Bernstein Litowitz Berger & Grossmann LLP

Due Diligence: Is It Enough?
Fiduciary Duty Post Madoff

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G. Anthony Gelderman, III
Bernstein Litowitz Berger & Grossmann LLP

The Falling Tide…

- **A rising tide lifts all boats, and in a strong economy errors and outright fraud by investment managers may not be apparent**

- **A falling tide lays bare the truth, and scrutiny of Trustees' decisions may increase as the economy sputters**

  - The Madoff fraud unraveled when investors, facing other losses, sought to withdraw capital from Madoff in droves and he was unable to secure new investments to maintain the Ponzi scheme

  - Media, government officials and beneficiaries focus more closely on performance when the economy is down.
    - Government facing more pressure on budgets
    - Beneficiaries more dependent upon benefits

Due Diligence: The Need To Refocus

A string of massive frauds by investment advisors has refocused attention on the need for institutions to conduct scrupulous due diligence before entrusting assets to an advisor.

(1) Madoff

(2) Bayou

(3) Stanford

(4) Nadel

(5) WG Trading

Due Diligence: The Need To Refocus

There is no silver bullet that will prevent or identify fraud.

These recent examples of large-scale fraud provide lessons that public pension funds can use to ensure that they are employing the best possible procedures to limit exposure to fraud.

Indeed, the vigilance of public pension fund Trustees is a major reason that the primary institutional victims of frauds such as Madoff were private charities and universities rather than public funds.

But, there is always room for improvement…

Foundations of Fiduciary Law

No fiduciary relationship is more complete and nearly as absolute as the relationship between a public pension fund trustee and a pension beneficiary.

General Fiduciary Guidelines

A Governing Fiduciary such as a Trustee seeking to properly fulfill his or her governance duties is charged to act in all matters associated with the trust with:

(1) Loyalty

(2) Prudence

(3) Skill

(4) Care

(5) Diligence

The Limits of the Trustee's Role

Trustees are not expected to personally investigate all agents and consultants who handle fund assets.

Trustees establish the standards and protocols that the fund, its agents and consultants must employ when conducting due diligence of asset managers and investment advisors.

Trustees may delegate the actual selection of asset managers and investment advisors to consultants and agents, including "fund-of-fund" managers, but that delegation must be made pursuant to the established standards and protocols for assessing those who will handle the fund's assets.

Duty to Delegate

Public pension fund trustees can not be held to learn and understand all matters under their supervision.

Thus, the trustee has the <u>duty to delegate</u> those tasks the trustee cannot properly do himself or herself. But, delegating in and of itself will not relieve a trustee from liability.

Whether to delegate has been said to be a question of prudence. When delegating the following applies:

- The duty of care in selecting qualified personnel;
- The duty to specify the scope of the delegation;
- <u>*The duty to monitor the agent to ensure the delegated duty is carried out in the best interest of beneficiaries*</u>; and
- <u>*The duty of loyalty to select an agent on the basis of the interests of the beneficiaries*</u>.

Know Your Advisor

Delegation to an advisor is appropriate only once the trustees have satisfied themselves as to the manager's experience, expertise and investment thesis

- In 2006, 20% of registered Investment Advisors were new registrants
- Inadequate disclosure by Investment Advisors is a top deficiency, according to Lori Richards, former Director of the SEC's Office of Compliance Inspections:
  - Failure to accurately disclose fee calculations
  - Failure to disclose conflicts of interest
  - Failure to disclose brokerage arrangements

Know Your Advisor

- **Even if an advisor's conduct with your fund is circumspect, misconduct in connection with other funds will impact your relationships**

- **Recent case of well-regarded advisor who was accused of engaging in "pay-to-play" with select funds**
  - **New York Attorney General is prosecuting.**

- **Disclosure of "pay-to-play" scheme led numerous innocent funds to quickly terminate the advisor and move quickly for replacement.**
  - **Diverts resources**
  - **Increases costs**
  - **Generates criticism**

It is fully appropriate to seek disclosures from advisors concerning potential misconduct in other aspects of their business.

Hope for the best…

… but, prepare for the worst.

