Ethical Decision-Making for Pension Plan Trustees

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Based on A Primer for Investment Trustees by Jeffery V. Bailey, CFA; Jesse L. Phillips, CFA; and Thomas M. Richards, CFA (C) 2011 The Research Foundation of CFA Institute
CFA Institute Resources

A Primer for Investment Trustees

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CODE OF CONDUCT FOR MEMBERS OF A PENSION SCHEME GOVERNING BODY

CFA Institute
A PRIMER FOR INVESTMENT TRUSTEES

- Governance Structure
- Investment Policy
- The Fund’s Mission
- Investment Objectives
- Investment Risk Tolerance
- Investment Assets
- Performance Evaluation
- ETHICS
ETHICAL DECISION-MAKING FOR TRUSTEES

- Fundamental Ethical Principles
- Ethical Decision-Making Framework
- Applying the EDM Framework: CASES
Identify Ethical Issues before they become Real Problems

- Harm to interests of beneficiaries/participants
- Regulatory enforcement actions
- Civil liability
- Criminal convictions
- Reputational damage
- Ethics investigations
TYPICAL ETHICAL ISSUES FACED BY TRUSTEES

• Expenditure of plan assets
• Relationships with third-parties
• Gifts
• Using position for personal gain
• “Pay-to-play”
• Other conflicts of interest
Fundamental Ethical Principles

CFA Institute Pension Trustee Code of Conduct

1. Act in the best interests of plan participants
2. Use reasonable care and prudent judgment
3. Act with skill, competence, diligence
4. Maintain independence and objectivity
5. Abide applicable law
6. Deal fairly among plan participants
7. Act consistently with the plan mission
8. Review/monitor effectiveness of service providers.
9. Maintain confidentiality
10. Communication/transparency
IDENTIFY THE ETHICAL PRINCIPLE

A airline company indicates that its mounting operational expenses are likely to put the financial viability of the company in jeopardy. The company proposes to reduce benefit levels for all participants and beneficiaries going forward to keep the company afloat.

A. Act in the best interests of plan participants
B. Act with skill, competence, and diligence.
C. Act with prudence and reasonable care.
D. Abide by all applicable law.
E. Maintain independence and objectivity.
1. **Act in good faith and the best interest of the plan participants and beneficiaries**

- Consider different types of beneficiaries and participants
- Earn long term returns v. Make existing payments
- Hold their interests above interests of plan sponsor
- Do not be swayed by outside interests
- Consider position of other stakeholders
IDENTIFY THE ETHICAL PRINCIPLE

A policeman, who serves as the union representative on a municipal pension plan, listens to the recommendations and advice of the plan’s consultants and outside investment advisors before making any investment decision. The board follows the recommendations of outside plan 95% of the time.

A. Act in the best interests of plan beneficiaries/participants
B. Act with skill, competence, and diligence.
C. Act with prudence and reasonable care.
D. Abide by all applicable law.
E. Maintain independence and objectivity.
2. Act with prudence and reasonable care

- Avoid harm to scheme participants & beneficiaries
- Act in good faith
- Follow plan parameters
- Rely on third party service providers
- Delegation to internal professional experts
A pension plan trustee on the investment committee regularly attends conferences, at the plan’s expense, to increase his understanding of investment issues. Her colleague, who sits on several other boards, regularly misses meetings and neglects to review material prepared by the investment staff.

A. Act in the best interests of plan beneficiaries/participants
B. Act with skill, competence, and diligence.
C. Act with prudence and reasonable care.
D. Abide by all applicable law.
E. Maintain independence and objectivity.
3. **Act with skill, competence, and diligence**

- Knowledge of: Policies, strategies, investments, etc.
- Some investments may require more thorough investigation
- Engage in educational, training opportunities
- Seek appropriate professional guidance
A pension trustee is appointed to the pension board by the union that represents 75% of company employees. The union asks the trustee to vote against a proposal it deems unfair to its members.

A. Act in the best interests of plan beneficiaries/participants
B. Act with skill, competence, and diligence.
C. Act with prudence and reasonable care.
D. Abide by all applicable law.
E. Maintain independence and objectivity.
4. **Maintain independence and objectivity by avoiding conflicts of interest**

- Avoid appearance of impropriety
- Place duty to pension plan ahead of appointing entity
- Avoid personal conflicts
- Avoid relationship with service providers
- Refuse gifts
- Ensure policies and procedures in place to address conflicts
- Disclose conflicts
IDENTIFY THE ETHICAL PRINCIPLE

A trustee serves on the board of a pension plan for a global manufacturing firm with employees in several countries. The trustee seeks advice from the plan’s outside attorney about whether a change of benefits proposal would appropriate in each of those countries.

A. Act in the best interests of plan beneficiaries/participants
B. Act with skill, competence, and diligence.
C. Act with prudence and reasonable care.
D. Abide by all applicable law.
E. Maintain independence and objectivity.
5. **Abide by all applicable laws, rules, and regulations, including the terms of the plan documents**

- Consult with professional advisors
- Ensure updated compliance procedures
- Report suspected illegal activities, irregularities
IDENTIFY THE ETHICAL PRINCIPLE

To reduce the pension liability and improve long-term financial health and viability of the plan for current employees, a trustee proposes to eliminate benefits for the immediate family members of deceased plan members.

