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Who's Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform

Thomas J. Fitzpatrick and Amy B. Monahan

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Much attention has been paid to the significant underfunding of many state and local employee pension plans, as well as efforts by states and cities to alleviate that underfunding by modifying the benefits provided to workers. Yet relatively little attention has been paid to the systemic causes of such financial distress—such as chronic underfunding that shifts financial burdens to future taxpayers, and governance rules that may reduce the likelihood that a plan's trustees will make optimal investment decisions. This article presents the results of a qualitative study of the funding and governance provisions of twelve public pension plans that are a mix of state and local plans of various funding levels. We find that none of the plans in our study satisfy the best practices that have been established by expert panels, but also that the strength of a plan's governance provisions does not appear correlated with a plan's financial health. Our most important finding is that, regardless of the content of a plan's governance provisions, such provisions are almost never effectively enforced. This lack of enforcement, we theorize, has a significant, detrimental impact on plan funding and governance. If neither plan participants nor state taxpayers are able to effectively monitor and challenge a state's inadequate funding or improper investment decisions, public plans are very likely to remain underfunded. We conclude by offering several possible reform options to address the monitoring and enforcement problems made clear by our study: automatic benefit haircuts, automatic tax increases, a low-risk investment requirement, and market monitoring through the use of modified pension obligation bonds.

Keywords: Public pensions, governance, public pension reform.

JEL Codes: H55, H75, K31.

Thomas J. Fitzpatrick is at the Federal Reserve Bank of Cleveland. Amy B. Monahan is at the University of Minnesota Law School. The authors are grateful to O. Emre Ergungor and John Carlson of the Federal Reserve Bank of Cleveland for their insight and guidance, Claire Hill, John Langbein, Brett McDonnell, and Ron Snell for helpful comments on earlier drafts, and Moira Kearney-Marks and Martha Kramer for valuable research assistance.

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INTRODUCTION

In the United States, there are more than 3,400 public pension plans covering over twenty-seven million state and local government employees.[1] These plans play an important role in providing retirement security for covered workers, yet on the whole they are significantly underfunded.[2] For states and municipalities, these plans are placing increasing pressure on budgets, as governments struggle with the tradeoffs that must be made between funding pensions and providing governmental

[1] U.S. GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSION PLANS: ECONOMIC DOWNTURN SPURS EFFORTS TO ADDRESS COST AND SUSTAINABILITY 4 (2012), *available at* http://www.gao.gov/assets/590/589043.pdf.
[2] *See e.g.*, *id.*at 12-15; PEW CENTER ON THE STATES, THE WIDENING GAP UPDATE 5 (2012), *available at*http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf.

services.[3] Much attention has been paid to the ability of state and local governments to address plan underfunding *ex post* by reducing benefits provided to employees, thereby reducing a plan's liabilities. This article seeks to move the debate in a new direction, by focusing on public pension plan governance – that is, the rules and regulations that apply to plan funding and investments.Examining the challenges of public pension plan governance is critical to understanding how systemic underfunding should be best addressed going forward, and must be a key piece of any comprehensive reform of such plans.[4]

In order to be financially sound, a pension plan must be adequately funded on an annual basis, and the plan's assets must be managed and invested in a sound manner. A plan's governance rules have a direct impact on whether both of these prerequisites are achieved. Governance rules set forth not only the rules for calculating required annual contributions, but also the extent to which the funding requirements can be enforced. Governance rules also supply the standards that govern asset management once the funds have been contributed. Despite the seemingly simple prerequisites for a financially-sound pension plan, the nature and structure of public pension plans make even these basic prerequisites difficult to achieve.

Ensuring that a plan is adequately funded on an annual basis is difficult because funding decisions are often left to political actors, who may rationally seek to delay funding or understate actual funding needs because they would rather use available revenue to secure current political gain rather than financially sound pension benefits payable decades in the future. And once funds have been transferred to a public pension plan, political pressures are again likely to impact investment decisions. According to basic trust principles, the assets of public pension plans have been set aside for the sole purpose of providing plan benefits to eligible retirees.[5] Control of these assets, however, is often in the hands of political actors, whose short-term political interests may be very different than future retirees' interests.[6] Imagine, for example, that you are an elected state official that sits on your state's pension board. While the state is struggling to make budgetary ends meet, the pension plan has significant assets it is looking to invest. You may be very tempted to

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[3] For an overview of the fiscal pressures facing states, see RICHARD RAVITCH & PAUL A. VOLCKER, REPORT OF THE STATE BUDGET CRISIS TASK FORCE (2012), *available at* http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

[4] We wish to note that governance is a key element of *any* reform of public pension plans, regardless of the form such reform takes. Governance is relevant to wholesale redesigns of such plans, as well as to reforms aimed at retaining and strengthening existing plans.

[5] John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH.L.REV. 72, 104 (1980).

[6] This problem is not unique to public pensions, but occurs generally with respect to state spending. *See* David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 690-91 (2012).

invest those assets within the state in a way that creates current jobs, rather than pursuing an investment strategy that is focused solely on achieving the desired mix of risk and return to safeguard retiree benefits.Indeed, the governance provisions of some plans *require* this type of economically-targeted investing. In this context, it is easy to see why public pension boards might make less than optimal investment decisions.

Mismatched incentives are not the only problem, however. It is also the case that those who are harmed by underfunding or poor investment decisions either do not monitor such actions, or would be unable to show any cognizable harm in court if they did effectively monitor such decisions. An employee or retiree, who has a direct interest in the fund's assets, is primarily interested in whether the fund has sufficient assets to pay his or her benefits. As a result, as long as the fund has sufficient assets to pay the individual's benefits, that individual is uninterested in making sure that the financing burden is fairly distributed over time, or in maximizing fund investment returns. Even for a young employee who is decades away from retirement, the incentive to monitor pension plan funding trustee decisionmaking is fairly small. After all, if the plan is systemically underfunded or trustees make poor investment decisions, the result often is simply that future taxpayers will have to contribute additional amounts to the plan. The harm to a young employee participating in an underfunded pension plan seems distant and tenuous. And that brings us to taxpayers, who are the "ultimate guarantor[s]" of public pension funds.[7] It is future taxpayers who are perhaps most directly at risk from underfunding and poor investing, but this poses yet another monitoring problem. How are future taxpayers to effectively enforce good governance, when they do not yet exist and the exact extent of the harm is unknown?

Despite the structural problems inherent in public plan governance, comprehensive studies of the issue are lacking. Rather, prior governance studies have tended to focus on discrete issues, such as the relationship between social or economically-targeted investing provisions and rate of return,[8] or the role of public plans as lead plaintiffs in securities class action lawsuits.[9] Two distinct expert bodies have, however, issued recommendations and best practices aimed at improving public plan governance. In the late 1990s, one of these bodies, the National Conference of Commissioners on Uniform State Laws (NCCUSL),tackled

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[7]KATELIN P. ISAACS, CONG. RESEARCH SERV., FEDERAL EMPLOYEES' RETIREMENT SYSTEM: BENEFITS AND FINANCING 9 (2012).

[8]*See, e.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Julia L. Coronado et al., *Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds*, 56 NAT'L TAX J. 579 (2003); David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187 (2005).

[9] David H. Webber, *Is "Pay to Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031 (2010).

public plan governance and issued a model law focused on trustees' fiduciary duties and the need for public disclosure.[10] Interestingly, only two states have adopted the model act.[11] Ten years later, the Stanford Institutional Investors' Forum published best practices for pension plan governance and this, too, has largely failed to change plan practices. Given an apparently strong consensus that public plan governance is flawed and in need of reform, it is puzzling why previous reform efforts have been unsuccessful.

Our current study attempts to provide more comprehensive information on the state of public plan governance than is currently available in order to better understand its challenges. After providing background on state and local pension plans in Part I, we examine in Part II the governance provisions of twelve state and local plans. In particular, we examine the ways in which the plans studied differ from the various expert recommendations regarding plan governance, and from each other. In addition, we focus on how the governance provisions that are in place are enforced. Our results show that nearly all plans studied differ materially from the best practices recommended by expert groups, and that there is no clear correlation between a plan's governance provisions and its funded status.Our study also illustrates important differences between state and local plans, suggesting that local plans are in even greater need of governance reforms than their state-level counterparts. Perhaps most importantly, we show that regardless of the content of a plan's governance provisions, there is nearly no effective enforcement of plan governance by any of the relevant stakeholders. The Article concludes in Part III by proposing various reforms that could help solve the enforcement problem we have identified. These reforms would give stakeholders a true incentive to monitor both contributions to a plan and also the investment decisions that are made with respect to plan assets.

I. BACKGROUND ON STATE AND LOCAL PENSION PLANS

There are over 3,400 pension plans that cover state and local employees.[12]Even by conservative estimates, these plans are underfunded by more than $750 billion.[13] Other estimates paint an even bleaker financial picture, estimating unfunded liability for such plans as high as $5

[10]NAT'L CONFERENCE OF COMM'RS ON UNIF.STATE LAWS, MANAGEMENT OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS ACT (1997),*available at* http://www.uniformlaws.org/shared/docs/management_public_employee_retirement_systems/mpersa_final_97.pdf (hereinafter "Model Act").

[11] The two states that have adopted the Model Act are Maryland and Wyoming. *See* Nat'l Conference of Comm'rs on Unif. State Laws, *Management of Public Employee Retirement Systems Act Enactment Status Map, available at*http://uniformlaws.org/Act.aspx?title=Management%20of%20Public%20Employee%20Retirement%20Systems%20Act.

[12]U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 1, at 4.

[13]PEW CENTER ON THE STATES, *supra* note 2, at 1.

trillion.[14] Despite being underfunded, these plans control an enormous amount of assets - $2.4 trillion - even after the financial market downturn in 2008.[15] This Part will explore the unique issues that play out in determining the rules by which these assets are contributed and invested.

A. Funding Public Pension Plans

The focus of this Article is on defined benefit pension plans, which raise unique funding issues. A defined benefit pension plan is one that guarantees the benefit amount to be paid to the participant, generally based on a formula that takes into account final salary and years of service.[16] The default form of benefit from such plans is a life annuity, which provides a fixed monthly benefit payment for as long as the participant lives.[17] If the plan lacks sufficient assets to pay benefits, whether because contribution levels were too low or investment results were insufficient, the employer (here, the government) must make up the shortfall. The participants and beneficiaries do not bear the investment risk associated with such plans.

Funding defined benefit plans is complicated. Generally speaking, each year the employer and employees should contribute enough money to the plan to cover both the cost of benefits earned during the year, and also a share of the plan's unfunded liability, if any, that occurs because funding assumptions have proven to be inaccurate.[18]When actuaries calculate the annual contribution amount, they must do so using a number of assumptions that may or may not be accurate.[19] For example, actuaries must make assumptions about how long plan participants will live post-retirement, when participants will begin receiving benefits, what salary growth will be like, average employee tenure, and the expected rate of return on fund assets.[20] It is easy to see how critical these assumptions are to the financial success of a plan. For example, a plan that assumes a 9% rate of return on fund assets will have to contribute a lower amount each year than a plan that uses a 7% return.If that investment assumption turns out to be inaccurate, the plan could be significantly underfunded, even though the full annual contribution was made each year.

While plans often use different assumptions when calculating the annual contribution that must be made, there is an additional complicating

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[14]Robert Novy-Marx & Joshua Rauh, *The Crisis in Local Government Pensions in the United States*, *in* GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE FINANCIAL CRISIS (Robert Litan and Richard Herring, eds., *forthcoming*).

[15]U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 1, at 36.

[16]Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 687 (2000).

[17]*Id*.

[18]Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 869 (2009).

[19]*Id*. at 843.

