion and control over the administration of the plan or management of the assets (not performance of ministerial tasks)**
- **A breach of fiduciary duty can lead to serious consequences such as personal liability and reputational risk of the Program causing an erosion of stakeholder confidence**

Fiduciary Duties

- The most important duties for CalABLE fiduciaries are those of loyalty, prudence and Program Document adherence
- **Duty of Loyalty**
 - Unwavering commitment to stay focused on the interests of the participants in the Program
- **Duty of Prudence**
 - Requires expertise and more than a good faith attempt to try to do the right thing
 - *“The Board... shall discharge their duties as fiduciaries...by investing with the care, skill, prudence and diligence...that a prudent person would use...”*
- **Duty of Obedience (i.e., to follow Program Documents)**
 - Follow the California Qualified ABLE Program Act and CalABLE Regulations

Fiduciary Duties, cont'd

- **Other fiduciary duties flow from the key fiduciary duties of loyalty, prudence and adherence:**
 - **Duty to diversify**
 - **Flows from the duty of prudence**
 - **Considers diversifying investment choices unless not prudent**
 - **Duty to refrain from prohibited transactions**
 - **Duty to delegate**
 - **Board is the ultimate fiduciary for the Program**
 - **Duty of prudence allows delegation but not abdication**
 - **Appropriate monitoring not able to be delegated**

Duty of Loyalty

- Also known as the “Exclusive Benefit Rule”
 - *"The assets of the trust, including the program fund, shall at all times be preserved, invested, and expended solely and only for the purposes of the trust and shall be held in trust for the designated beneficiaries..."*
§ 4878 (i) of the Qualified ABLE Program Act
- Interpretation of loyalty
 - When creating policies or making other decisions for the Program, Board members can “only wear one hat ”
 - Courts have held that a trustee may not wear a second hat as a representative of an entity that may have appointed him or her to the fiduciary position
 - Board members are not to balance interests of outside parties
 - Board members are not to act in their own self-interest

Duty of Loyalty, cont'd

- Each Board member has a fiduciary duty that is owed to all beneficiaries of the trust
- There will be those who expect you to represent them and be their advocates when you serve on the Board, but
 - No fiduciary duty is owed to whoever appointed you
 - No fiduciary duty is owed to the local business community
 - No fiduciary duty is owed to taxpayers of the State
 - No fiduciary duty is owed to the Legislature or Executive Branch
- Regardless of how one comes to serve on the Board, the fiduciary duty is the same for each member

Duty of Loyalty, cont'd

- **Duty to pay only reasonable Program expenses also flows from the duty of loyalty**
 - **Paying expenses from trust assets is a fiduciary decision**
 - **Expenses must be reasonable and necessary for the administration of the trust**
 - **Not incurred “but for” trust administration**
 - **Reasonable does not mean the least costly**

Duty of Loyalty, cont'd

- **Duty of Loyalty also encompasses the laws relating to conflicts of interest**
 - **Even the appearance of a conflict of interest must be avoided**
 - **If avoidance is not possible, conflicts must be disclosed promptly and managed**
 - **Recusal from votes and not taking some actions might be necessary**
- **Bottom line – fiduciary duty takes precedence over other duties**
- **Laws are complex so it is important to check with legal counsel if there is any doubt as to whether a conflict of interest exists**

Duty of Prudence

Prudent: exercising sound judgment in practical matters; cautious in conduct; sensible; not rash ---- Webster's Dictionary

*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 investments succeeded or failed. ---- Donovan v. Cunningham*

- Variety of terms
 - Prudent man: ordinary care that you would use with your own property; a lower standard than is expected today of Board members
 - Prudent person: politically correct version of “prudent man”
 - Prudent investor: comes from the Uniform Prudent Investor Act, adopted in nearly all states and follows modern portfolio theory
 - Prudent expert: the ERISA standard, which is the highest standard of care; this is the recommended standard