- **Investment contracts, including alternative investments such as limited partnerships, hedge funds and funds-of-funds should empower the Trustee to terminate the relationship in certain circumstances:**
  - **Allegations of fraud or misconduct – without requiring indictment, admission or conviction**
  - **Failure to perform adequate diligence of sub-advisors, whether demonstrated by allegations of sub-advisor misconduct, deviation from investment guideline or failure to perform**
  - **"Critical man" provisions**

Remember the "headline" risk, and be sure that you can terminate an agent even if the misconduct at issue arose in connection with a fund other than your own.

Trust, but verify

Methods of verification vary for different advisors (pension consultants, asset managers, fund-of-fund managers)

Identify the critical facts important to your selection of each advisor and verify to the level that provides comfort and resolves open questions.

<u>Reliance upon reputation alone, however sterling, is insufficient</u>

Trust, but verify

Examples of verifiable facts:

- **Confirm references**
- **Review ADV Forms**
- **Documentation concerning investment methodology**

- **Site visits by Trustees, staff or consultants**

- **Identify gatekeepers (custodians, auditors, etc.)**
  - **Lack of gatekeepers was critical to success of Madoff and Bayou**

- **Submit specific questions:**
  - **Terminations by other clients**
  - **Regulatory censure**
  - **Client complaints to regulators**
  - **Severance of former employees**

Trust, but verify

When delegating responsibility for the ultimate investment to a pension consultant or fund-of-funds, the Board must retain oversight:

- **Learn the identity of all sub-advisors**
- **Create due diligence checklist to ensure that consultants and funds-of-funds perform when selecting a sub-advisor and require verification that all requirements have been satisfied**
- **Verify that consultant or fund-of-funds will continue to supervise sub-advisors, including specifics such as frequency of audits and site visits**

The SEC is NOT Your Proxy

- **SEC cannot and does not investigate all indications of fraud**

- **Registration by an investment advisor does not guarantee:**
  - **Experience**
  - **Expertise**
  - **Honesty**
  - **or even full disclosure.**

- **Massive Ponzi schemes such as Sanford and Madoff demonstrate that the SEC cannot be relied upon to identify or prevent fraud.**

- **The SEC and state regulators do not serve as proxies for Trustees in conducting adequate diligence of investment advisors**

Madoff: The Warning Signs

- **If its too good to be true…**
  - Madoff would not explain his investment strategy
  - Madoff refused to permit outside audits
  - Madoff did not provide electronic access to accounts
  - Madoff did not charge fees based on assets under management
  - Madoff’s results could not be duplicated

Liability for Breaching Fiduciary Duties

A trustee is liable for a loss resulting from his or her failure to use the care and skill required of a trustee.

How do trustees protect themselves and the fund from liability for losses?

1) Trustees should ensure that the fund has established procedures and policies for all vital plan functions.
2) Trustees should ensure that such procedures are followed in an orderly fashion. <u>The processes and procedures the Board has in place are the best defense to potential liability.</u>
3) Boards should consider purchasing insurance coverage for officers' and directors' liability.

Process, Process, Process

The Risk of Litigation

- ***Estes v. Clark* and *Chase v. Anthony***
- **Class Action suits against Trustees by public pension beneficiaries**
- **Both cases allege violations of the Duty of Care and Duty of Loyalty**

- **Duty of Care:**
  - **Trustees allegedly approved direct investments in violation of "prudent person" standard**
    - **Companies with outstanding liens and judgments**
    - **Investments allegedly made contrary to advice of consultants**
    - **Investments in high-risk collateralized debt obligations (CDOs)**
  - **Allegedly committed insufficient time to analyzing investments**

- **Duty of Loyalty:**
  - One Trustee allegedly received political contributions from company in which fund made a direct, private investment

Adhere to Key Fiduciary Duties

Whether considering a direct investment at the Board level, delegating responsibility for the ultimate investment to a pension consultant or fund-of-funds, or reviewing the decisions of those delegates, adherence to fundamental fiduciary duties is the best way to protect your fund, and yourself:

- ***Care***
- ***Diligence***
- ***Loyalty***

Care

A trustee must apply watchful attention to his or her duties. In practical terms this means:

- The trustee must ensure the collection of funds and monies due to the plan.

