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**NOVEMBER 17, 2020**

**AGENDA ITEM 6  
INFORMATION ITEM**

**CALIFORNIA ABLE ACT BOARD**

***Review of Board Fiduciary and Governance Training and Best Practices - AKF Consulting***

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***Information Item***

The California ABLE Act Board will review and discuss the importance of having an annual fiduciary training provided by Ms. Andrea Feirstein with AKF Consulting. This training and its regular updates provides protection for Board members by establishing sound and consistent procedures that govern their decision-making. The session planned is intended to:

- Remind Board members of why they are deemed to be fiduciaries
- Review what being a fiduciary means
- Summarize the rules and best practices that fiduciaries should follow
- Provide guidance and checklists on how to follow those rules

# California ABLE Act Board

## Fiduciary and Governance Training

November 17, 2020

## Today's Discussion

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**Appendix 1: Checklist – Common and Best Practices**

**Appendix 2: Statutory and Regulatory Sources**

## **Section 1.**

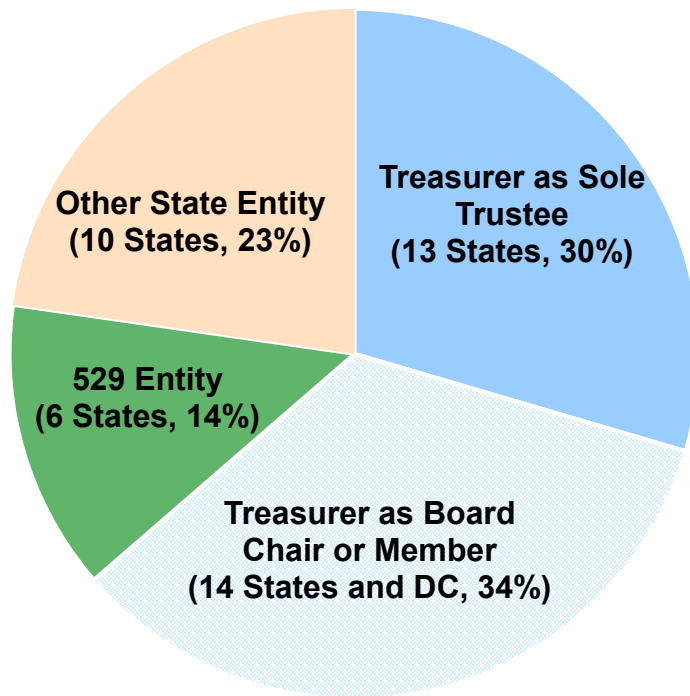
# **Oversight and Fiduciary Duties of Administrators**

## Administrators of ABLE Programs

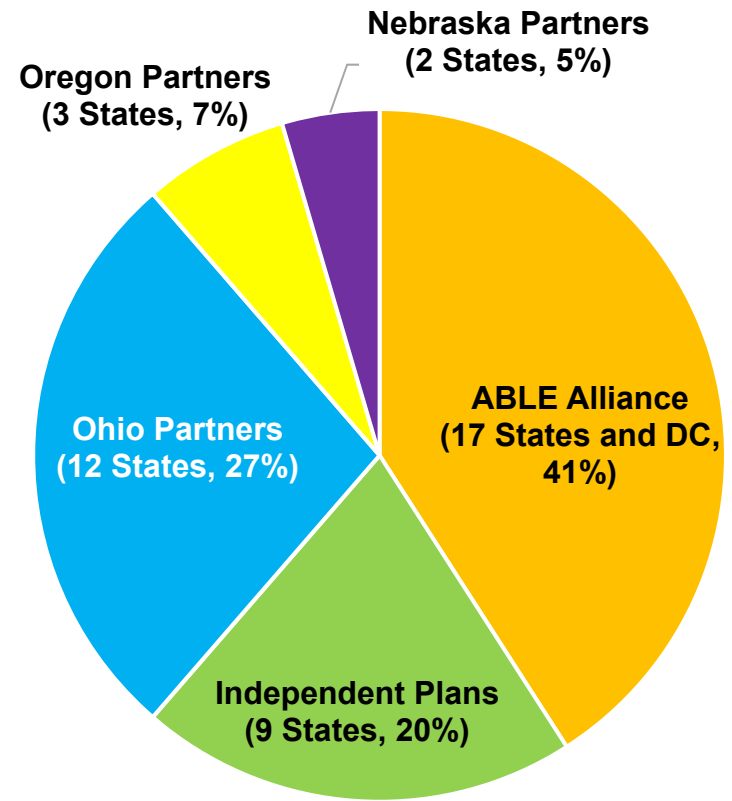
- **Pursuant to Section 529A, states, agencies or instrumentalities “establish and maintain” qualified tuition programs**
- **State legislation authorizes each State’s Program:**
  - Identifies the administrator
  - Sets the oversight duties and obligations
  - May identify management models as well
- **Governance and oversight vary by the organization responsible for maintaining each Program**