[20]*Id.*

factor with respect to how a plan's future liabilities are discounted to present value. Public plans use the plan's expected rate of return on its investments to discount plan liabilities. Financial economists, however, argue that plan liabilities should be discounted using a risk-free rate of return, a much lower figure than a plan's expected rate of return on investments.According to these economists, by using an unrealistically high discount rate, public plans are significantly understating their liabilities and overstating the plans' funded status.[21]

Not only is it difficult to determine the correct rate of funding, but in many states and municipalities there is no enforceable requirement to actually make what is known as the annual required contribution (ARC).[22]In many states, the decision to fund the state pension plan is subject to the legislative budgeting process. If legislators decide that other budgetary needs have greater importance, the pension plan simply is not fully funded. And there are many reasons for legislators to avoid full pension funding, one of which is the time-inconsistency inherent in inter-temporal decision making. That is, legislators may be likely to underfund public pension plans because they mistakenly give current needs greater weight than future needs. The personal discount rates people use to make decisions about future events change based on how close that event is to the present.[23] In particular, as costs or benefits become closer to the present, we tend to discount them at much lower rates than we use to discount events further in the future. This phenomenon is well-documented with respect to individuals making retirement savings

[21]*See, e.g.*, Jeffrey R. Brown & David W. Wilcox, Discounting State and Local Pension Liabilities, 99 AMER. ECON. REV. 538 (2009); Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN.1207 (2010). The discount rate used by public plans is higher than that used by private pension plans, which typically use the long-term corporate bond rate for such purposes. Forman, *supra* note 18, at 862-63.

Recently the Government Accounting Standards Board approved Statement No. 68, which slightly revises the discount rate public pension plans are allowed use. To the extent that plans are funded, they can continue to use their projected rate of return. But the unfunded liability of pension plans will be changed to the yield on 20-year, AA rated municipal bonds. Additionally, the change in net pension liability due to differences between the assumed and realized investment returns must be recognized over a five year period. Press Release, Government Accounting Standards Board, GASB Improves Pension Accounting and Financial Reporting Standards (June 25, 2012) *available at* http://www.gasb.org/cs/ContentServer?site=GASB&c=GASBContent_C&pagename=GASB%2FGASBContent_C%2FGASBNewsPage&cid=1176160126951. While this will not have much of an impact on the funding status of well-funded plans, it will result in underfunded plans reporting an even larger funding gap.

[22] See Pew Center on the States, *supra* note 2, at 5 (2012) (showing that 31 states failed to pay 100% of their required contribution for the 2010 fiscal year).

[23]*See, e.g.* R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization* 23 REV. OF ECON. STUDIES 165 (1955); Richard H. Thaler, *Some Empirical Evidence on Dynamic Inconsistency* 8 ECON.LETTERS 201 (1981); GEORGE LOWENSTEIN, CHOICE OVER TIME (1992).

decisions,[24] and it is likely that the same psychology affects legislators making pension funding decisions.As a result, legislators may attempt to defer contributions to public pensions in order to make room in state budgets for more immediate concerns. They may do so even though they know that it will require higher contributions in the future, and then for similar reasons resist or attempt to delay making the increased contributions that result.[25] If the choice is between funding current needs, or funding pension benefits that will be paid out in thirty years, it is easy to see why current needs might win out. There is also, of course, a public choice aspect to the pension funding dynamic.A legislator that has an interest in being re-elected would be wise to favor current needs that provide tangible benefits to her constituents over funding future benefits for state workers.

The problem with systemic underfunding, regardless of its precise cause, is that it shifts the burden of paying for current benefits to future taxpayers.[26]It is essentially a form of off-balance sheet borrowing. The problem is compounded when the estimates that were used to calculate the ARC turn out to be incorrect.Even if the government contributes the ARC each year, if the assumptions used to calculate the ARC are incorrect, for example if the plan fails to meet its assumed rate of return, the burden of financing plan benefits is shifted to future taxpayers. Requiring future taxpayers to share in the cost of certain governmental expenditures is not necessarily a bad thing. It may make abundant sense when it comes to lasting capital investments that will benefit those future taxpayers. It is harder, however, to justify imposing the costs of current state consumption on future taxpayers who will receive no corresponding benefit.[27]Good governance rules, which ensure that funding assumptions are reasonable, annual required contributions are made, and that pension fund investment decisions are sound, help to ensure that funding burdens are fairly distributed.

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[24] *See, e.g.* David Laibson *Golden Eggs and Hyperbolic Discounting* 112 Q. J. OF ECON. 443 (1997) (modeling hyperbolic discounting and arguing it, along with increased liquidity in financial markets, explains a decline in U.S. savings rates), Shlomo Benartzi et al.,*Choice Architecture and Retirement Savings Plans*, *available at* http://ssrn.com/abstract=999420 (using hyperbolic discounting in the design of a retirement savings plan).

[25] Potential examples of this phenomenon can be found in our sample states. For example, during New York City's fiscal crisis, the state pension decided to acquire risky bonds of a finance intermediary supporting New York City at par instead of at the 20% discount they were selling for in markets. Tron v. Condello, 427 F.Supp. 1175 (S.D.N.Y. 1976). Another possible example of this is the California Legislature's decision to defer contributions and subsequent fight against amortizing those contributions over a five year period instead of a 40 year period. Bd. of Admin.of the Pub. Employees' Ret. Sys. v. Wilson, 52 Cal. App. 4th 1109 (Cal. 1997).

[26]*See* Hess, *supra* note 8.

[27]*See* Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L. J. 888, 907 (2012).

B. Pension Boards and Plan Investments

Typically, public plans are governed by a board of trustees that is responsible for plan investment and administration.[28] The make-up of such boards varies significantly from plan to plan, but trustees typically come from one of three groups: trustees who serve by virtue of their public office (such as a state treasurer who automatically serves on the board), trustees who are appointed by an elected official, and representatives of plan beneficiaries, who are typically elected by current employees and retirees.[29] Very few plans require that trustees have any financial or investment background or expertise.[30]

Given the political influence that is present on many boards, scholars have raised concerns that politicians are likely to interfere in board decisionmaking in order to secure political gain.[31] Examples of board actions that appear politically motivated include investments of fund assets in local economic activity, or the selection of in-state investment managers.[32] It is easy to see how the long-term interests of public sector employees may not match the short-term interests of political board members, who may wish to trade local economic gain achieved through investing plan assets in local firms for a lower rate of return.[33]

Several scholars have drawn on the robust literature regarding corporate board performance in analyzing public pension boards. Corporate boards typically have two types of members: inside directors who are managers of the firm, and independent, outside directors. Outside directors have been theorized to be more effective monitors of corporate behavior than their inside counterparts, who may act in their own best interests rather than the best interests of shareholders.[34]Empirical evidence regarding the impact of outside directors on firm performance is, however, mixed.[35]

In applying corporate board research to the pension plan context, independent plan trustees (those elected by plan beneficiaries) are likened to outside directors.[36]Independent plan trustees should help monitor the

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[28] One notable exception is the New York Common Retirement Fund, which is managed by the state comptroller as the sole trustee. *See* Andria L. Bentley, *The New York State Comptroller as Sole Trustee of the Common Retirement Fund: A Constitutional Guarantee?*, 72 ALB. L. REV. 761 (2009).

[29] Romano, *supra* note 8, at 800-01.

[30] Webber, *supra* note 6, at 2064 (also noting that prior research demonstrates that board members' formal financial expertise is not correlated with fund performance).

[31]*See, e.g.*, Hess at 195-99. *See also* Webber, *supra* note 6 (studying allegations that public funds pursue securities class actions in return for campaign contributions from plaintiffs' lawyers).

[32] Hess, *supra* note 8, at 195-99.

[33]*See* Coronado et al., *supra* note8, at 581.

[34] Lisa M. Fairfax, *The Elusive Quest for Director Independence, in*RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill & Brett H. McDonnell eds., 2012).

[35]*Id*.

[36] Hess, *supra* note 8, at 195-96.

political appointees. However, given that these elected trustees are not truly independent, but rather represent current workers who are often unionized, these trustees may in fact have their own agenda to pursue.[37] Professor David Hess has argued that because these trustees have their personal retirement at stake, they may be more comparable to inside directors with significant equity interests in the firm.[38] Given the fact that even poorly funded pension plans have sufficient assets to pay benefits for many years in the future, it is unclear how strong the analogy to corporate directors may be. With public funds, there is no real benefit to independent trustees in increasing the fund's performance, unlike corporate directors who directly benefit from an uptick in stock price.

Several empirical studies have attempted to test whether the political nature of public pension boards affects outcomes by examining the relationship between board composition and a plan's rate of return. As an initial matter, one study found that public plans earn lower rates of return than their private pension counterparts, suggesting that public pension boards may in fact be negatively affected by their political nature.[39]The results of more detailed studies examining the correlation between board composition and rate of return, however, have been mixed.[40]We identified one study finding that political board members are *positively* correlated with a fund's rate of return,[41] while two earlier studies found the opposite to be true.[42]

Board composition is not, however, the whole story. Many boards operate under investment rules that appear to prevent the implementation of modern portfolio theory, which advocates for a broadly diversified portfolio in order to minimize risk and maximize return.[43]Historically, state and local pension plans were very conservative investors. As recently as the 1990s, many public plans were prohibited from or severely limited in making equity investments.[44] That changed in the 1990s as public plans saw equity investments as a way to "chase return" and help solve plan underfunding.[45]

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[37]*See id*. at 198.
[38]*Id*.
[39] Coronado et al., *supra* note 8, at 591-93 (finding that, after controlling for equity allocation and plan size, public plans earned 33 basis points less than private plans).
[40] Hess, *supra* note 8, at 213 (finding that political trustees had a positive impact on performance, but elected trustees did not); Romano, *supra* note 8, at 826 (finding that elected trustees were positively correlated with investment return).
[41] Hess, *supra* note 8, at 213.
[42]Romano, *supra*note8, at 826; Coronado et al., *supra* note 8, at 588.
[43] For an overview of modern portfolio theory, see Harvey E. Bines, Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine, 76 COLUM. L. REV. 721, 734-50 (1976).
[44] Hess, *supra* note 8, at 194.
[45]*See id*. Recent actions by some public pension plans suggest that they are viewing alternative investments – private equity, hedge funds, etc. – as a new way to chase yield. Recently plans in Alabama, Florida, Georgia, Kansas, Minnesota, North Carolina, Tennessee, and Texas passed laws granting or expanding the authority of plans to invest

While equity investing is now commonplace, collective decisions regarding where to invest assets that many consider to be "public" is controversial. The tension here is in part caused by the fact that trust principles require that pension plan assets be invested *solely* in the interests of trust beneficiaries,[46] yet various actors view public pension funds as "public" money. Instead of simply charging pension trustees with investing trust assets solely in the interest of plan beneficiaries, many public plans face both affirmative investment requirements as well as investment restrictions that have little to do with retirees' best interests. In many states and cities, plans have affirmative requirements to invest in the local economy, often referred to as economically-targeted investing, or ETI.[47] Also common are affirmative requirements to undertake "social" investing that aims to support not just the geographic region, but various approved causes.[48] Such criteria are varied, but include requirements to invest in women-, minority-, or disabled-owned businesses.[49]In addition to requirements encouraging or requiring investments that are thought to have important collateral benefits, many plans are absolutely restricted from investing in businesses that are deemed undesirable, such as tobacco companies, predatory lenders, and those that do business in certain countries.[50] Placing both affirmative requirements and restrictions on pension boards may lead to suboptimal investment decisions,[51] although empirical evidence generally does not show a significant reduction in rate of return.[52]Regardless, it is clear that requiring certain investments and prohibiting others may violate trust law if they require trustees to

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in alternative investments. ALA. H.B. 515 (eff. Sept. 1, 2011), Fla. H.B. 1417 (eff. July 1, 2012), Ga. S.B.402 (eff. July 1, 2012), Kan. H. 2461 (eff. July 1, 2012), Minn. S.B. 1808 (eff. May 10, 2012), N.C. H.B. 318 (eff. June 23, 2011), Tenn. S.B. 3262 (eff. May 12, 2012), Tex. H.B. 1061 (eff. June 17, 2011). Michigan and New Jersey are considering similar changes. Mich. H.B. 5416 (introduced Feb. 21, 2012), N.J. S. 1140 (introduced Jan. 23, 2012).

[46]*See* Langbein & Posner, *supra* note 5, at 96-97.

[47]*See, e.g.* CAL. GOV'T. CODE § 20194(a) & (d) (requiring investment in California real estate unless it would be imprudent to do so), OHIO REV. CODE ANN. §§ 3307.152(D)(1)) & 3307.154(B)(1) (requiring the use of Ohio-based broker-dealers and investment managers).

[48]*See* Webber,*supra* note 9, at 2065-68.

[49]*See id*. at 2067.