Duty of Prudence, cont'd

- **Duty of prudence requires more than a good faith attempt to do the right thing:**
 - **Understand facts and what is being voted on**
 - **Investigate options, review information on what others are doing**
 - **Seek expert advice**
 - **Delegation mitigates risk as long as delegation process was prudent**
- **A good process is more important than a good outcome:**
 - **Best defense to potential liability**
 - **Board members are judged by the “prudence” of their process**
 - **Written documentation is critical**
- **Delegation still requires an ongoing duty to monitor**
- **Law requires prudence, not perfection!**

Duty of Obedience

- Trustees have a duty to follow the written terms of a trust without deviating from any requirements
- For all fiduciaries, the duty is often stated as the duty to follow “Program Documents”
- For CalABLE, the enabling statute is the primary Document (e.g., Chapter 15 of the Qualified ABLE Program Act). Other federal and state laws and regulations may also be applicable.
- “Program Document” also includes other documents that the Board has formally adopted (e.g., the CalABLE Program Disclosure Statement)
 - Regulations, Policies and Procedures (e.g., the Investment Policy Statement), etc.
 - Open meetings and open records laws are usually incorporated by reference and thereby become part of the Program Documents

Fiduciary Liability

- **Laws governing public fund fiduciaries may impose liability for breach of duty; sovereign immunity laws may apply in some cases**
- **When fiduciaries delegate responsibility the liability is shifted**
 - **Oversight is still required**
 - **The delegation must continue to be prudent**
- **Consequence of breach of duty**
 - **Personally liable to make good any losses to the Program resulting from the breach and to restore any profits which have been made through use of Program assets**
 - **Other equitable or remedial relief as a court may deem appropriate**
 - **Liability usually not relieved in bankruptcy**
- **Attorney-client privilege may run to the Program rather than to an individual fiduciary**

Co-Fiduciary Liability

- **Co-fiduciary liability means “you are your brother’s keeper” or “the duty to squeal”**
- **Liability can result if a fiduciary enables, knowingly participates in, or knowingly undertakes to conceal a breach by another fiduciary**
- **For liability to attach, you must have actual knowledge of an action that you know to be a breach**
- **A fiduciary has a duty to speak up and take reasonable steps to prevent or halt a co-fiduciary’s breach**
- **Resignation from the Board is usually not sufficient**

Mitigating Fiduciary Liability

- **Initial orientation and continuing education on fiduciary responsibility**
- **Clear understanding of fiduciary duty and common examples where fiduciary duties exist**
- **Thorough, detailed and disciplined decision-making process with clear documentation of actions and rationale**
- **Obtain expert advice from legal counsel, staff and others, as appropriate**
- **Prudent delegation and diligent oversight – critical to understand what authority has been delegated and what has been retained**
- **Good Board governance policies including clearly defined roles and responsibilities, accountability, and a commitment to continual oversight**

Summary of Board Member's Responsibilities

- Act in the interest of CalABLE beneficiaries
- Carry out duties prudently
- Follow CalABLE Program Documents
- Diversify Program investments
- Pay only reasonable Program expenses
- Seek the assistance of an independent expert if the Board member does not possess the education, experience or skill necessary to carry out his/her duties
- Understand the subject matter in order to question or challenge advice
- Do not abdicate fiduciary duties

Section 3

Good Governance Practices

Good Governance

- **Governance is the structure, manner, and process by which a Board exercises authority or control**
- **Good governance begins with understanding of fiduciary duty**
- **Good governance policies and practices can help Boards meet fiduciary responsibilities**
- **Governance is not:**
 - **Management**
 - **Day-to-day operations**
 - **Tactical decisions**
 - **Staff functions**
 - **Details of policy implementation**

Essential Elements of Good Governance

- **Accountability**
- **Transparency**
- **Adherence to laws, rules and policies**
- **Effectiveness and efficiency**
- **Inclusiveness – engaging in participatory processes**
- **Maintaining clear distinction between roles of the Board, the Executive Director and the staff**
- **Future focus that has an outward vision rather than internal preoccupation**