# ABLE Oversight and Management

## State Oversight



## Business Model



Data current as of October 26, 2020

## ABLE Program Oversight and Governance

- **Regardless of administration, boards and trustees are fiduciaries**
- **Other parties also may be fiduciaries**
- **Breaches of fiduciary duty have serious consequences**
- **Understanding the duties and implementing thorough decision-making processes mitigate the risk of a fiduciary breach**

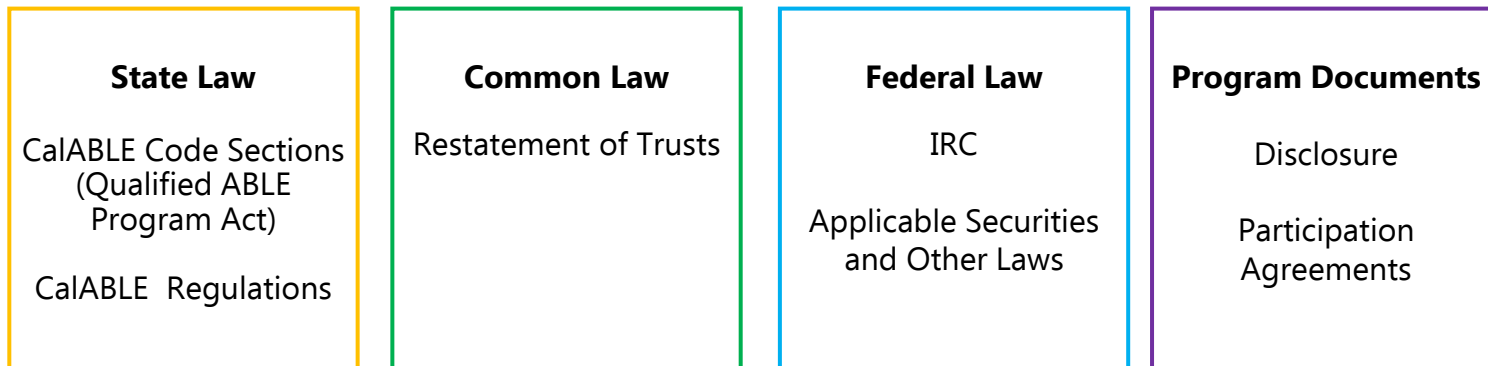
## Who is a Fiduciary?

- **Boards and trustees** are the highest-level fiduciaries with the broadest responsibility
- **Others** may be fiduciaries, too, by virtue of the work they perform or by contract:
  - Executive Directors
  - Investment managers and municipal advisors
  - Not auditors or attorneys
- **Determined by work performed:**
  - Do they have discretion over program administration or management of the assets
  - Not merely the performance of ministerial tasks



## Sources of Fiduciary Duties

- **California Code Sections authorizing and establishing CalABLE are primary sources**
- **Fiduciaries are held to extremely high standards of conduct**
- **Sources for and guidance on fiduciary duties:**



## Common Law Underpinnings

- **Duty of Care:**
  - Act in good faith, in the best interest of the entity
  - Standard: ordinarily prudent person acting under similar circumstances
  - Seek professional assistance where necessary
- **Duty of Loyalty:**
  - Put entity's interests ahead of personal interests
  - Act solely for the benefit of designated beneficiaries
- **Duty of Obedience:**
  - Follow governing documents and the entity's mission
  - Comply with the law

## CalABLE's Fiduciary Duties

- **The most important duties for CalABLE fiduciaries are those of loyalty, prudence and Program document adherence**
- **Duty of Loyalty:**
  - "Exclusive benefit rule"
  - Unwavering commitment to stay focused on the interests of the designated beneficiaries in the Program
- **Duty of Prudence:**
  - The Board is required to discharge its duties as fiduciaries by investing with the care, skill, prudence and diligence...that a prudent person would use
  - Requires expertise and more than a good faith attempt to try to do the right thing
  - Test of prudence is CONDUCT, not RESULTS
- **Duty of Obedience:**
  - Follow the California Qualified ABLE Program Act and CalABLE Regulations

## 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 designated beneficiaries in 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**