  This may include bringing suit to recover monies owed the fund.
- The trustee must ensure that beneficiaries receive all benefits owed.
- The trustee must ensure that the beneficiaries are informed on a periodic basis of the operations of the plan and the financial health of the plan.
- The trustee must maintain the fund with up to date investments and do his/her best to make the fund financially secure.
- The trustee is under a duty to minimize the risk of loss by ensuring the reasonable diversification of investments through asset allocation, except where it is clearly not prudent to diversify.

Diligence

Diligence means the attention and care legally expected or required of a person. For a public pension plan trustee, it means he or she must diligently pay attention to the details of his or her work.

All trustees should, in the pursuit of diligence:

- Attend all Board and committee meetings, except in the most extraordinarily personal circumstances.
- Prepare studiously for Board and committee meetings.
- Read the statutes and internal policy/mission statements concerning your plan, including ethics policy statements.
- Read the past three annual reports of your plan as well as the past three audit reports.
- Establish a working knowledge of the open records and open meeting laws of your state as well as the ethics laws of your state.
- Become familiar with the qualifications and reputation of the plan’s auditor, investment consultant and actuary.

Diligence

All trustees should, in the pursuit of diligence (continued):

- Ask the investment officer to explain the current fund asset allocation to you.
- Ask to have the various performance benchmarks explained to you.

    As a trustee, you must understand the asset allocation system because as a plan trustee, you will be called upon to approve the percentage of assets to be invested in various asset classes. The classes of investments are expanding with the advent of the global economy, which presents a particular challenge to trustees.
- Network with other trustees.
- Learn to understand actuarial reports. These reports spell out the financial health of your system. Thus, a working knowledge of actuarial reports is vital to trustees.
- Obtain advice from experts (whether legal counsel, investment advisors or others) to answers questions you may have.

Duty of Loyalty

- **Critical to ensure that any connections between Trustees and potential Investment Advisors are fully disclosed, and Trustees with conflicts recused from relevant discussions.**
  - Madoff scandal revealed the surprising number of Trustees for investment funds (often private charities) who personally directed the investment of assets to Madoff based upon their personal relationship.
  - New York Attorney General charges against Ezra Merkin, who operated Madoff feeder funds, includes his role as Trustee for institutions that he placed into Madoff investments.
  - Recent suit against Trustees of Midwest public pension alleges that certain Trustees received political contributions from companies seeking private equity investments from the fund.

Common Sense

- **Use your common sense in approaching decisions. While common sense alone is *never* enough on which to base fiduciary decisions, if a deal looks too good to be true-often it is.**

- **Don't allow yourself to be pressured into making a decision.**

- **Don't ever be afraid to ask questions. What you don't know, can hurt you in the trustee arena.**

- **Always remember that you are acting in a public capacity.**

The "front page test" should be one of your everyday benchmarks:
"If we take this action, am I comfortable with it being described on the front page of the local newspaper read by my family and friends?"

Common Sense

- **Do not lose sight of the fact that the ultimate responsibility for the fund lies with the Board. Thus, the buck stops with you.**
- **If you believe a staff member or money manager is not properly serving the fund, you have an affirmative obligation to address the problem.**
- **If you do not understand an investment after careful examination and consideration, you should not approve that investment.**
- **If your gut feeling is that there is some problem, follow through on your feeling. Trustees are just as liable for doing nothing as they are for doing the wrong thing.**

Common Sense

- **Do not settle for jargon from your staff, consultants and attorneys. Demand plain English. All to often, professionals hide behind jargon to avoid the difficult task of communicating clearly.**

- **Know what you don't know. Hire competent professionals to fill in the gaps.**

- **<u>Embrace excellence</u>. Your beneficiaries deserve it.**

Remember the Basics

- **Diversify investments**
  - **Numerous funds invested 100% of assets with Madoff**

- **Understand the investment**
  - **Madoff refused to explain his investment method or submit to audits**
  - **When utilizing funds of funds, understand the ultimate investment and who is responsible for conducting diligence of that investment**

- **Avoid (or disclose) conflicts**
  - **Trustees who placed assets with Madoff as a result of personal relationships may have breached duties**