A. Deal fairly and objectively with plan beneficiaries/participants
B. Review the performance and actions of plan service providers.
C. Act consistently with the mission and the policies of the plan.
D. Engage in timely, accurate, and transparent communication.
E. Maintain confidentially of plan/beneficiary/participant information.
6. **Deal fairly, objectively, and impartially with all participants and beneficiaries**

- No preferential treatment to a particular class
- Balance interests of all beneficiaries and participants
In 1998, the pension plan for a large global organization adopted socially responsible investment policies at the behest of its employees. Now, several trustees are pushing for investment in coal, nuclear, and oil production companies that have recently enjoyed excellent financial returns as a way to boost the lagging performance of the plan.

A. Deal fairly and objectively with plan beneficiaries/participants
B. Review the performance and actions of plan service providers.
C. Act consistently with the mission and the policies of the plan.
D. Engage in timely, accurate, and transparent communication.
E. Maintain confidentially of plan/beneficiary/participant information.
7. Take actions that are consistent with the established mission and the policies that support that mission

- Draft and review policies addressing risk tolerances, return objectives, liquidity requirements, tax considerations, etc.
- Take action consistent with policies
- Consider suitability of investments
- Achieve appropriate investment blend
An outside investment manager handling the $15 billion portfolio of fixed income investments of pension plan loses 50% of its portfolio managers and analysts when they decide to leave and start their own investment firm. The manager assures the plan trustees that service will be unaffected.

A. Deal fairly and objectively with plan beneficiaries/participants
B. Review the performance and actions of plan service providers.
C. Act consistently with the mission and the policies of the plan.
D. Engage in timely, accurate, and transparent communication.
E. Maintain confidentially of plan/beneficiary/participant information.
8. Regularly review:

a) the efficiency and effectiveness of the plan’s success in meeting its goals,

b) the performance and actions of service providers including investment managers, consultants, actuaries, etc.

- Develop rules for employing investment managers
- Ensure managers employ qualified personnel
- Ensure managers comply with professional standards
- Review performance of managers
A pension trustee appointed to the pension board by the union shares investment reports given to the board with union leaders.

A. Deal fairly and objectively with plan beneficiaries/participants
B. Review the performance and actions of plan service providers.
C. Act consistently with the mission and the policies of the plan.
D. Engage in timely, accurate, and transparent communication.
E. Maintain confidentially of plan/beneficiary/participant information.
9. **Maintain confidentiality of plan, participant, and beneficiary information**

- Individual information
- Competitive ability (transactions, holdings, etc.)
- Privacy policies relating to handling such info
IDENTIFY THE ETHICAL PRINCIPLE

At its next board meeting, the governing board of a pension plan will be voting on eliminating benefits of those participants not yet fully vested in the plan. The plan notifies all employees that a regular review of benefits will be taking place at the next meeting, which may or may not lead to a material change in benefits.

A. Deal fairly and objectively with plan beneficiaries/participants
B. Review the performance and actions of plan service providers.
C. Act consistently with the mission and the policies of the plan.
D. Engage in timely, accurate, and transparent communication.
E. Maintain confidentially of plan/beneficiary/participant information.
10. Communicate with participants, beneficiaries, and supervisory authorities in a timely, accurate, and transparent manner

- Full and fair disclosure
- No misrepresentation
- Regular communication
- Plain language, effective communication
PENSION TRUSTEE CODE OF CONDUCT

- Voluntary
- Global standard
- Principle-based
- Flexible implementation
- Complements existing policies/governance structures
- Infuses trust and confidence in pension plan participants
EFFECTIVE ETHICAL THINKING BEGINS WITH:

• Recognizing that ethical dilemmas are a *normal* and *predictable*.

• Becoming *more conscious* about your thoughts and behaviors, to increase the *likelihood that you will notice and act on ethical issues* before they become destructive.

• Utilize a *framework for making ethical decisions*.
ETHICAL DECISION MAKING FRAMEWORK

**Identify**
- Ethical principles
- Duties to others
- Important facts
- Conflicts of interest

**Consider**
- Situational influences
- Alternative actions
- Additional guidance
SITUATIONAL INFLUENCES

These biases can influence a person to engage in unethical conduct

• Obedience to authority
• Conformity with others
• Following group decisions
• Incrementalism
• Responding to incentives
• Overconfidence in ability to act appropriately
ETHICAL DECISION MAKING FRAMEWORK

Identify
- Ethical principles
- Duties to others
- Important facts
- Conflicts of interest

Consider
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- Alternative actions
- Additional guidance
Developing A Framework For Ethical Decisions:

Case Studies

• Illustrate ethical analysis in real-life scenarios
• Apply the ethical framework for decision making
• Prompt discussion of key concepts
Zeller sits on the board of a public pension plan. The plan has a significant investment in MMEG, a large media/entertainment company. Zeller, his fellow trustees, and trustees from other pension plans with significant holdings in MMEG, are invited to headquarters in Hollywood as part of a corporate retreat. The company pays for Zeller’s travel and accommodations for a 2-day tour of company facilities. As part of the trip, MMEG hosts a celebrity meet-and-greet at a top Hollywood nightclub, and hosts a dinner and a golf tournament as part of the trip. Zeller:

A. Should not make the trip.
B. Can accept reimbursement since the company is paying the expenses for all attendees, not just Zeller.
C. Can accept reimbursement so long as the arrangement is disclosed to the fund’s Executive Director.
D. Should not accept reimbursement or participate in the events.
# APPLICATION OF THE FRAMEWORK: CASE 1

<table>
<thead>
<tr>
<th>Principle(s):</th>
<th>Independence and Objectivity</th>
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<tbody>
<tr>
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<td>Duties:</td>
<td>Pension Plan</td>
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<tr>
<td>Facts:</td>
<td>Cost of the Trip</td>
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<td>Plan Policies for Gifts</td>
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<td>Value of Entertainment</td>
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<td>Conflict:</td>
<td>Personal Benefit from Dinner, Golf, Meet &amp; Greet</td>
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<td>Influences:</td>
<td>Overconfidence</td>
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<td>Conformity</td>
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Snead, a trustee for a large pension fund, also sits on the investment board for the endowment of a charity that provides assistance to the widows and families of military personnel killed overseas. Believing the charity’s investment committee would benefit from the pension fund’s experiences, he gives the charity some of the general economic research produced for the pension fund. Snead also gives them a list of the pension fund’s investments and recommends that the endowment follow the same investment strategy as the pension fund. Snead:

A. Acted properly since the information is for a charity – not a for-profit entity.
B. Should get permission from the pension fund before sharing the materials with the charity.
C. Can use the general economic research, but not with regard to the list of investments.
D. Should not provide any information to the charity.
# APPLICATION OF THE FRAMEWORK: CASE 2

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<th>Principle(s):</th>
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<td>Best interests</td>
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<td>Duties:</td>
<td>Pension Plan v. Charity</td>
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<tr>
<td>Facts:</td>
<td>Type of Information, Public v. Private</td>
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<td>Conflict:</td>
<td>Trustee v. Charity Board Member</td>
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<td>Influences:</td>
<td>Overconfidence</td>
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<td>Incrementalism</td>
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Wylie, a trustee of the Acme corporation pension fund, is a former colleague and good friends with the CEO of Sigma Investment Advisors, an investment consultant advising pension funds. Wylie recommends that the Acme corporation pension plan hire Sigma to manage Acme’s pension assets for a flat rate of $5 million per year. Wylie has extensive experience with Sigma’s CEO at when the CEO was at his previous firm and believes Sigma to be a good match for Acme’s needs. Wylie:

A. Acted properly because Sigma is a highly respected consultant with at good reputation.

B. Acted improperly because the fee structure is improper and indicates preferential treatment of Sigma.

C. Acted properly if he disclosed his relationship to Sigma’s CEO.

D. Acted improperly as he should have excluded Sigma from the consultant search because of his existing relationship with the CEO.
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<th>Principle(s):</th>
<th>Best Interests</th>
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<td>Conformity</td>
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O’Shea is the CFO of a public furniture manufacturing company and serves as a trustee of the company’s pension plan. Eighty percent of plan assets are invested in company stock. As CFO, O’Shea is aware of possible looming product defect litigation over its line of baby cribs is likely to drive the value of the company significantly lower. O’Shea should:

A. Share the information about the litigation with other trustees so that they can make an informed investment decisions for the plan.

B. Recommend a freeze of investment in the company stock for the fund, while not disclosing the reason for the recommendation.

C. Recommend divesting company stock holdings from the plan and diversifying investment options.

D. Do nothing with the information about the litigation.
APPLICATION OF THE FRAMEWORK: CASE 4

Principle(s): Best Interests
   Abide by Applicable Law
   Communication/Transparency

Duties: Pension Plan v. Capital Market Integrity

Facts: Likelihood of Litigation
   Publicity of Crib Defects
   Financial Impact to Company

Conflict: CFO v. Trustee
   Plan Participant v. Company
RESOLVING ETHICAL DILEMMAS

- Understand applicable fundamental ethical principles
- Recognize that ethical issues are normal and predictable.
- Notice and act on ethical issues before they become problems.
- Be aware of and address negative situational influences.
- Apply Ethical Decision-Making Framework

**Identify:** Principles, Duties, Facts, Conflicts

**Consider:** Negative Influences, Alternatives, Guidance
ACTIONS

- Adopt ethical guidelines/a code of conduct for trustees and staff
- Establish policies for dealing with ethical issues
- Review and revise to be relevant and robust
- Establish well-documented investment decision-making process
- Disclose of conflicts of interest
- Establish criteria for outside managers, include ethics
- Engage in periodic training/education for trustees
THANK YOU FOR PARTICIPATING!

Please complete the course evaluation that you will receive by email.