## Additional Fiduciary Duties

- **Duty to Diversify:**
  - Flows from prudence
  - Investments should be diversified unless not prudent
- **Duty to Refrain from Prohibited Transactions:**
  - Avoid self-dealing and all conflicts of interest
- **Duty to Delegate:**
  - Prudence allows for delegation but not abdication
  - Boards cannot delegate appropriate monitoring

## Federal Guidance on Fiduciaries

- **Employee Retirement Income Security Act of 1974 (“ERISA”)** may provide some fiduciary standards
- **Investment Company Act of 1940 (“40 Act”)** can provide governance standards for unregistered investment options
- **Internal Revenue Code of 1986**, as amended, on non-profits can provide governance considerations
- **Uniform Prudent Investor Act (“UPIA”)** establishes standards of prudence for investment portfolios

## ERISA on Fiduciaries

- **Generally, ERISA does not apply to governmental plans, i.e. State-run investment plans**
- **Status is based on the functions performed, not just a person's title, 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..." \*
- **Includes the trustee, investment advisers and individuals exercising discretion in administration**
- **Excludes attorneys, accountants and actuaries acting in their professional capacity**

\* ERISA 404(a)(1)(B) (*Emphasis added*)



## '40 Act on Governance Duties

- **Directors of investment companies and public companies generally share common responsibilities**
- **Examples of duties specific to investment company directors:**
  - Approve time of NAV calculations and procedures for valuation of securities
  - Approve trading practices and procedures
  - Approve investment objectives and policies
  - Monitor credit quality and valuation of funds

## Federal Securities Law Foundation

- **California's Qualified ABLE Program Act establishes the trust as an instrumentality of the State:**
  - CalABLE designated beneficiaries open ABLE accounts
  - Contributions to CalABLE accounts are invested in units of the trust
  - The trust units are "municipal securities"\*
- **Securities Act of 1933:**
  - Municipal securities are exempt from registration
  - *Anti-fraud provisions apply to issuers*
- **Securities Exchange Act of 1934:**
  - Municipal securities are exempt from most reporting requirements
  - *Municipal securities are subject to anti-fraud provisions*
- **Trust Indenture Act of 1939:**
  - Provisions do not apply to municipal securities

\* Interpretations of Rule D-12 of the Municipal Securities Rulemaking Board specify that interests in 529 and 529A that constitute municipal securities are referred to as "municipal fund securities" (Interpretations, January 18, 2001 and April 12, 2016. A municipal fund security is a municipal security that, but for application of Section 2(b) of the Investment Company Act of 1940, would be an investment company.

## 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

- **Municipal trusts do not register securities or sales of securities**
- **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)
- **Content is always subject to anti-fraud prohibitions of securities laws:**
  - *"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"*
  - *Interpretation:* You cannot misstate a **material** fact and you can't fail to state a **material** fact IF that **material** fact would make the statement not misleading ... In other words, if that **material** fact would have caused the investor not to be misled...or maybe not to have invested

## Fiduciary Liability

- **Laws governing fiduciaries may impose liability for breach of duty:**
  - Sovereign immunity may apply
- **Delegating responsibility may shift the liability BUT:**
  - Oversight is still required
  - Delegation must continue to be prudent
- **Consequences of breach of duty:**
  - Personal liability for losses and restoration of profits that 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

- **“You are your brother’s and sister’s keeper” ... “you have a duty to squeal”**
- **Liability can result if a fiduciary enables, knowingly participates in, or knowingly undertakes to conceal a breach by another fiduciary**
- **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

- **Have a clear understanding of fiduciary duty and where it exists**
- **Establish disciplined and thorough decision-making processes**
- **Obtain expert advice as appropriate**
- **Be prudent in delegations and diligent in oversight**
- **Initial orientation and continuing education on fiduciary responsibility**

## Summary of Board Member's Responsibilities

- **Act in the interest of CalABLE designated beneficiaries**
- **Understand the subject matter (seek expert advice if necessary)**
- **Carry out duties prudently**
- **Follow CalABLE Program Documents**
- **Diversify Program investments**
- **Pay only reasonable expenses**
- **Delegate but do not abdicate fiduciary duties**



## **Section 2.**

# **Guidance on Good Governance**

## What is Governance?

- **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**
- **Inclusiveness – engaging in participatory processes**
- **Clear distinction between roles of the Board and the staff**

## Exhibiting Good Governance

- **Procurement Processes**
- **Investment Policy Statements**
- **Performance Benchmarks (Administrative and Marketing)**
- **On-going Program and Investment Reviews**

