



# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

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### Agenda Item 18

**MEETING DATE:** March 18, 2020

**SUBJECT:** Education: Fiduciary Care and Alternative Assets Investing

**SUBMITTED FOR:**  Consent  Deliberation and Action  Receive and File

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#### **RECOMMENDATION**

Staff recommends the Board receive and file this educational report about fiduciary care and alternative asset investing.

#### **PURPOSE**

This item supports the 2019-20 Strategic Management Plan by providing Board educational sessions to improve effective oversight and management of the investment program.

#### **DISCUSSION**

This presentation provides an overview and update on an important topic: how the Board can meet its fiduciary duties while continuing to invest with fund managers that are increasingly demanding contractual concessions. This presentation makes four primary points:

- SCERS' members have a right to fiduciary care in the investment of system assets, but fiduciary compliance has become more challenging and complex;
- Managers of alternative assets, which play an increasingly crucial role in SCERS' portfolio, are increasingly demanding contractual concessions, including concessions regarding their own standard of care;
- Those concession present legal risk for SCERS' trustees and staff, including potential personal risk;
- Although that legal risk cannot be entirely eliminated, it can be effectively managed and mitigated – by taking steps to ensure that the system's portfolio and strategy as a whole are always of fiduciary quality.

At the conclusion of this presentation, Staff will present two next steps. First, Staff intends to continue investing with alternative asset managers as part of the Strategic Asset Allocation, despite the challenging contracting environment. Second, Staff will undertake a search for qualified counsel to perform a systematic, periodic “fiduciary health check” of the portfolio. Such a periodic review would ensure that, even if individual managers do not agree to the fiduciary standard, SCERS’ investment strategy and portfolio in the aggregate always pass fiduciary muster.

In the next few weeks, Staff will survey the marketplace and formulate more details about who could perform the review and what the review could consist of. At a future Board meeting, Staff will present the Board with specific recommendations regarding revisions to the existing investment policies and/or a new policy.

### **ATTACHMENT**

- Fiduciary Care and Alternative Assets Investing Presentation

Prepared by:

Reviewed by:

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Stephen Lau  
General Counsel

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Eric Stern  
Chief Executive Officer

# FIDUCIARY CARE AND ALTERNATIVE ASSETS INVESTING

March 18, 2020



**SCERS**

SACRAMENTO COUNTY  
EMPLOYEES' RETIREMENT SYSTEM

## OVERVIEW – Four Takeaways

1. Members have a right to fiduciary care in the investment of system assets, but fiduciary compliance has become more challenging and complex.
2. Managers of alternative assets, which play an increasingly crucial role in SCERS' portfolio, are increasingly demanding contractual concessions, including concessions re: the standard of care.



## OVERVIEW – Four Takeaways

3. Those concessions present legal risk for trustees and staff, including potential personal risk.
4. Although that legal risk cannot be entirely eliminated, it can be effectively managed and mitigated – by taking steps to ensure that the system's portfolio and strategy as a whole are always of fiduciary quality.



## OVERVIEW – Next Steps

- Staff will continue investing in alternative assets funds under the Strategic Asset Allocation, despite the challenging contract environment.
- Staff will search for qualified counsel to perform a systematic, periodic “fiduciary health check.” Such review would ensure that, even if individual managers do not agree to the fiduciary standard, SCERS’ investment strategy and portfolio in the aggregate always meet the fiduciary standard.



# 1. FIDUCIARY STANDARD OF CARE

- Generally, “fiduciary care” refers to:
  - Duty of Loyalty
  - Duty of Care or Prudence
  - Duty of Expertise
- The Board’s fiduciary duties are both constitutional and statutory in origin.
  - Section 17 of Article XVI of the California Constitution
  - Government Code section 31595
- Members have a constitutional and statutory right to fiduciary handling of system assets.