[50]*See, e.g.*CAL. GOV'T. CODE§ 7513.7 (restricting investments in Iran), CAL. GOV'T. CODE§ 7513.6 (restricting investments in Sudan), N.Y. RETIRE. & SOC. SEC.LAW§423-a (restricting investments in Northern Ireland), 40 ILL. COMP. STAT. 5/1-110.10 (requiring Illinois finance companies to certify compliance with the Illinois High Risk Home Loan Act in order to be eligible for pension investments).

[51]*See* Langbein & Posner, *supra* note 5, at 76.

[52]*See, e.g.*, Alicia H. Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, Center for Retirement Research at Boston College, Working Paper 1999-01 (1999), at 5-10 (finding evidence that plan trustees may in fact only undertake such investments when they are predicted to match the market rate of return, and further that economically-targeted investing did not have a significant effect on fund performance); Hess, *supra* note 8, at 194 (finding that economically-targeting investing did not impact fund performance).

subordinate the interests of participants and their retirement security to other unrelated objectives.[53]

C. The Diffuse Nature of Public Pension Mismanagement Harms

Not only does the nature of public pension plans raise the risk of suboptimal investing due to political interference, the problem is further compounded by the diffuse nature of the harm that results. Recall that defined benefit pension plans pay benefit amounts set by formula. Any fund returns in excess of the amount necessary to pay benefits may result in lower future contribution requirements, but do not otherwise revert to either participants or beneficiaries. As a result, there appears to be little incentive for plan participants to monitor the investment policies of their pension plan.[54]After all, if close monitoring by participants leads to the plan earning an additional 1% return on assets, the participant is no better off. It is in fact future taxpayers who are better off, as they will need to contribute less money to the plan if the rate of return is higher. Theoretically, then, it is taxpayers who should monitor fund performance. Keep in mind, however, that the effects of funding and investment decisions may not be felt until some point far in the future, reducing the taxpayer's incentive to closely monitor such plans. And, of course, monitoring pension board decisions is a difficult task, with only small marginal benefits to an individual taxpayer. As will be discussed below, even if taxpayers were sufficiently motivated to monitor board performance, they will have a very difficult time challenging suboptimal decisions.

D. Prior Governance Studies

Most studies of public pension plan governance have focused on the statistical relationship between board composition and rate of return, given the concern that political board members will be motivated by concerns other than minimizing risk and maximizing return. As mentioned above, some of these studies found that the presence of political board members is negatively correlated with rate or return, while at least one found that political board members are positively correlated with a fund's performance.[55]One study examined whether either tight fiscal constraints or political pressure result in plans manipulating the actuarial assumptions they use in order to lower the amounts they would otherwise have to

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[53]*See* Langbein & Posner, *supra* note 5, at 96-97. The Department of Labor has taken the position in the context of private employer pensions that investments with collateral benefits (such as meeting certain social objectives) may be undertaken only if the investment, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments. *See* DOL Op. Ltr. 98-04A (May 28, 1998).
[54] Coronado et al., *supra* note 8, at 581.
[55]*See* note 8, *supra*.

contribute to the plan.[56]The study found evidence that plans facing fiscal constraints and those subject to political pressure are both more likely to have optimistic actuarial assumptions than those plans that are not.[57]

Other studies have looked at broader governance issues, such as investment restrictions and the effect of various board duties and policies on rates of return. Professor Hess found that economically targeted investment (ETI) and shareholder activism on the part of public funds had no impact on a fund's rate of return.[58] That same study, however, found that having an ethics code was *negatively* correlated with rate of return.[59] Two studies found that the application of the duty of prudence to pension trustees had an insignificant effect on rate of return.[60] A later study found a positive correlation between both the duty of prudence and the presence of elected board members, but the impact was a relatively small quarter point improvement in returns.[61] We could not locate any prior studies that examined plans' complete package of governance provisions, or examined the issue of enforcement.

II. STATE AND LOCAL PLAN GOVERNANCE PROVISIONS

While comprehensive studies of public plan governance provisions are lacking, several expert bodies have reacted to the perceived shortcomings in public plan governance by issuing recommendations and best practices for public plans. The subparts below review the two primary sets of recommendations, those put forward in a model act by the National Conference of Commissioners on Uniform State Laws, and those issued by the Stanford Institutional Investors' Forum. We also provide an overview of how the federal government has structured its pension plan, before presenting the results of our current study.

A. The Model Act

In 1997, the National Conference of Commissioners on Uniform State Laws (NCCUSL), approved and recommended the "Uniform Management of Public Employee Retirement Systems Act" (the "Model Act"). The drafters noted that public plans were not subject to the participant protections contained in the Employee Retirement Income Security Act of 1974 (ERISA), the federal law that governs retirement plans sponsored by

[56] Tim V. Eaton & John R. Nofsinger, *The Effect of Financial Constraints and Political Pressure on the Management of Public Pension Plans*, 23 J. ACCT. & PUB. POL'Y 161 (2004).
[57]*Id*.
[58] Hess, *supra* note 8, at 211.
[59]*Id*. at 214.
[60]Olivia Mitchell & Ping-Lung Hsin, *Public Pension Governance and Performance, in* THE ECONOMICS OF PENSIONS: PRINCIPLES, POLICIES, AND INTERNATIONAL EXPERIENCE (S. Valedes-Prieto ed., 1997); John Nofsinger, *Why Targeted Investing Does Not Make Sense*,27FIN. MGMT. 87 (1998).
[61] Coronado et al., *supra* note8, at 588.

private employers.[62] They also noted that state laws differed significantly in how they regulated such plans, and that state laws relating to public retirement plans have "failed to keep pace with modern investment practices."[63]The act sought to protect participants and beneficiaries by imposing fiduciary duties on plan trustees, and by allowing effective monitoring of such plans through significant disclosure requirements.[64]The Model Act does not address notable issues such as funding requirements or board composition and trustee expertise.[65]

The fiduciary duties contained in the Model Actsubject public plan trustees to duties that are very similar to those imposed on private plan fiduciaries under ERISA.[66]Trustees and other fiduciariesare required under the act to discharge their duties:

> (1) solely in the interest of the participants and beneficiaries;
>
> (2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;
>
> (3) with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;
>
> (4) impartially, taking into account any differing interests of participants and beneficiaries;
>
> (5) incurring only costs that are appropriate and reasonable; and
>
> (6) in accordance with a good-faith interpretation of the law governing the retirement program and system.[67]

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[62] Model Act, *supra* note 10, at 2

[63]*Id*.

[64] While the focus of the act is on fiduciary duties and disclosure, the act covers a total of six categories: trust requirements; trustee authority over assets; trustee and fiduciary duties; disclosure requirements; enforcement provisions; and a prohibition on assignment or alienation of benefits under most circumstances. *See generally* Model Act, *supra* note 10.

[65] Informal conversations with individuals involved in the NCUSSL process indicate that these issues were omitted from the deliberations about the Model Act because they were considered "too political" and therefore unlikely to ever be adopted.

[66] While the Model Act borrows extensively from the Employee Retirement Income Security Act of 1974 (ERISA), NCUSSL declined to incorporate ERISA's prohibited transaction rules, which make certain transactions with related parties per se impermissible.Steven L. Willborn, *Public Pensions and the Uniform Management of Public Employee Retirement Systems Act*, 51 RUTGERS L. REV. 141 (1998) (stating the opinion that the committee that the prohibited transaction rules would add unnecessary complexity and duplicate what many states already had in conflict of interest policies).

[67] Model Act, *supra* note 10, at §7.

Note that in evaluating the actions of fiduciaries, the Act adopts a prudent person standard, where a fiduciary's actions are evaluated against those of a prudent person "acting in like capacity and familiar with those matters," rather than adopting a higher "prudent expert" standard.[68]

In addition to detailing the duties that a plan trustee owes to plan participants and beneficiaries, the Act also goes into significant detail with respect to trustees' investment decisions. The Act lists six factors that trustees shall take into account when making investment decisions, and requires that plan investments be diversified unless it is clearly prudent not to do so.[69]A major change from existing state law is the act's prohibition on categoric restrictions on investments.[70] At the time the Model Act was adopted by NCCUSL, over half the states had some type of categoric restriction[71] on plan investments in place.[72]The Model Act also provides that trustees may consider the collateral benefits of an investment (i.e., those created in addition to investment return) "only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits."[73]This provision regarding collateral benefits is important with respect to placing limitations on so-called economically-targeted or social investing provisions. As was previously mentioned, there are many reasons why public pension funds might want to use trust assets to invest in the local economy. The provision in the Model Act regarding collateral benefits would permit such investment only if the investment would be prudent without considering collateral benefits like a boost to the state economy or an increase in local employment. This approach to economically-targeted or social investing is consistent with Department of Labor guidelines that apply to private pension plan investments.[74]Finally, the Model Act requires public plans to adopt an investment policy that details the plan's investment strategy and approach.[75]

In addition to imposing fiduciary duties and investment regulation, the Model Act also imposes fairly extensive disclosure obligations on public retirement systems. The aim of such disclosure requirements was to both signal to trustees and fiduciaries that they would be held accountable, and to allow interested parties to perform a monitoring function, whether that be unions, the press, or participants and beneficiaries.[76] Under the Model

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[68] Willborn, *supra* note 66, at 147.
[69] Model Act, *supra* note 10, at § 8.
[70] Willborn, *supra* note 66, at 150.
[71] Categoric restrictions are those that prohibit entire investment classes, such as a prohibition on purchasing equities.
[72] Willborn, *supra* note 66, at 150.
[73] Model Act, *supra* note 10, at §8(a)(5).
[74]*Id*. at 32.*See also* DOL Op. Ltr. 98-04A.
[75]*Id*. at §8(b).
[76]*See id*. at §§13-17; Willborn, *supra* note 66, at 169. One study suggests that public plans have room for improvement when it comes to complying with required accounting disclosures, reinforcing the need for clear and enforceable disclosure requirements. *See*

Act, public plans are required to distribute a summary plan description and summaries of any material modification to the plan, as well as an annual report and annual financial disclosure.[77]

While not emphasized in the act's prefatory note, the Model Act also contains significant enforcement provisions. The act provides that fiduciaries are personally liable for any losses that result from a breach of fiduciary duty, and that any agreements attempting to limit such liability are void.[78] Fiduciaries are, however, permitted to be covered by various types of liability insurance.[79]According to one participant in the NCUSSL process, the provision in the Model Act providing for personal liability for fiduciaries is "undoubtedly one of the most controversial provisions of the Act."[80] The act further provides that a public employer, participant, beneficiary or fiduciary may maintain a cause of action to enjoin an act, practice, or omission that violates that act, or for other appropriate equitable relief.[81] This enforcement language is based largely on ERISA's provisions that apply to private employer plans.[82]

Despite the relatively modest aims of the Model Act, in the fifteen years since its approval by NCUSSL, only two states, Wyoming and Maryland, have adopted it.[83]We found evidence that only one other state even considered the Model Act,[84] indicating perhaps that states viewed the Model Act as flawed in some way or that they simply were not interested in public plan governance reform. One goal of our study is to better understand how state and local plan governance diverges from the Model Act, given its very low adoption rate.

B. *The Clapman Report*

The National Conference of Commissioners on Uniform State Laws was not the only expert body to weigh in on public plan governance. In 2007, the Stanford Institutional Investors' Forum issued a committee report recommending best practices for pension funds, commonly referred to as the "Clapman Report" in reference to the committee's chair, Peter Clapman.[85]The best practices focused on five key areas: transparency of a fund's rules and governance structure; a fund's leadership, including the

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Thomas E. Vermeer et al., *Do Local Governments Present Required Disclosures for Defined Benefit Pension Plans?*, 31 J. Account. Pub.Pol'y 44 (2012).

[77] Model Act, *supra* note 10, at §13.

[78] Model Act, *supra* note 10, at §11.

[79]*Id*.

[80] Willborn, *supra* note 66, at 160-61.

[81] Model Act, *supra* note 10, at §19.

[82] Model Act,*supra* note 10, at 41-43.

[83]WYO. STAT. ANN. § 9-3-401 *et seq*.; MD.CODE ANN., STATE PERS. & PENS. § 40-101 *et seq*.

[84]*See* Proposed Bill 6348 (Conn. 1999).