## Governance Best Practices

- **Prepare for and attend all meetings**
- **Act in good faith and in the best interest of all designated beneficiaries**
- **Know and abide by applicable laws, regulations and Program policies**
- **Where appropriate, delegate to experts but maintain vigilant oversight**
- **Establish and document prudent processes; review regularly to ensure consistency and relevancy**

## The Bottom Line

- **Prudence is more than just trying to do the right thing:**
  - Understand what's being voted on
  - Investigate all options
  - Seek expert advice
- **A good process is more important than a good outcome:**
  - Written procedures are critical
  - Following established procedures and written policies is the best defense to liability
- **Fiduciary duties require prudence, not necessarily perfection!**

## **Appendix 1.**

# **Checklist – Common and Best Practices**

## Checklist – Common and Best Practices

- **Prepare for and attend all meetings**
- **Act in good faith and in the best interest of designated 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 –
    - Program Administrator
    - Investment Manager(s)
    - Investment and Program Consultants
    - Independent Auditors
- **Clearly define and enumerate roles and responsibilities between the Board and staff**
- **Regular review of efficiency and effectiveness of the Program's goals**

## Checklist – Common and Best Practices, cont'd

- **Assess performance and actions of staff and service providers**
- **Benchmark operations to similar programs and best practices**
- **Obtain independent expert advice**
- **Require transparency and accountability**
- **Communicate with all stakeholders in a timely, accurate and transparent manner**
- **Maintain confidentiality of designated beneficiary information**
- **Offer orientation and continuing education on relevant topics**

# Appendix 2.

## Statutory and Regulatory Sources

## Employee Retirement Income Security Act of 1974 (“ERISA”)

- **Federal law that establishes minimum standards for pension plans in private industry regarding participation, vesting, benefit accrual and funding**
- **ERISA plans must provide participants with information about plan features and funding, and furnish information regularly and free of charge**
- **Provides extensive rules on the federal income tax effects of transactions associated with employee benefit plans**
- **ERISA requires accountability of plan fiduciaries, and, in addition to insuring participants are informed, it also gives participants the right to sue for benefits and breaches of fiduciary duty**
- **[Pub.L. 93-406, 88 Stat. 829, enacted September 2, 1974, codified in part at 29 U.S.C. ch. 18](#)**

## 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.
- <http://uniformlaws.org/home>

## 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
- <https://www.sec.gov/answers/about-lawsshtml.html#secact1933>

## 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))
- <https://www.sec.gov/answers/about-lawsshtml.html#secexact1934>

## 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))**
- **<https://www.sec.gov/answers/about-lawsshtml.html#trustinact1939>**



## 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))**
- **<https://www.sec.gov/answers/about-lawsshtml.html#invcoact1940>**

## 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))**
- <https://www.sec.gov/answers/about-lawsshtml.html#invadvact1940>

## **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**
- **<https://www.sec.gov/answers/about-lawsshtml.html#df2010>**

## 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](http://msrb.org)

# AKF Legal Disclosure

Pursuant to Municipal Securities Rulemaking Board (“MSRB”) Rule G-42, on Duties of Non-Solicitor Municipal Advisors, Municipal Advisors are required to make certain written disclosures to clients and potential clients which include, among other things, Conflicts of Interest and Legal or Disciplinary events of AKF and its associated persons.

## **Conflicts of Interest** ***Compensation***

AKF represents that in connection with the issuance of municipal fund securities, AKF receives compensation from its client issuers for services rendered on an hourly, retainer or fixed fee basis. Consistent with the requirements of MSRB Rule G-42, AKF hereby discloses that such forms of compensation may present a potential conflict of interest regarding AKF’s ability to provide unbiased advice regarding a municipal fund security transaction. This potential conflict of interest will not impair AKF’s ability to render unbiased and competent advice or to fulfill its fiduciary duty.

## ***Other Municipal Advisor Relationships***

AKF serves a wide variety of clients that may from time to time have interests that could have a direct or indirect impact on the interests of other AKF clients. For example, AKF serves as Municipal Advisor to other municipal fund securities clients and, in such cases, owes a regulatory duty to such clients just as it will with the entity receiving this presentation, if hired. These other clients may, from time to time and depending on the specific circumstances, have competing interests. In acting in the interests of its various clients, AKF could potentially face a conflict of interest arising from these competing client interests. AKF fulfills its regulatory duty and mitigates such conflicts by dealing honestly and with the utmost good faith with all clients.

If AKF becomes aware of any potential or actual conflicts of interest after this disclosure, AKF will disclose the detailed information in writing to the client or obligated person in a timely manner.

## **Legal or Disciplinary Events**

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