# 1. FIDUCIARY STANDARD OF CARE

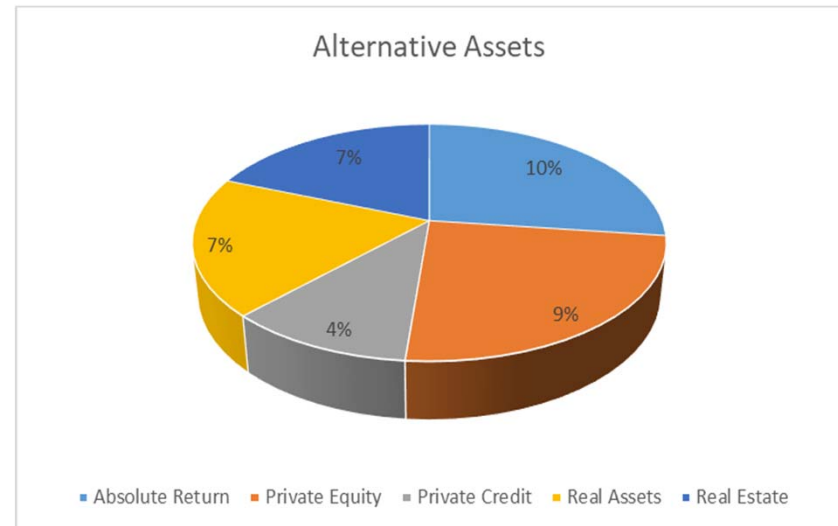
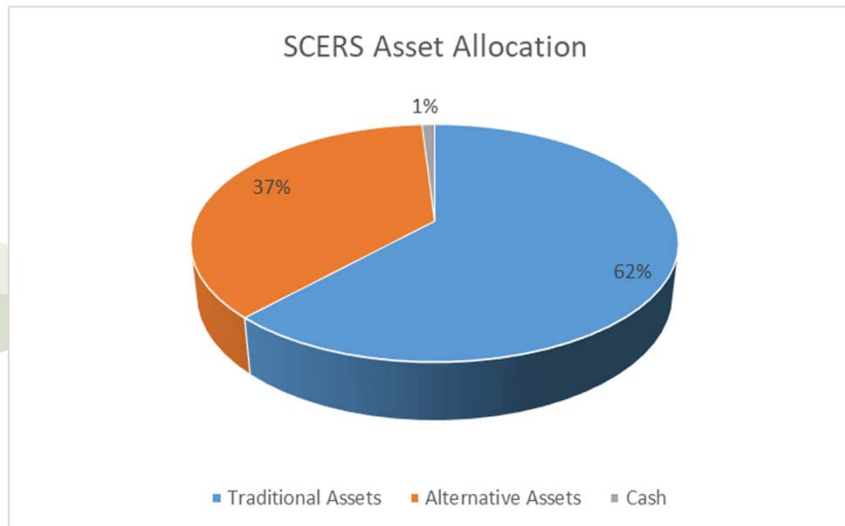
- Hence, Master Investment Policy Agreement: Investment consultants, managers, and delegates must “agree to be fiduciaries to the system.”
- For investors, a “fiduciary duty” is a potent weapon in litigation. This is why investment professionals often resist accepting it.
- How does one measure whether the Board has exercised “fiduciary care” in its investment decisions? By reference to components of the portfolio, or the portfolio as a whole?





## 2. SCERS ALTERNATIVE ASSETS

- Alternative assets represent a meaningful component of SCERS' total plan.