[85]THE STANFORD INSTITUTIONAL INVESTORS' FORUM, COMMITTEE ON FUND GOVERNANCE BEST PRACTICE PRINCIPLES (2007), *available at* http://www.directorsandboards.com/DBEBRIEFING/July2007/FundGovernanceReport.pdf (hereinafter "Clapman Report").

governing body and executive staff; trustee attributes and core competencies; approach to addressing conflicts of interest and related disclosure policy; and delegation of duties and allocation of responsibilities among relevant authorities.[86] The Clapman Report does not address either funding requirements or enforcement provisions.

The principles begin with an emphasis on the need for transparency regarding the rules and principles controlling a fund's governance and management of actual and potential conflicts of interest, emphasizing that such rules should be available in a single location easily accessible by interested parties.[87] Within this central location should also be included all relevant statutes, regulations, and other sources of law such as judicial opinions.[88] With respect to the governing body, the committee recommended that it "should consist of appropriately qualified, experienced individuals dedicated to fulfilling their fiduciary duties to fund beneficiaries. Viewed as a group, the board should be composed of individuals with a portfolio of skills that allows it to make responsible, informed investment and legal decisions, and to discharge its fiduciary obligations to fund beneficiaries."[89] The committee also recommended that the governing body abide by ERISA-like fiduciary duties.[90]While acknowledging a place for varied experiences and roles, the committee listed attributes and core competencies that each individual trustee should possess.[91] Most of these attributes focus on the ability of the individual to make independent, well-reasoned decisions consistent with fiduciary obligations.[92] The report also recommends that a governing body should have a "sufficient number of trustees competent in financial and accounting matters so that the body is capable of understanding modern portfolio theory, diversification principles, basic financial analysis, and fundamental accounting principles."[93]

The report also spends a fair amount of time discussing issues related to potential conflicts of interest. It begins with the recommendation that the fund should establish and disclose its conflict of interest policy and provide training for affected parties.[94] The committee not only defines "conflicts of interest" for this purpose, but also recommends that governing bodies require the recusal of trustees who have even the appearance of a conflict of interest with respect to a transaction.[95] In order to enforce a conflict of interest policy, the committee notes that appropriate authorities must have access to the information necessary to

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[86]*Id*. at 5.
[87]*See id*. at 6.
[88]*Id*.
[89]*Id*. at 7.
[90]*Id*. at 8. ERISA's primary fiduciary provisions can be found at 29 U.S.C. §1104.
[91]*Id*. at 10.
[92]*Id*. at 10-11.
[93]*Id*. at 11.
[94]*See id*. at 13-16.
[95]*Id* .at 13.

enforce the policy, and details the types of information that must be reported.[96] In addition, the committee details twelve items that the fund should publicly disclose.[97] The items to be disclosed include an annual summary of actual or potential conflicts of interest that were identified and how they were managed or controlled.[98]

The report supports delegation of board duties where the delegation is made consistent with the trustees' fiduciary obligations.[99] In addition, the report recommends that any outside parties to whom material responsibility is delegated comply with the fund's conflict of interest and ethics policies; in particular, disclosing all relationships with providers or suppliers that they recommend to the fund.[100] Our research did not find any plan formally adopting the recommendations of the Clapman Report, although given the nature of these recommendations such actions may be difficult to reliably find.

C. *FederalEmployees' Retirement System*

State and local governments are not the only governments that struggle with the difficult issues involved in investing a large amount of assets for the benefit of public employees. The federal government also maintains a defined benefit pension plan for its workers, and its governance provisions provide an interesting contrast and alternative approach to that taken by state and local plans. The Federal Employees' Retirement System (FERS), which is the pension plan for federal workers hired on or after January 1, 1984, has a relatively simple governance system. While employee contribution rates are set by statute, participating federal agencies are required to contribute on an annual basis the full normal cost of benefits less employee contributions.[101] The employee and employer contributions are credited to the Civil Service Retirement and Disability Fund, where 100% of the amounts contributed are used to purchase special-issue U.S. Treasury Bonds.[102] In explaining why the federal employee plan invests only in Treasury bonds, the Congressional Research Service stated:

> Who would make the investment decisions, and what would be the acceptable level of investment risk for the funds? The most fundamental risk is that poor investment choices would result in the trust fund losing value over time. Another question would be how the fund would decide what assets to purchase. Deciding what would constitute an appropriate investment for a fund that consists mainly of monies provided by taxpayers could be controversial. Not all

[96] *Id*. at 14.
[97] *Id*. at 14-15.
[98] *Id*.
[99] *Id.* at 17.
[100] *Id*. at 17.
[101] 5 U.S.C. §§ 8422 & 8423 (2006).
[102] *Id*.

> companies, industries, or countries would be seen by the public as appropriate places to invest these funds.[103]

Because federal agencies must fund the full normal cost of benefits under FERS, and monies contributed are placed in non-volatile Treasury bonds, arguably no further governance provisions are necessary. While the "funded" status of FERS has varied somewhat over the years, the most recent estimates suggest that FERS had a surplus of $12.1 billion at the end of fiscal year 2010.[104]

D. *A Comparison of State and Local Plan Governance Provisions*

For our study, we wanted to examine the governance provisions that apply to a broad range state and local pension plans. We therefore selected six state and six local plans for inclusion in the study. Within both the state and local groups, half of the plans we selected were generally considered to be well-funded, while half were considered to be underfunded, on the theory that, if governance provisions do drive plan performance, a mix of well-funded and poorly-funded plans would give us the best range of governance provisions to study. Identifying plans' funding status is more difficult than it perhaps seems, given that self-reported funded ratios are subject to assumptions that may differ dramatically among plans.[105] As a result, we used third-party reports that attempted to standardize funding assumptions in order to accurately identify relatively well-funded and less-well-funded plans.[106]The six state plans selected include three funds – California Public Employees' Retirement System (CALPERS), Florida Retirement System (Florida RS), and Washington Public Employee's Retirement System (Washington PERS) – that were relatively well funded and three funds – the Teachers' Retirement System of the State of Illinois (Illinois TRS), New York State & Local Employees' Retirement System (New York State & Local ERS), and the State Teachers Retirement System of Ohio(Ohio STRS) – that

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[103]ISAACS, *supra* note 7, at 14.
[104] Stephen Losey, *FERS Retirement Fund Projects Surplus*, FED. TIMES, Apr. 23, 2012, *available at* http://www.federaltimes.com/article/20120423/BENEFITS02/204230302/1041/BENEFITS.
[105] Forman, *supra* note 18, at 848.
[106] For state-level plans, we utilized research from the Center for Retirement Research at Boston College, Alicia H. Munnell et al., *Can State and Local Pensions Muddle Through?* (2011). To select local plans, we used Robert Novy-Marx & Joshua Rauh, *The Crisis in Local Government Pensions in the United States*, *in*GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE FINANCIAL CRISIS,(Robert Litan and Richard Herring eds., 2011).We did not simply pick the top three and bottom three plans identified by the publications, but also took into account some geographic diversity. For example, because we included Illinois TRS as an underfunded plan in our state study, we did not include any City of Chicago plans as underfunded plans in our municipal study group. There is, however, some geographic duplication between our state and local plans.

were relatively underfunded. At the municipal level we selected three well-funded municipal plans: the City of Milwaukee Employees' Retirement System, the City of Tampa General Employee Retirement Fund, and the San Antonio Police & Fire Pension Fund. Also included were three plans that are generally considered underfunded: the City of Philadelphia Pension System, the State-Boston Retirement System, and the Teachers' Retirement System of New York City.

Our definition of "governance" provisions was quite broad. We included relevant statutes, regulations, and also internal governance documents such as investment policies and procedures. While not strictly a governance provision, we also included any funding requirements relevant to the plan. After all, even a plan with ideal governance provisions may fail if the government has no obligation to contribute an amount to adequately fund liabilities.

A plan's governance provisions may, of course, only be useful to the extent that they can be enforced. For that reason, we also researched whether the plan had been a party to two different types of lawsuits. The first were suits that sought to enforce the government's funding obligation (if any), and the second were lawsuits that sought to enforce pure governance provisions – namely, how the plan trustees managed the plan's assets.[107] And because some allegations of mismanagement may also be handled through settlements outside the court system, we searched news sources to determine whether any such allegations had been made and how they were addressed.

After gathering all of the relevant data, we compared the results against the main provisions of the Model Act, as well as the main criteria in the Clapman Report. Our results are presented in detail below, with key points summarized at a high level in Appendices A and B.

1. General Trust & Fiduciary Provisions

a. State Plans

Most of the trust and fiduciary provisions in the Model Act can be found in our sample of state plans. All state plans hold plan assets in trust,[108] and are subject to fiduciary powers and duties that are

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[107] There is a third type of lawsuit, those that challenge the payment of an individual's benefit under the plan. Because those lawsuits are challenging the interpretation of the plan's benefit provisions, and not its funding or governance, they were not relevant to our study.

[108] N.Y. Legal Op. 90-54 (1990), *available at* http://osc.state.ny.us/legal/1990/legalop/op90-54.htm; N.Y. RETIRE. & SOC. SEC.LAW§422; OHIO REV. CODE ANN. §3307.15; FLA.STAT. ch. 121.045; WASH.REV. CODE § 41.34.120; CAL. CONST.art.XVI, § 17(a); WASH. REV. CODE § 41.34.120 (in Washington, while plan assets are required to be held in trust for investment purposes, the funds themselves are not trusts. *See* Pub. Employees Council of Wash. v. Charles, 62 P.3d 470 (Wash. 2003)). Our finding with respect to trust requirements is not surprising,

substantially consistent with the Model Act. For all plans, trustees are required to act solely in the interest of beneficiaries, and in most cases this duty is further clarified as acting with the exclusive purpose of providing benefits and paying reasonable expenses.[109] All state plans contain the key fiduciary standard of the Model Act, that trustees to act with the care, skill, and caution of a prudent person in light of the circumstances at the time of the decision.[110] Four plans in our state sample protected participant's benefits from creditors by statutorily prohibiting assignment or alienation of member benefits.[111]

There are a number of provisions in the Model Act that either none, or few, of the state plans mirror. None of the fund governance provisions from our sample require that trustees act in accordance with a good faith interpretation of the law, and only one-third of state plans require them to only pay costs that are appropriate and reasonable.[112] No state plans explicitly require trustees to act impartially.

b. Local Plans

All of the municipal funds studied held their assets in trust,[113] and most provided that the trustees must act solely in the interests of participants and beneficiaries.[114] Notably, however, the governance provisions of two of the three underfunded local plans did not even explicitly state this core fiduciary duty. Threemunicipal funds mirrored the key Model Act standard that trustees were required to act with the care, skill, and caution that a prudent person would use under the circumstances,[115] with two well-funded plans requiring trustees to follow the *stricter* "prudent investor" standard.[116]Five of the local plans in our

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given that plans must hold assets in trusts in order to comply with Internal Revenue Code requirements. *See* I.R.C. §401(a).

[109]CAL. CONST. art.XVI, § 17(a); OHIO REV. CODE ANN. § 3307.15; N.Y. COMP. CODES R. & REGS.tit. 11, § 136-2.1 &N.Y. RETIRE. & SOC. SEC.LAW§ 177; WASH.REV. CODE § 41.34.120; 40 ILL. COMP. STAT.5/1-109; FLA.STAT. ch.121.30 & 215.444.

[110]CAL. GOV'T CODE § 20151(c) &CAL. CONST. art.XVI § 17(c); OHIO REV. CODE ANN. §3307.15(A); N.Y. COMP. CODES R. & REGS.tit. 11, §136-2.3, N.Y. RETIRE. & SOC. SEC.LAW§ 177(9)(b); WASH. REV. CODE§ 43.33A.140; 40 ILL.COMP. STAT. 5/1-109(b); FLA.STAT. ch. 215.47(10).

[111]FLA. STAT. ch. 121.131; N.Y. RETIRE. & SOC. SEC.LAW§ 110; OHIO REV. CODE ANN. §3307.41; CAL. GOV'T CODE § 21255.

[112]OHIO REV. CODE ANN. §3307.51; CAL. CONST. art.XVI § 17(b);CAL GOV'T CODE§ 20151(a).

[113]CITY OF BOSTON MUNI.CODE 5-6.3 (2011); FLA.STATE LAW ch 23559, Special Act of 1945, §6; MILWAUKEE CITY CHARTER § 36-09 (2011); N.Y.C. ADMIN.CODE § 13-534; PHILA.CODE § 22-1200; TEX.REV. CIV. STAT. ANN. art.6243o, § 1.04(a).