Processes for Governance

- **Procurement Processes:**
 - **Delineate appropriate roles for Board and staff in –**
 - **Development and approval of RFPs**
 - **Evaluation of responses**
 - **Final approval of contracts**
 - **Staff should ensure open and fair solicitations**
 - **Recommendations should reflect weighted criteria that bidders understand**
 - **If sole source procurement, basis for closed process should be clear**
- **Establishment of Performance Benchmarks:**
 - **Administration and operations**
 - **Marketing costs and results**
 - **Investment policies and performance targets**
- **Investment Policy Statements and Monitoring Criteria:**
 - **Establish roles, responsibilities and process**
 - **Also defines selection criteria and monitoring procedures**
 - **Ramifications for underperformance should be clear**

Processes for Governance, cont'd

- **On-going Reviews:**
 - **Monthly investment results to key staff and independent Investment Consultant from Investment Manager**
 - **Quarterly reports to the Board from Program Manager (including the Investment Manager) and the independent Investment Consultant**

Summary

- **All Board members are fiduciaries and have strict legal requirements they operate under**
- **Board members may delegate certain duties but cannot abdicate their overall fiduciary responsibility**
- **The duties of prudence and loyalty are most important**
- **The duty to follow the law and Program Documents is critical as well**
- **Seek advice about fiduciary issues when in doubt**
- **There are serious consequences when fiduciary duties are breached**
- **A culture of good governance adds both tangible and intangible value**

Appendix 1

Checklist – Common and Best Practices

Checklist – Common and Best Practices

- **Prepare for all meetings**
- **Diligently attend all Board and assigned committee meetings**
- **Act in good faith and in the best interest of participants and beneficiaries in all decision making**
- **Be familiar with and abide by all applicable laws, regulations and Program Documents**
- **Delegate, where appropriate, to experts pursuant to a prudent process**
- **Establish and document prudent processes**
- **Periodically review policies and procedures to ensure consistency and relevancy**
- **Differentiate Board policies from management policies**
- **Take actions consistent with the mission and policies of the Program**

Checklist – Common and Best Practices, cont'd

- **Perform continual oversight – applies to Board and staff**
- **Institute reporting tools and procedures that facilitate oversight:**
 - **Internal Sources examples –**
 - **Executive Director Reports**
 - **Internal Audit**
 - **Risk Management Dashboard**
 - **External Sources examples –**
 - **Investment Manager(s) and Investment Consultant**
 - **External Auditors**
 - **Custodian Bank**

Checklist – Common and Best Practices, cont'd

- **Clearly define and enumerate roles and responsibilities between the Board and staff**
- **Regular review of efficiency and effectiveness of the Program's goals**
- **Assess performance and actions of staff and service providers (e.g., Program Manager and Investment Managers, consultants and auditors)**
- **Benchmark operations to similar programs and best practices**
- **Develop and maintain comprehensive charters for the Board and committees**
- **Obtain independent expert advice**

Checklist – Common and Best Practices, cont'd

- **Require transparency and accountability**
- **Communicate with all stakeholders in a timely, accurate and transparent manner**
- **Maintain confidentiality of participant and beneficiary information**
- **Offer orientation and continuing education on relevant topics**

Appendix 2

Statutory and Regulatory Sources

Uniform Prudent Investor Act (“UPIA”)

- Reflects changes in investment practice since the late 1960s, specifically with regard to modern portfolio theory
- Establishes that standard of prudence applies to any investment in the context of the total portfolio, rather than to individual investments
- Allows trustees to delegate investment management functions, subject to appropriate safeguards (such delegation was expressly forbidden by the former trust law)
- Fosters a greater degree of diversification in investment portfolios and allows for derivatives, commodities and futures:
 - Despite these investments individually having a relatively higher degree of risk, they could potentially reduce overall portfolio risk and boost returns when considered in a total portfolio context.
- uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf

Securities Act of 1933 (the “33 Act”)