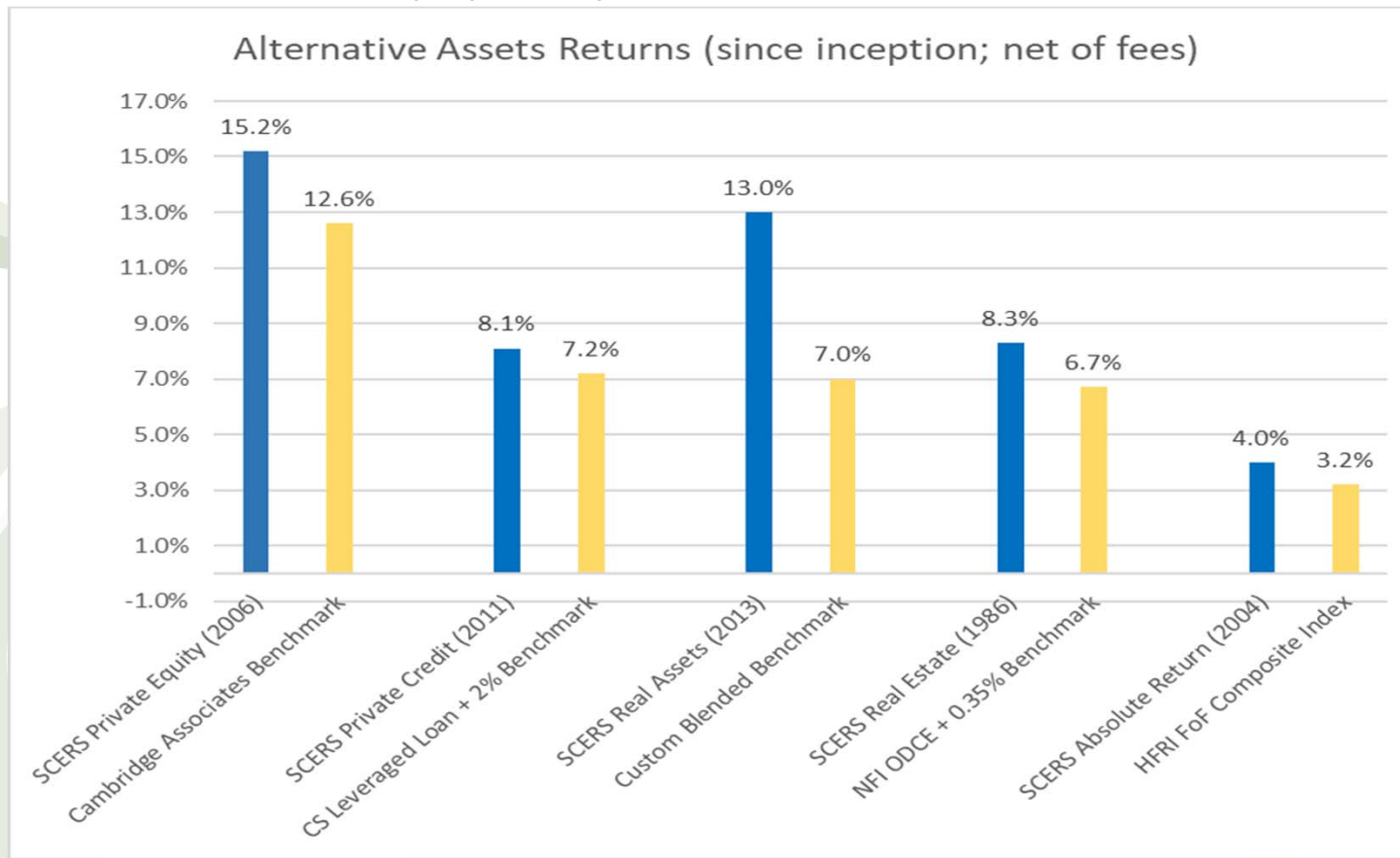


- Role of alt assets: enhanced returns, diversification, cash flows
- Strategic asset allocation emphasis: increased diversification, reduced volatility, downside protection, increased cash flows



## 2. SCERS ALTERNATIVE ASSETS

- Strong returns on an absolute and relative basis
  - Outsized excess returns
  - Capital market assumptions point to lower returns going forward
  - Alternative assets play an important role in a low return environment



## 2. SCERS ALTERNATIVE ASSETS (Implementation)

- Top performing managers are most sought after
  - High dispersion of returns between median and top quartile funds
  - Greater demand than allocations available
- Implementation considerations
  - Allocation cuts
  - Minimal leverage on terms and fees
  - Varying contractual concessions in negotiations



## 2. SCERS ALTERNATIVE ASSETS (Standards of Care)

- Each private fund transaction involves extensive negotiations over the fund documents – particularly with respect to the manager’s and general partner’s standard of care.
- The outcome of the standard of care negotiations depends on many factors, including: structure of vehicle, jurisdiction, asset class, leverage, and demand.
  - Most popular jurisdictions for private funds are Delaware or Cayman Islands. Other common jurisdictions are British Virgin Islands, England, Ireland, Isles of Man, Jersey, and Luxembourg.
- The negotiated standard of care is usually anchored to one of three legal sources:
  - Prudent expert standard under the California Constitution
  - Fiduciary duties of a general partner under Delaware corporate law
  - Fiduciary duty under the Investment Advisers Act of 1940



## 2. SCERS ALTERNATIVE ASSETS (Standards of Care)

### Prudent Expert Standard

- The manager must discharge its duties and exercise its powers with competence, care, skill, prudence and diligence under the circumstances then prevailing and that a prudent person 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, and with the customary standard of care in the industry of professionals providing similar services to a U.S. pension plan consistent with its duty of loyalty to investor.
- Source: CA Constitution; common law and trust law
- **Managers of commingled alternative investment private funds rarely accept this as a contractual standard of care.**



## 2. SCERS ALTERNATIVE ASSETS (Standards of Care)

### Delaware Law re: Limited Partnerships and Limited Liability Companies

- LP General Partner or LLC Manager must discharge its duties and exercise its powers in the interest of the limited partners or members and fund.
- The limited partners and members, as a whole, are owed a fiduciary duty and have fiduciary recourse.
- But these Delaware law fiduciary duties can be modified, or even waived, by contract.
- No fiduciary duties are owed to individual limited partners or members.