[114]FLA. STAT. ANN. §112.656(1); MASS.GEN. LAWS ch. 32, §23(3); MILWAUKEE CITY CHARTER § 36-09-2-d-3 (2011).TEX. REV. CIV. STAT. ANN. art.6243o, §1.04(b).

[115]FLA. STAT. ANN. §112.661(4); MASS.GEN. LAWS ch. 32, §23(3); PHILA.CODE § 22-1001(1).

[116]MILWAUKEE CITY CHARTER § 36-09-1-d-1 (2011); TEX.REV. CIV. STAT. ANN. art.6243o, § 7.04(a).

study protected participants' benefits through anti-alienation and anti-assignment provisions, consistent with the Model Act.[117]

There were many Model Act fiduciary provisions that no municipal plan in our study had in its governance provisions. These included the requirements that trustees act impartially, and incur costs only that are reasonable and appropriate. Only one municipal plan had a requirement similar to the Model Act's provision that trustees act in accordance with a good-faith interpretation of the law governing the retirement system.[118] On the whole, the municipal plans studied had much less detailed fiduciary provisions than the Model Act would require, and two of the underfunded plans failed to contain even basic provisions regarding fiduciary duty.

2. Investment Provisions

a. State Plans

One of the Model Act's primary objectives was to enable public plans to implement modern portfolio theory in structuring their investment decisions.[119] To that end, the Model Act provides that trustees may invest in any kind of property or type of investment, provided the Act's other provisions are complied with.[120] Here we see a significant, if unsurprising, divergence between the Model Act and the state plan governance provisions studied.

Nearly every state plan in our study limits the makeup of the portfolio or the amount of any one company's stock or bonds that may be held by the plan, and often prohibits specific investments.[121] None of the state plans in our study have governance provisions addressing the consideration of an investment's collateral benefits. Most of the state plans do, however, have provisions favoring home-state investing over other, comparable investments, and home-state investment managers over out-of-state investment managers.[122]

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[117] MILWAUKEE CITY CHARTER § 36-10(a) (2011); TEX.REV. CIV. STAT. ANN. art.6243o; FLA.STATE LAW ch 23559, Special Act of 1945, §20; MASS.GEN. LAWS ch. 32, §19; PHILA. CODE §22-1303.

[118] *See* N.Y.C. ADMIN. CODE § 13-508.

[119] *See* Model Act,*supra* note 10, at 2.

[120] *See id*. at §7(a)(4).

[121] *See* OHIO REV. CODE ANN. §3307.15(A);WASH. REV. CODE § 43.33A.140;N.Y. RETIRE. & SOC. SEC.LAW § 423;CAL. GOV'T CODE§ 7513.7 (restricting investments in Iran);CAL. GOV'T CODE§ 7513.6 (restricting investments in Sudan);N.Y. RETIRE. & SOC. SEC.LAW §423-a (restricting investments in Northern Ireland);40 ILL. COMP. STAT. 5/1-110.6 & 110.15(restricting investments in Sudan and Iran). Florida approves specific investments. FLA. STAT. ch. 215.47 (permitted investments).

[122] *See, e.g.* OHIO REV. CODE ANN. §3307.154(B)(2) (use of Ohio-qualified investment managers);OHIO REV. CODE ANN. §3307.152 (A) & (B) (use of Ohio-qualified licensed securities dealers); FLA. STAT. ch. 215.47(7) (investing in Florida-based businesses);CAL. GOV'T CODE§ 20194(a) & (d) (requiring investment in California real estate unless imprudent to do so); 40 ILL. COMP. STAT.5/1A-108.5 (encouraging funds to invest in

There are several investment provisions of the Model Act that were not well-represented in our state sample. None of the state plans required general economic conditions to be considered by trustees when investing, although all considered them in their actuarial reports. Similarly, no state plans specifically required the consideration of liquidity, regularity of income, or the preservation or appreciation of capital when investing.[123] No state plans required investment objectives to be reviewed annually, or that a reasonable effort be made to verify the facts of investments. Only one plan had any governance provisions related to the consideration of inflation,[124] and only one required that trustees consider investments in the context of the overall portfolio.[125]

There are a number of investment provisions from the Model Act that are almost universally adopted in our sample of state plans. Every state plan requires the development of a statement of investment objectives or policies,[126] and consideration of the investment's total return when investing.[127] Nearly all plans require investments to be diversified unless it would be clearly prudent not to do so.[128]

b. Local Plans

Like the state plans discussed above, the municipal plans in our study did not reflect the ideals of the Model Act, which favor unrestricted investing and a complex mix of factors that should inform investment decisionmaking. Of the six municipal plans in our study, only one well-funded plan allowed unrestricted investment.[129] The other local plans all

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Illinois businesses); and N.Y. RETIRE. & SOC. SEC.LAW§ 423-b (establishing a venture capital fund for New York businesses).

[123] Ohio STRS does, however, have a board policy that contains a specific liquidity requirement when investing. STATE TEACHERS' RET. SYS. OF OHIO, STATEMENT OF INVESTMENT OBJECTIVES AND POLICY §2.1 (2010), *available at* https://www.strsoh.org/pdfs/CAFR2011/11-investments.pdf.

[124] While the Model Act requires trustees to consider the impact of inflation and deflation when making investment decisions, none of our state plans contained that explicit requirement. Washington PERS, however, requires a statutorily-defined rate of inflation to be considered for asset valuation. WASH. REV. CODE § 41.45.035.

[125] WASH. REV. CODE § 43.33A.140.

[126] *See* WASH. REV. CODE § 43.84.150;OHIO REV. CODE ANN. §3307.15(B), 40 ILL.COMP. STAT. 5/1-113.6;N.Y. COMP. CODES R. & REGS.tit. 11, §136-2.3;FLA.STAT. ch. 215.475 &FLA.ADMIN.CODE ANN. r. 2,§ 18701(b).

[127] This is required by statute or board policy in each plan. FLA. STAT. ch. 215.47(10);CAL. CONST. art.XVI § 17(d);OHIO REV. CODE ANN. §3307.15(B);WASH.REV. CODE § 43.33A.110, TEACHERS' RETIR.SYS. OF THE STATE OF ILLINOIS, INVESTMENT POLICY 4 (2011); OFFICE OF THE STATE COMPTROLLER, GENERAL INVESTMENT POLICIES FOR THE NEW YORK STATE COMMON RETIREMENT FUND 6 (2010),*available at* http://www.osc.state.ny.us/pension/generalpolicies.pdf.

[128] *See* 40 ILL. COMP. STAT. 5/1-109(c);CAL. CONST. art.XVI § 17(d);FLA. STAT. ch. 112.661(8), WASH. REV. CODE § 43.33A.140, and OHIO REV. CODE ANN. §3307.15(A).

[129] The San Antonio plan was the only plan in our study without investment restrictions. The San Antonio plan's investment provisions can be found at TEX. REV. CIV. STAT. ANN. art.6243o, §7.

had some type of investment restriction in place, generally placing limits on certain types of investments and completely prohibiting others.[130] Notably, only one of the local plans studied contains social investing provisions. The Philadelphia plan prohibits investment in companies operating in Northern Ireland that do not follow the MacBride principles,[131] as well as investments in tobacco companies and those companies engaged in predatory lending.[132]Interestingly, only one of the local plans in our study had an*affirmative* requirement that favored the local economy. The Tampa plan is subject to a requirement, imposed by state law, to use in-state investment managers.[133]

The City of Philadelphia, one of the underfunded local plans in our study, spells out standards that investment managers must meet in order to be chosen to handle plan assets.[134] However, the Investment Policy adopted by the Plan's investment committee then provides that such standards may be lowered if necessary to "increase participation of minority, women, and disabled-owned investment managers."[135] Philadelphia was the only local plan in our study that prohibited the hiring of investment managers that made a contribution to a municipal official or candidate in the municipality that controls the pension system, although this restriction was provided through state, and not local, law.[136]

The Model Act contains very detailed provisions regarding trustee investment decisions. As with the fiduciary duty requirements discussed above, the municipal plans studied contain much less detail with respect to investment decisionmaking than the model act. Several Model Act provisions related to investment decisions were not found in any municipal plan's governance provisions. The provisions that were wholly absent from the municipal plans were the requirements that trustees in investing and managing the assets shall consider general economic conditions, the possible effect of inflation or deflation, expected total return, needs for liquidity, regularity of income, and preservation or appreciation of capital; and that the trustees could only consider collateral

[130] For example, in the Tampa plan, no more than 65% of assets can be invested in common or preferred stock, with no more than 10% invested in the common stock of a single company. In addition, only bonds with certain ratings can be purchased. FLA. STATE LAW ch 23559, Special Act of 1945, §6(c)(2).

[131] The "MacBride principles" are a corporate code of conduct for U.S. firms doing business in Northern Ireland, and are designed to counter religious discrimination in the workplace. *See* SEAN MCMANUS, THE MACBRIDE PRINCIPLES (2001), *available at*http://www.irishnationalcaucus.org/pages/MacBride/MacBride%20Principles%20The%20Essence.htm.

[132]PHILA.CODE §§ 22-1001(3), (4), & (5).

[133]FLA. STATE LAW ch 23559, Special Act of 1945, §6(A).

[134]CITY OF PHILA.BD. OF PENSIONS & RET., INVESTMENT DIVISION, POLICIES AND PROCEDURES MANUAL §10.1 (2012), *available at*http://www.phila.gov/pensions/pdfs/Investment_Policy_2012-.pdf.

[135]*Id*. at §10.2.

[136]*See* 53 PENN. CONS. STAT. § 895.704-A(a).

benefits of an investment if the investment would be prudent without the collateral benefit.

Another group of investment-related provisions from the Model Act are present only in a small number of local plans in the study group. Two of the well-funded municipal plans provided that trustees, in investing and managing the assets, should consider the role that each investment plays within the overall portfolio.[137] Half of the local plans (two well-funded and one underfunded) provided that trustees should diversify plan investments unless it is clearly prudent not to do so.[138] Only a single well-funded municipal plan provided that trustees should make a reasonable effort to verify facts relevant to the investment and management of the assets.[139]

The Model Act also provides that trustees must adopt a statement of investment objectives and policies. The governance provisions of twolocal plans in our study had such a requirement (one well-funded and one underfunded plan), although for one of these plans the investment policy was both very brief and difficult to locate.[140] One underfunded local plan had an investment policy in place, although it was not required to do so.[141] That same plan did, however, adopt an internal rule that investment objectives and policies be reviewed annual – the only municipal plan in our study to do so.[142]Half of the municipal plans in our study not only had no affirmative requirement to adopt an investment policy, but they also did not voluntarily create such a policy and make it publicly available. In other words, for half of the municipal plans, there would be no easy way for an interested party to determine the basis on which the plan is making investments.

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[137]MILWAUKEE CITY CHARTER § 36-09-1-d-1 (2011); TEX.REV. CIV. STAT. ANN. art.6243o, § 7.04(a).

[138]MASS. GEN. LAWS ch. 32, §23(3); MILWAUKEE CITY CHARTER § 36-09-1-d-2 (2011); TEX.REV. CIV. STAT. ANN. art.6243o, § 7.04(b).

[139]MILWAUKEE CITY CHARTER § 36-09-1-d-1 (2011).

[140]MASS. GEN. LAWS ch. 32, §20(5)(j) (requiring disclosure of the plan's investment policy in its annual report); MILWAUKEE CITY CHARTER § 36-09-1-b (2011). Boston's investment policy is available only in its annual report. It is less than one-half of a page in length. *See* State-Boston Ret. Sys., Financial Statements and Required Supplementary Information (2010), *available at* http://www.cityofboston.gov/Images_Documents/12388State-Boston-FS-1210-FINAL_tcm3-29473.pdf.

[141] The City of Philadelphia does not appear to be subject to any requirement to create an investment policy, yet it has done so. *See* CITY OF PHILA. BD. OF PENSIONS & RET., INVESTMENT DIVISION, POLICIES AND PROCEDURES MANUAL (2012), *available at*http://www.phila.gov/pensions/pdfs/Investment_Policy_2012-.pdf.

[142]*Id*. at §4.3.