- Exempts issuers of municipal securities from registration (Section 3(a)(2))
- “Truth in securities” has two basic objectives:
 - Requires that investors receive financial and other significant information about securities being offered
 - Prohibits deceit and misrepresentation in the sale of securities
- [sec.gov/about/laws/sa33.pdf](https://www.sec.gov/about/laws/sa33.pdf)

Securities Exchange Act of 1934 (the “34 Act”)

- Created the SEC and empowers it to register, regulate and oversee:
 - Brokerage firms, clearing agencies and transfer agents
 - Self regulatory organizations (“SROs”) including Financial Industry Regulatory Authority (“FINRA”) and the Municipal Securities Rulemaking Board (“MSRB”)
- Establishes periodic reporting requirements for registered entities or transactions
 - Municipal securities generally are exempt from reporting requirements (Section 3(a)(29))
 - BUT some initial and ongoing disclosures apply (Rule 15c2-12)
- Identifies and prohibits deceitful conduct
- Grants the SEC disciplinary powers over regulated entities and the persons associated with them
 - SROs are essential to the entire process (municipal broker-dealers may not contravene any rules of the MSRB (Section 15B))
- [sec.gov/about/laws/sea34.pdf](https://www.sec.gov/about/laws/sea34.pdf)

Trust Indenture Act of 1939

- **Applies to debt securities – including bonds and interests in publically offered trusts**
- **Requires a trustee to protect and enforce the rights of bondholders and rights must be included in a trust indenture**
- **Municipal trusts are exempt based upon '33 Act exemption (Section 304(a)(4)(A))**
- [sec.gov/about/laws/tia39.pdf](https://www.sec.gov/about/laws/tia39.pdf)

Investment Company Act of 1940 (the “40 Act”)

- **Regulates companies that engage primarily in investing, reinvesting and trading in securities**
- **Focus of the Act is to provide the public with information about a fund and its objectives, and about the investment company structure and operations**
- **Explicitly not applicable to government entities or officers or employees “acting as such in the course of his official duty” (Section 2(b))**
- **[sec.gov/about/laws/ica40.pdf](https://www.sec.gov/about/laws/ica40.pdf)**

Investment Advisers Act of 1940 (the “Advisers Act”)

- Firms that provide advice about securities investments must conform to regulations designed to protect investors:
 - Advisers with more than \$100 million in client assets must file Form ADV with SEC
 - If assets > \$25 million but < \$100 million, adviser registers with state
- Does not apply to states or subdivisions or to officers or employees “acting as such in the course of his official duty” (Section 202(b))
- [sec.gov/about/laws/iaa40.pdf](https://www.sec.gov/about/laws/iaa40.pdf)

Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

- Amends Section 15B ('34 Act) to require registration of municipal advisors and imposes fiduciary duty on them
- "Municipal advisor" is any person that provides advice to or on behalf of a municipal entity regarding municipal securities, including advice with respect to the structure, timing, terms and similar matters concerning such issues
- Excludes registered Investment Advisers, attorneys offering "legal advice", engineers and accountants
- Act also creates the Consumer Financial Protection Bureau
- sec.gov/about/laws/wallstreetreform-cpa.pdf

Municipal Securities Rulemaking Board (“MSRB”)

- **Established by Congress in 1975:**
 - **Mission is to protect investors, municipal entities and obligated persons, and to promote a fair and efficient municipal market**
 - **Operates Electronic Municipal Market Access (“EMMA”) to promote transparency and provide widespread access to information**
- **MSRB rules are intended to:**
 - **Prevent fraudulent or manipulative practices**
 - **Promote just and equitable principles of trade**
- **Has no enforcement powers – its rules are enforced by:**
 - **FINRA for securities firms**
 - **Office of the Comptroller of the Currency, the Federal Reserve, or the FDIC for banks**
 - **SEC for municipal advisors, securities firms and bank dealers**
- **Bottom line: jurisdiction is over securities firms, municipal dealers and municipal advisors, NOT municipal issuers**
- **msrb.org**