## 2. SCERS ALTERNATIVE ASSETS (Standards of Care)

### Section 206 of Investment Advisers Act of 1940

- Under Advisers Act, a registered adviser owes a fiduciary duty to client. In LLP/LLC context, the fiduciary duty is owed to the fund as a whole but not to limited partners and members.
- Adviser Act duty cannot be negotiated away by contract.
- This is a **regulatory duty enforceable only by the SEC**, and not private litigation by limited partners and members.
- **Usually, registered adviser managers merely acknowledge the fact of registration, rejecting contractually enforceable fiduciary duties.** Occasionally, however, advisers accept a contractual fiduciary duty co-extensive with the regulatory fiduciary duty.



## 2. SCERS ALTERNATIVE ASSETS (Concessions Sought)

What kinds of contractual concessions have been demanded by fund managers and fund counsel?

- Limited Fiduciary Standard of Care
- Indemnification and Exculpation
- Venue / Jurisdiction
- Waiver of Jury Trials
- Conflicts of Interest and Related Party Transactions
- Disclosure / Reporting
- Devotion of Time / Key Man Requirements
- General Partner Sole Discretion
- LPAC Rights / Obligations
- Withdrawal Rights
- Fund Termination and General Partner Removal (Cause versus No Cause Removal)





## 2. SCERS ALTERNATIVE ASSETS (Concessions Sought)

- What has been SCERS' response to these concession demands?
- What are some of SCERS' negotiation tactics in this environment?
- What about other similarly situated public pension systems?



## 2. SCERS ALTERNATIVE ASSETS (Due diligence)

- Mosaic of risk factors with potential investments
  - Investment; operational; counterparty; liquidity; currency; terms; legal
- Multiple voices and eyes perform due diligence and evaluate risk factors
  - Staff; consultants; outside counsel
- View all risk factors holistically before making an investment
  - Is SCERS being compensated for underlying risk factors?
- Smaller individual allocations than traditional assets based on above



### 3. LEGAL RISKS TO CONTRACTUAL CONCESSIONS

- On a transaction-by-transaction basis, staff performs due diligence, negotiates aggressively, and carefully weighs anticipated performance against the concessions demanded.
- Nevertheless, there is unavoidable legal and reputational risk in entering into contracts with managers that do not agree to be fiduciaries to the system.
- This risk potentially extends to trustees personally.



### 3. LEGAL RISKS TO CONTRACTUAL CONCESSIONS

Foreseeable argument: “Members have a constitutional right to fiduciary handling of system assets. Therefore, SCERS’ investment delegates must agree to exercise fiduciary care, and SCERS must have recourse in the event of a fiduciary breach. Failure to negotiate such agreement is a lapse of duty by SCERS’ staff and trustees. Or, SCERS’ staff and trustees would be vicariously liable for any sub-fiduciary conduct on the part of such investment delegates.”



## 4. MANAGING LEGAL RISK

Counter-argument: “It is true that members have a right to the fiduciary handling of system assets. But the appropriate frame of reference is at the portfolio level and not the individual fund or individual manager level. It is unfair to assess fiduciary care by reference to any single component. It is possible for an investment portfolio or strategy to be fiduciary-quality in the aggregate, even if certain components of the portfolio include limited fiduciary recourse.”



## 4. MANAGING LEGAL RISK

- The latter is a compelling and logical argument commonly made in investment litigation. Experience is that sophisticated judges understand and accept this argument.
- Argument is further bolstered by Sec. 17(d), Art. XVI of CA Constitution, which mandates portfolio diversification. This mandate justifies contract compromises if necessary to build a diverse portfolio that's fiduciary in the aggregate.
- Alternative assets will remain a significant part of SCERS' portfolio, and managers will continue to seek concessions re: the standard of care. It is important for SCERS put itself in a good position to (1) present its case that its portfolio in the aggregate is of fiduciary quality, and (2) preserve its fiduciary case going forward as it is confronted with continuing demands for contract concessions.



## NEXT STEPS

- In the long term, Staff recommends that the Board continue to authorize investments with alternative asset managers, despite the challenging contracting environment.
- In the coming weeks, Staff will undertake a search for qualified counsel to perform a systematic, periodic “fiduciary health check” of the portfolio, and to give prospective advice.
- Such periodic review and advice would ensure that, even if individual managers do not agree to the fiduciary standard, SCERS always maintains a strong case that its investment strategy and portfolio as a whole are of fiduciary quality.
- At a future Board meeting, Staff will present the Board with its findings re: counsel, along with specific recommendations regarding revisions to the existing investment policies and/or a new policy.





QUESTIONS OR COMMENTS?