3. Board Composition and Trustee Expertise

a. State Plans

While the Model Act is silent with respect to board composition and trustee expertise, much has been written about public pension plan board composition.[143] The Clapman Report did not prescribe a specific board make-up, but instead focused on ensuring that board trustees have relevant expertise and continually monitor and update their skills.[144]

Although the specific details of board composition among our state plans vary,five of the six plans were governed by boards comprised of a majority of political officials or political appointees.[145] Only one, relatively underfunded plan, Ohio STRS, had a board that had a majority of elected members.[146]

The Clapman Report also recommended that in order for boards to function effectively, they needed the authority to select or dismiss key staff members.[147]In all state plans, the board or Comptroller has the ability to hire or dismiss key staff, although in Florida that power is limited by a requirement that the governor must also vote in favor of any executive director approved by the board.[148]

Nearly all trustees in our state study group are required to have investment experience and expertise or be advised by an individual or group that does, with CALPERS being the only plan without any such

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[143]*See, e.g.*, *supra*.note 8.

[144]*See* Clapman Report, *supra* note 85, at 10-12.

[145]Among the better-funded plans, Florida RS has a three-member board, all of whom are government officials: the Governor, the state Chief Financial Officer, and the Attorney General.FLA. STAT. ch. 215.44(1). Washington PERS has a fifteen member board, and the ten voting members are evenly split between plan participants and government officials, but the majority of the plan participants are appointed by the governor.WASH. REV. CODE § 43.33A.020.California PERS has a thirteen member board, six of whom are elected plan participants, and seven of whom are government officials or appointed by government officials.CAL. GOV'T CODE § 20090. Among the less well-funded plans, Illinois TRS has a thirteen member board consisting of one ex officio government official, six members appointed by the governor with the consent of the senate, and six members elected from plan participants.40 ILL. COMP. STAT. 5/16-163, 16-164, & 16-65. Finally, New York State & Local ERS has no board – the State Comptroller is the trustee and individual in charge of the retirement fund.N.Y. COMP. CODES R & REGS. tit. 11, § 136-2.3.

[146]Ohio STRS has a board of eleven members, seven of whom are elected plan participants, three of whom are appointed by government officials and one government official.OHIO REV. CODE ANN. §3307.05.

[147] Clapman Report, *supra* note85, at 8.

[148]State of California Bd. of Admin.Pub.Employees' Ret. Sys.Delegation Resolution No. EXEC-95-101 (III)(C)(1)(c); OHIO REV. CODE ANN. §3307.04; 40 ILL. COMP. STAT. ANN. 5/16-163; NEW YORK STATE COMMON RET. FUND, GENERAL INVESTMENT POLICIES (2010), *available at* http://www.osc.state.ny.us/pension/generalpolicies.pdf; FLA.STAT. ANN. § 215.441 (allowing the board to elect the executive director by a majority vote, although the governor must approve the selection); WASH.REV. CODE § 43.33A.100.

requirement.[149] Only half of our state plans require trustees to obtain continuing education.[150] None of the plans requires an annual evaluation of trustee skills.

b. Local Plans

The six local plans in our study had a mix of board composition. Only one, well-funded plan had a board whose majority was elected employee and retiree representatives.[151] Three local plans in the study, one well-funded and two poorly-funded, had boards with political appointee majorities.[152] One well-funded plan was evenly split between employee representatives and politicians, while one poorly-funded plan was split evenly between political and elected representatives, with those board members choosing one, additional, independent board member.[153] While the boards of well-funded plans were more likely to have non-political majorities, there certainly was not an overwhelming correlation between plan structure and plan funded status. Four of the six local plans in our study had the authority recommended by the Clapman Report to select or dismiss key staff members, evenly split between well- and poorly-funded plans.[154]

One underfunded local plan's board had unique requirements that governed the board's ability to take action, which appeared to be devised to ensure that board decisions were not unduly dominated by either political or employee members. In the New York City Teacher's Plan, the board can act only with the approval of (1) either the comptroller or a

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149 OHIO REV. CODE ANN. §3307.05; N.Y. RETIRE. & SOC. SEC.LAW§ 423; WASH.REV. CODE § 43.33A.020; 40 ILL.COMP. STAT.5/16-164; FLA.STAT. ch. 215.441.

150 FLA. STAT. ch. 112.661(14); OHIO REV. CODE ANN. §3307.051; WASH. STATE INVESTMENT BD., POLICIES & PROCEDURES 2.002.00 (2012), *available at* http://www.sib.wa.gov/information/bi_po.asp.

151 TEX. REV. CIV. STAT. ANN. art. 6243o, § 2.01 (board is comprised of nine trustees: the mayor or her appointees; two members of the municipalities governing body; two active firefighters elected by plan participants; two active police officers elected by plan participants, and two elected retirees).

152 FLA. STATE LAW ch 23559, Special Act of 1945, §6 (board is comprised of seven members: three elected representatives, three individuals appointed by the major, and the city's Chief Financial Officer); N.Y.C. ADMIN. CODE § 13-507 (board is comprised of seven members: the president of the Board of Education; the Comptroller of New York City; two members appointed by the mayor; and three members of the retirement association); PHILA. HOME RULE CHARTER, art. 3, §803 (board consists of nine trustees, five of whom are City of Philadelphia officials, and four of whom as elected representatives).

153 MASS. GEN. LAWS ch. 32, §20(4)(b) (board has five members: the city auditor, two members appointed by the mayor, two elected representatives, and one member chosen by the remaining four board members, who is neither an employee, retiree, or government official).

154 MASS. GEN. LAWS ch. 32, §20(4)(e); CITY OF MILWAUKEE RULES & REG. §VII.E; N.Y.C. ADMIN. CODE § 13-509; TEX.REV. CIV. STAT. ANN. art.6243o, §§ 2.05, 3.01(a), 7.05(a).

board member elected by the mayor, (2) an elected member and (3) two other board members.[155]

One area where the local plans in our study fell far short of ideals is with respect to trustee expertise and training. Not a single plan in our study required that any trustees have investment and financial market expertise or experience, or that any type of trustee skill evaluation take place. Two plans, however, imposed some type of trustee training and continuing education requirements.[156] In both of these cases, the trustee educational requirements were provided by state, and not local, law.[157]

4. Disclosure Requirements

a. State Plans

The drafters of the Model Act placed a premium on disclosure requirements, on the theory that disclosure is an essential element to monitoring and enforcement. All of the state plans in our study fell short of the Model Act ideal with respect to disclosure.

While all of the state plans are required to issue annual financial and actuary disclosures,[158]as well as an annual report,[159] none of the plans are required to provide summary plan descriptions or summaries of material modification to plan participants.

State plans follow the Model Act protection of investment decisions by shielding them entirely from open meeting and records laws, or at least delaying their disclosure.[160] Every state plan board, or the State Comptroller in the case of the New York State & Local ERS, is statutorily subject to a code of conduct or ethics that covers conflicts of interest, and all but one well-funded plan (Washington PERS) must disclose actual or potential conflicts of interest.[161] In all cases, the board or State

[155] N.Y.C. ADMIN. CODE § 13-512.
[156] FLA. STAT. ch. 112.661(14); MASS.GEN. LAWS ch. 32, §20(7).
[157] *Id*.
[158] WASH. REV. CODE§ 41.45.030(1);OHIO REV. CODE ANN. § 3307.51(A), OHIO ADMIN. CODE § 3307-1-04;N.Y. RETIRE. & SOC. SEC.LAW § 11(d); 40 ILL.COMP. STAT.5/16-175;FLA.STAT. ch. 112.63(2);CAL. GOV'T CODE § 20227.
[159] WASH. REV. CODE§ 41.50.265;OHIO REV. CODE ANN. §171.04(B);N.Y. RETIRE. & SOC. SEC.LAW § 11(d); 40 ILL.COMP. STAT.5/16-175;FLA.STAT. ch. 121.135;CAL. GOV'T CODE § 7503.
[160] *See*CAL. CODE REGS.tit. 2, § 559(d)(9); 5 ILL. COMP. STAT. 120/2(c)(7);WASH. REV. CODE§42.56.270(6); FLA.STAT. ch.215.4401(2); N.Y. PUB. OFF. LAW §105(1)(h);OHIO REV. CODE ANN. §121.22(G).
[161] OHIO REV. CODE ANN. §§ 102.01 (code of ethics) & 102.02 (required disclosures); WASH. ADMIN.CODE § 287-04-029 (code of conduct for board members and employees of the board); FLA.STAT. ch. 112.3144 (code of ethics and disclosure for officers), FLA.STAT. ch. 112.3145 (code of ethics and disclosure for board members);FLA.STAT. ch. 112.3146 (making board member disclosures public); N.Y. PUB. OFF. LAW§ 74 (code of ethics for public employees), N.Y. COMP. CODES R. & REGS.tit. 2, § 320.5 (code of ethics for advisory council), N.Y. COMP. CODES R. & REGS tit.11, § 136-2.4 (governance responsibility and ethics provisions for employees, committees, investment managers, and consultants), N.Y. COMP. CODES R. & REGS tit. 11, § 136-2.5(g)(5) (requiring

Comptroller defines governance rules and makes them accessible to the public.[162] While not required by statute, all funds also publicly disclose organizational charts.[163]

b. Local Plans

Like the state plans in our study, all of the municipal plans fell short of the Model Act ideal with respect to disclosure. Each of themunicipal plans in our studyis required to provide some type of annual report that includes financial information,[164]while only one plan required that a plan summary be provided to participants, [165] and none required that participants be updated if there was a material modification of the plan.

While most of the Model Act's disclosure provisions were aimed at enabling effective monitoring, one of the provisions provides that the plan need not disclose information under state open meeting and records laws if doing so would jeopardize investment decisions and objectives. None of the municipal plans in our study provided such protection.

Similarly, only two local funds in our study lived up to the ideals of the Clapman Report, which recommends that funds define and make public their governance rules.[166] Most plans do, however, disclose their leadership structures.[167]Only one local plan had any type of requirement to report actual and potential conflicts.[168]

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triennial audits of conflict of interest disclosures); CAL. CODE REGS.tit. 2, § 560 (requiring the adoption of a conflict of interest code), CAL. CODE REGS.tit. 2, § 18730 (disclosures, and prohibitions); 5 ILL.COMP. STAT. 420/3A-30 (requiring disclosure of contracts with the state), 5 ILL. COMP. STAT. 420/3A-35 (conflicts of interest) 5 ILL. COMP. STAT. 420/4A-102 (disclosure). *See also* WASH. STATE INVESTMENT BD., POLICIES & PROCEDURES 2.00.100 (2011) (detailing the conflict of interest policy, requiring disclosure, and providing for monitoring).

[162] This information is available through the plans' websites.

[163] This information is provided through the plans' websites.

[164]FLA. STAT. ch. 112.661(15); MASS.GEN. LAWS ch. 32, §20(5); MILWAUKEE CITY CHARTER § 36-15-9; N.Y.C. ADMIN.CODE § 13-517; PA.CONS. STAT. § 895.201(e). The San Antonio plan is required to make an annual report to the governing body, but there is not any apparent requirement to disclose the report to the public. *See* TEX. REV. CIV. STAT. ANN. art. 6243o, §3.01(e)

[165]FLA. STAT. ch. 112.66.

[166] Only the Milwaukee and Philadelphia plans had public, easily accessible governance rules.

[167] For most of the plans, the plan's leadership structure was easily accessible on the plan's website. This was not true for the Tampa plan (one of the well-funded plans in our study group), and the leadership structure for the New York City plan was available, but only from within the annual report.

[168]SAN ANTONIO FIRE & POLICE PENSION FUND,STANDARDS OF CONDUCT, FINANCIALDISCLOSUREANDCONFLICTSDISCLOSURES 8 (2010), *available at* http://www.safireandpolicepension.org/SSLFolder/pdf/BoardDisclosures%20FINAL.pdf.

5. Funding Requirements

a. State Plans

While plan funding requirements are perhaps not strictly speaking a governance issue, they are intimately related to a plan's ability to achieve its goals. We found that employers for each of the state plans in our study are statutorily required to make their annual contributions,[169] although some statutes give their administrators more power to collect those contributions than others. California has a unique constitutional provision that gives the CALPERS board complete actuarial authority to determine annual contributions, and state statute requires the legislature and the governor to fund the plan in accordance with the CALPERS' funding determination.[170] Illinois TRS and Florida RS both allow the automatic deduction of missed payments from any state money being transferred to the employer.[171] Ohio STRS and CALPERS are given the ability to charge penalties and interest for late payments, and CALPERS is explicitly granted the right to recoup collection and legal fees incurred during the collections process.[172] New York State & Local ERS requires payments to be made in full each fiscal year, but seems to have no penalty for payments that are not made.[173] Any member of Washington PERS may sue to force employers to pay contributions.[174]

Funding requirements are often only as good as the actuarial assumptions that are used to calculate funding needs. In this regard, the Model Act requires that the trustees of public pension plans use "reasonable actuarial factors" to determine the adequacy of funding.[175] While each of the state plans in our study rely on actuaries to calculate contribution rates and funded status, none of them are subject to a requirement that the actuarial assumptions used be reasonable.[176]

[169] CAL. GOV'T CODE§ 20831; OHIO REV. CODE ANN. 3307.28; 40 ILL. COMP. STAT.5/1616-158; N.Y. RETIRE. & SOC. SEC. LAW§ 23-a(b)(3); FLA. STAT. ch. 121.061(1); WASH.REV. CODE§ 41.50.120.

[170] *See* CAL. CONST. art.XVI, §17(e); CAL. GOV'T CODE§ 20814.

[171] FLA. STAT. ch. 121.061(2)(b); 40 ILL. COMP. STAT. 5/16-158.1; 40 ILL. COMP. STAT. 5/1-107.

[172] CAL. GOV'T CODE§§ 20831, 20572(a) – (b); OHIO REV. CODE ANN. §3307.292 & Ohio Admin.Code § 3307-3-05.

[173] N.Y. RETIRE. & SOC. SEC.LAW§ 23-a(b)(3).

[174] WASH. REV. CODE § 41.45.050(3).*See also* Retired Pub. Employees Council of Wash. v. Charles, 148 Wn.2d 602 (Wash. 2002) (holding that retirees and employees have vested contractual rights to the systematic funding of the retirement system to maintain actuarial soundness). Washington PERS is also entitled to charge interest and fees on late contributions, but only for employers that are not political subdivisions of the state. WASH. REV. CODE § 41.40.048.

[175] Model Act, *supra* note 10, at §8(a)(1)(F).

[176] OHIO REV. CODE ANN. §3307.51(A); 40 ILL.COMP. STAT. 5/16-176; N.Y. COMP. CODES R. & REGS.tit 11, § 136-2.6; CAL. GOV'T CODE § 20227; FLA. STAT. ch. 121.192; WASH.REV. CODE § 41.45.030(1).

Examining whether the plans in our study made the annual required contribution as calculated pursuant to GASB Statement Number 25 gives us a mixed picture of the states' funding record.[177] Among our well-funded plans, only one made annual contributions that were equal to or exceeded 100% of the required annual contribution for each of the past five years.[178] The same was true of our underfunded plans, with only one making the full required annual contribution.[179] The other two underfunded plans in our study made contributions significantly below the annual required contribution.[180]

b. Local Plans

The municipal plans in our study all contain requirements related to annual employer contributions. One of the well-funded plans, San Antonio, has funding rates that are not actuarially determined, but rather are set by state statute.[181] The remaining five plans all appear to require annual, actuarially-determined contributions, albeit with specifics that differ as to how such amounts are determined. Milwaukee in fact goes even further, and requires the city to contribute not only the normal cost of benefits, but also any additional amount necessary to get the plan above 100% funded.[182] The city council (referred to in Milwaukee as the "Common Council") even has the power to implement a dedicated tax if necessary to obtain the required funds.[183] Importantly, not a single municipal plan in our

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[177] Note that the annual required contribution calculated under GASB Statement Number 25 may be different than the required contribution calculated by the plan's actuaries pursuant to the plan's funding provisions.

[178] California was the only state to make all required annual contributions, although it did so only for the main "Public Employees Retirement Fund" and not the judicial retirement plans. *See* CALIFORNIA PUBLIC EMPLOYEES RET. SYS., COMPREHENSIVE ANNUAL FINANCIAL REPORT 84 (2011), *available at* http://www.calpers.ca.gov/eip-docs/about/pubs/comprehensive-annual-fina-report-2011.pdf. Florida did not make the full amount of its annual required contributions over the most recent five years. *See* THE FLORIDA RETIREMENT SYSTEM, ANNUAL REPORT 40 (2011), *available at* https://www.rol.frs.state.fl.us/forms/2010-11_Annual_Report.pdf (Florida did, however, contribute more than 100% in some of the most recent five years). Washington made the full annual required contributions only for the Law Enforcement Officers & Fire Fighters Plan 2, and not for any of its other plans. *See* WASHINGTON STATE DEPT. OF RET. SYS., COMPREHENSIVE ANNUAL FINANCIAL REPORT 84 (2011), *available at* http://drs.wa.gov/administration/annual-report/cafr/.

[179] *See* NEW YORK STATE & LOCAL RET. SYS., 2012 COMPREHENSIVE ANNUAL FINANCIAL REPORT 54 (2012), *available at* http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_12.pdf.

[180] *See* TEACHERS' RET. SYS. OF THE STATE OF ILLINOIS, COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2011 51 (2011), *available at*http://trs.illinois.gov/subsections/pubs/cafr/cafr.htm; STATE TEACHERS RETIREMENT SYSTEM OF OHIO, COMPREHENSIVE ANNUAL FINANCIAL REPORT 22 (2011), *available at* https://www.strsoh.org/about/CAFR11.html.

[181] TEX. REV. CIV. STAT. ANN. art.6243o, §§4.04 & 4.05.

[182] MILWAUKEE CITY CHARTER § 36-08-6-9.

[183] *Id*. at § 36-08-6-9(f).

study contained any "reasonableness" requirement with respect to actuarial factors.

The State of Florida has a constitutional provision providing that there can be no increase in public employee pension benefits unless the governmental unit that employs the individuals has made or concurrently makes provision for funding the increase on a sound actuarial basis.[184] This funding requirement applies to the Tampa plan, a well-funded plan included in our study.

Our municipal plans had a mixed record with respect to making the full amount of annual required contributions calculated pursuant to GASB Statement Number 25. One well-funded plan has made 100% of the ARCs for the last five years,[185] while another well-funded plan did not do so only because local law requires that contributions cease when the plan is fully funded.[186] We were unable to determine whether the third well-funded plan made its ARCs because such information was not readily available to the public. Of the three relatively poorly funded plans, two out of three made their full ARCs in each of the most recent five years.[187]

6. Enforcement

One clear finding of our study is that enforcement of plan governance provisions is perhaps the most difficult piece of the public plan governance equation. The Model Act contains detailed provisions regarding the standard to which fiduciaries should be held accountable, whether trustees should be able to insure against personal liability, who can file suit to enforce plan governance provisions, and the remedies available in such suits. We detail first the governance provisions relevant to enforcement before examining lawsuits in the relevant states that sought to enforce either funding requirements or fiduciary duties.

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[184]FLA. CONST. art 10, §14.
[185]SAN ANTONIO FIRE & POLICE PENSION FUND, 2011 ACTUARIAL REPORT, *available at* http://www.safppf.org/Rpt_AnnualReports.aspx?RepFolder=Sept302011.
[186]EMPLOYEES' RETIREMENT SYSTEM OF THE CITY OF MILWAUKEE, ACTUARIAL VALUATION REPORT 30 (2012),*available at* http://www.cmers.com/CMERS/Reports/Actuary/2012.pdf. *See also* MILWAUKEE CITY CHARTER § 36-08-6-A2 (establishing full funding limitation).
[187]*See* NEW YORK CITY TEACHERS' RETIREMENT SYSTEM, 94TH ANNUAL REPORT 73 (2012), *available at* https://www.trsnyc.org/WebContent/tools/brochure/annualReport.pdf (showing 100% of ARCs were made from 2006-2011); CITY OF PHILADELPHIA MUNICIPAL RETIREMENT SYSTEM, ACTUARIAL VALUATION AS OF JULY 1, 2010 50 (2011), *available at* http://www.phila.gov/pensions/pdfs/2010_Philly_AVR_0321.pdf (showing contributions less than 100% of ARC for past eight years); STATE-BOSTON RETIREMENT SYSTEM, DECEMBER 31, 2010 FINANCIAL STATEMENT 19 (2011), *available at* http://www.cityofboston.gov/Images_Documents/12388State-Boston-FS-1210-FINAL_tcm3-29473.pdf (showing at least 100% of ARC made in years 2005-2010).

a. State Plans

(1) Statutory Provisions Establishing Liability

Very few plans in our study contained liability provisions that were anywhere near as detailed as the Model Act. Three of the state plans in our sample – one relatively well-funded and two relatively poorly-funded – explicitly allow either participants[188] or state residents[189] to maintain an action for injunctive or equitable relief to enforce the act. Two of the three plans that do not explicitly allow for suits to enforce the act do explicitly allow the board to be sued, and do not shield them from liability, suggesting that plan participants would be able to bring suit to enforce the act in those states, as well.[190] Only Washington PERS, a well-funded plan, is silent on suing the board to enforce the act. In three of the states that allow suits the trustee or fiduciary sued may be held personally liable, but California and Illinois either cap liability or allow for indemnification (Ohio is silent on both).[191] Florida RS and New York State & Local ERS are silent on who can enforce the act beyond members of the board, and Washington PERS only allows the board to dismiss the violator, and specifically immunizes board members from liability for the actions of other board members.[192] Florida, though silent on who can enforce the act, is the only plan in our state sample that specifically voids any agreements limiting fiduciary liability as contrary to public policy.[193] All state plans except Washington PERS and New York State & Local ERS explicitly allow[194] or require[195] the plan to be insured against damage arising out of a breach of duty owed by a trustee or fiduciary.Nevertheless, perhaps the most interesting finding of our entire governance study is that, for all of the work that goes into discussing and creating well thought out governance provisions, these provisions appear to almost never be enforced, as will be detailed further below.

(2) Funding Lawsuits

As noted above, all of the plans in our study were subject to annual funding requirements, although with different levels of enforceability. For example, in Ohio, the State Retirement System Board may sue employers

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[188] 40 ILL. COMP. STAT.5/16-171 (the board may sue or be sued), 40 ILL. COMP. STAT. 5/1-115 (participants can sue to enjoin or obtain equitable relief).
[189] CAL. GOV'T CODE§ 91003(a); N.Y. STATE FIN.LAW § 123-b.
[190] OHIO REV. CODE ANN. §3307.03; FLA.STAT. ch. 112.66(6).
[191] *See* 40 ILL. COMP. STAT. 5/1-114 (liability);40 ILL.COMP. STAT.5/1-107 (indemnification unless violation was willful or the result of gross negligence); CAL. GOV'T CODE §§ 91003.5-91006 (capping liability); OHIO REV. CODE ANN. §3307.181.
[192] WASH. ADMIN.CODE § 287-04-039 (allowing for dismissal);WASH. REV. CODE§ 43.33A.070 (board members will not be liable for the violations of other board members).
[193] FLA. STAT. ch. 112.66(4).
[194] FLA. STAT. ch. 112.656(3), 111.072; CAL. GOV'T CODE§ 7511(a) & (b).
[195] OHIO REV. CODE ANN. §3307.181(E).

for failure to pay their contributions and collect past due amounts.[196] In Washington, planmembers may also sue, but only to enforce the collection of amounts determined by the legislature, even if they are not approved by the Pension Funding Committee.[197]

Our review of case law illustrates that these funding requirements are very rarely able to be effectively enforced.For example, Illinois TRS, one of the most underfunded plans in the country, has a long history of successfully fending off participant lawsuits to increase the level of contributions to their plan. In 1973, the Illinois Court of Claims held that the State of Illinois owed over $2 billion in missed contributions to Illinois TRS.[198] However, when the legislature passed bills appropriating amounts towards the missed contributions, the Governor used his line-item veto power to reduce the amount of the appropriations. Pensioners sued to collect the full amount appropriated under the non-impairment clause of the Illinois constitution, but the court held that the clause did not give pensioners a contractual right to a specific level of plan funding – only to the benefits they receive upon retirement.[199]

Similarly, in 1993 when the Illinois General Assembly essentially refinanced their unfunded pension obligations by extending the period over which they were amortized by 13 years, pensioners sued claiming it weakened the plan's funding status.[200] In that case the court held that not only did they not have a right to a specific level of funding, but the only change to funding formulas they could challenge is one that put the plan in imminent danger of bankruptcy.[201] Even when the funding levels enacted by the legislature and accepted by the governor were not being followed, the court held that Illinois pensioners could not require the collection of state contributions.[202] In light of this case law, perhaps it is not surprising that Illinois pensions are so underfunded.

In contrast, in the early 1990s, the California legislature made a series of changes to the way it funded the California Public Employees' Retirement Fund. Initially, contributions were made on a monthly basis, which was changed to quarterly, then semiannually, then semiannually in arrears, then annually in arrears.[203] The Board of California PERS challenged the "in arrears" financing as an unconstitutional impairment of contract because of the lost interest that would have accrued if the payments were made when due, rather than in arrears. The court held that the lost interest due to in arrears funding amounted to an unconstitutional

[196] Ret. Bd. of State Teachers' Ret. Sys. v. Kurtz, 110 Ohio St. 332 (Ohio 1924).
[197] Retired Public Employees Council of Wash. v. Charles, 148 Wn.2d 602 (Wash. 2002).
[198] Illinois Educ. Ass'n v. State of Illinois, 28 Ill. Ct. Cl. 379 (Ill. 1973).
[199] People ex rel.Illinois Federation of Teachers v. Lindberg, 60 Ill. 2d 266 (Ill. 1975).
[200] McNamee v. State of Illinois, 173 Ill.2d 433 (Ill. 1996).
[201] *Id*. at 447-47.
[202] Sklodowski v. State of Illinois, 182 Ill. 2d 220 (Ill. 1998).
[203] Bd. of Admin.of the Pub. Employees' Ret. Sys. v. Wilson, 52 Cal. App. 4th 1109, 1117 (Cal. 1997).

impairment of contract, and that California "PERS members have a contractual right to an actuarially sound retirement system."[204]

When New York was faced with a budget crisis, the state changed the method of funding pension benefits from the aggregate cost method (which funds some benefits before they accrue) to the projected unit credit method (which funds benefits only when they accrue).[205] This change was designed to save employers money on contributions the first few years after the switch, after which contribution rates would significantly increase.[206] In this case, employees were successfully able to challenge the change in funding method as a violation of their contractual rights because it divested the State Comptroller of discretion over which method to use for the plans.[207] When the funding method was changed back to the aggregate cost method, it resulted in state employers being behind on the contributions they should have been making. But rather than appropriate the amount of missed contributions, the legislature ordered that missed payments be collected out of the supplemental reserve fund, out of which supplemental allowances are paid to retirees.[208] Again participants sued and were successful in overturning this act of the legislature as a violation of their contractual pension rights because it infringed on the Comptroller's freedom to manage the funds in the manner he considered to be most fiscally appropriate.[209] But when the plan found itself overfunded in the late 1990s, the legislature provided that administrative costs would be paid out of the fund provided it did not result in the plan being underfunded. The court upheld that change, as the Comptroller never had discretion over how administrative costs were paid, and no benefits were reduced.[210]

(3) Fiduciary Lawsuits

Our research indicates that the states in our study group were very rarely sued regarding their investment decisions or other alleged breaches of fiduciary duties. We located one case that alleged New York had used pension plan assets to assist the City of New York in escaping potential bankruptcy. In response to the New York City budget crisis of the 1970s, the state legislature established a Municipal Assistance Corporation to act as a financing intermediary for the city.[211] They then passed a law authorizing and requiring the State Comptroller to purchase Municipal Assistance Corporation bonds for the pension fund.[212] The court struck down the requirement (but upheld the authorization) to purchase such

[204] *Id*. at 1118.
[205] McDermott v. Regan, 82 N.Y.2d 354, 358-59 (N.Y. Ct. App. 1993).
[206] *Id*. at 359.
[207] *Id*.
[208] McCall v. State of New York, 219 A.D. 136 (N.Y. App. Div. 1996).
[209] *Id*.
[210] Guzdek v. McCall, 193 Misc.2d 759 (N.Y. Sup.Ct. 2002).
[211] N.Y. RETIRE. & SOC. SEC.LAW§ 179.
[212] Sgaglione v. Levitt, 37 N.Y.2d 507, 511 (N.Y. 1975).

bonds as an impairment of pension benefits because it infringed on the Comptroller's discretion in managing the funds.[213] In so doing, the court stated that "neither plaintiffs nor the courts…are entitled…to assess the market worthiness of securities in which [a public pension trustee] may invest."[214] When the Comptroller purchased the bonds at par from the Municipal Assistance Corporation instead of on the open market where they were trading for a 20% discount, the court again stated that it was not entitled to assess the market worthiness of the securities.[215]

(4) Other Enforcement Actions

Both New York and Illinois have both had problems with pay-for-play scandals in the past decade, where high-level administrators of public funds were requiring kickbacks to place business with various investment firms.[216] These cases were criminal in nature, and therefore did not involve participant lawsuits.

b. Local Plans

(1) Statutory Provisions Establishing Liability

The municipal plans in our study fell far short of the Model Act ideals with respect to establishing trustee liability. The Act, for example, is explicit that a trustee's decision should be evaluated at the time the decision is made, and not with the benefit of hindsight. None of the municipal plans contained a similar provision. Two plans, each well-performing, did contain the Model Act provision that trustee decisions would be evaluated in the context of the portfolio as a whole, and not in isolation.[217]

Not only were plans lacking in establishing the standards that apply to trustee decisions, they were also somewhat lacking in establishing the type of liability trustees would face, and whether such liability could be insured

[213] *Id*.
[214] *Id*. at 513.
[215] Tron v. Condello, 427 F.Supp. 1175 (S.D.N.Y. 1976). The court also stated that the plan participants should seek remedy in a state tort action for breach of fiduciary duty, but that would have likely been unsuccessful in light of another provision passed by the legislature stating that the purchase of Municipal Assistance Corporation bonds was prudent, would not be a breach of fiduciary duty, and would not otherwise give rise to liability. *See* N.Y. RETIRE. & SOC. SEC.LAW§ 179.
[216] *See* Press Release, Teachers' Retirement System of the State of Illinois, TRS Reacts to Levin Plea; Pledges Continuing Cooperation in Finding, Punishing Wrongdoers (October 27, 2006), *available at* http://trs.illinois.gov/subsections/press/2006/October27.pdf; Danny Hakim, *Former Hevesi Aide Pleads Guilty in Pension Case*, N.Y. TIMES, March 10, 2010;Danny Hakim & Louise Story, *Hevesi Adviser in Pension Scandal Makes Deal to Plead Guilty to Felony*, N.Y. TIMES, Nov. 4, 2010; Karen Freifeld, *Ex-New York Official Hevesi Gets Up To 4 Years In Prison For Pay-To-Play*, BLOOMBERG, Apr. 15, 2011.
[217] MILWAUKEE CITY CHARTER § 36-09-1-d-1; TEX.REV. CIV. STAT. ANN. art.6243o, § 7.04(b).

against. Just one plan, from the poorly-funded group, contained the Model Act provision that explicitly states that trustees would be personally liable to the system for any breaches of fiduciary duty.[218] Only one plan, well-funded, provided that any agreement attempting to limit fiduciary liability was void.[219] Two well-funded plans had specific provisions allowing the plan to insure itself against liability or loss resulting from a breach of fiduciary duty,[220] while two different plans specifically provided that trustees could insure themselves against such liability.[221]

Importantly, only two plans (one well-funded, and one poorly-funded) explicitly allow participants, beneficiaries, or fiduciaries to maintain a cause of action against plan fiduciaries to enforce plan provisions or to redress a violation of fiduciary duties.[222]

(2) Enforcement Actions

The municipal plans in our study were subject to even fewer enforcement actions than our state plans. Of the six municipal plans studied, only one was subject to a lawsuit challenging an investment decision. No other plan was subject to a lawsuit challenging either the government's responsibility to fund the plan, or any other type of lawsuit challenging the board's management of plan assets.[223]

The one lawsuit among our studied plans helps illustrate why these types of lawsuits are in fact quite rare. In *Philadelphia Lodge No. 5, Fraternal Order of Police v. Philadelphia Bd. of Pensions and Retirement*, a public employee union sued the City of Philadelphia, attempting to enjoin the city's retirement plan from purchasing short term bonds from the financially distressed city.[224] It is easy to understand the union's objection. If the city was in such poor financial shape that there was not a market for its short-term bonds, presumably employees and retirees would not want their retirement assets invested in such funds. From a fiduciary perspective, the bond purchase appears to be a clear breach of fiduciary duty, as it was not undertaken *solely* in the interests of plan participants and beneficiaries. Rather, the city appeared to be using retirement plan assets in order to benefit the city itself. The trial court, in an unpublished decision, denied the injunction, and the plan went ahead and purchased the bonds.[225] The union appealed the trial court's decision, but by the time the

[218] MASS. GEN. LAWS ch. 32, §24.
[219] FLA. STAT. ch. 112.66.
[220] FLA. STAT. ch. 112.656(3); TEX.REV. CIV. STAT. ANN. art.6243o, §3.01(a).
[221] MASS. GEN. LAWS ch. 32, §§20A & 20B; MILWAUKEE CITY CHARTER § 36-15-2-e-4.
[222] FLA. STAT. ch. 112.66; MASS.GEN. LAWS ch. 32, §24.
[223] On the other end of the spectrum, one well-funded municipal fund sued the city treasurer, who had failed to follow the Board's investment direction. *See* Bolen v. Bd. of Firemen, Policemen & Fire Alarm Operators' Trustees, 308 S.W.2d 904 (Tex. Civ. App. 1957).
[224] 606 A.2d 603 (Pa. 1992).
[225] *See id*. at 604-05.

appellate court heard the appeal, the city had repaid the bonds, rendering the issue moot.[226]

Litigation, of course, is not the only means to enforce governance provisions. We also searched news reports to determine if any governance issues were resolved through more informal means. The results, however, were not much different that our litigation searches. For the municipal plans studied, we found no indication that board actions were ever subject to public scrutiny. Our news searches did indicate that each of the three well-funded local plans had taken action themselves to deal with sub-par investment managers or investments.[227] Only one of the poorly-funded plans had similar news reports.[228]

III. KEY FINDINGS &RECOMMENDATIONS

Our study suggests some serious shortcomings in public plan governance. Very few plans appear to follow best practices and, even where they do, our study does not suggest a correlation between such practices and the funded status of a plan.[229]We are careful, however, not to infer too much from this lack of an apparent correlation, as our study was not designed to empirically test the correlation between governance and funded status. It may be that a correlation would be found if a broader sample of funds was studied. It may also be the case that a correlation could become apparent if our current low-interest rate environment continues for several more years, further eroding funding ratios.

One general theme to emerge from our work is that both state and local governance provisions are generally less detailed than those required by expert recommendations. For example, none of the plans requires trustees to act in accordance with a good faith interpretation of law (though one municipal plan contains a similar provision), and none of the plans require trustees to use reasonable actuarial factors to determine funding needs. The practical impact of these omissions, however, varies significantly with the specific provision, as we can see if we analyze the two examples of omissions just mentioned. Failing to affirmatively state that trustees must act in accordance with a good faith interpretation of the law likely has a very minor impact on fund performance. Trustees are already bound by the duty of prudence, which requires that trustees act as

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[226]*See id*. at 605-06.

[227]*See* Arnella J. Ford, *San Antonio 911 Drops Capital Guardian*, INVESTMENT MGMT. WKLY., Oct. 18, 2004; *Alliance on Hot Seat at Tampa Employees*, MONEY MGMT. LETTER, July 6, 2003; Carl Spivak & Dan Bice, *City Consultants Fired as Billing is Investigated*, Milwaukee J. Sentinel, July 10, 2003, at A News.

[228]*See Alternatives Briefs*, 39 PENSIONS & INVESTMENTS, March 21, 2011, at 28 (reporting that the Boston plan terminated an investment manager due to suboptimal performance).

[229] This finding is perhaps not too surprising, given that the two states that have adopted the Model Act do not have plans that are among the best-funded in the country. *See* PEW CENTER ON THE STATES, *supra* note 2, at 5 (finding that Wyoming's pensions are 86% funded, while Maryland's are 64% funded).

a prudent person would act in like circumstances. It seems highly likely that acting in accordance with a good faith interpretation of applicable law would be required under the duty of prudence, and that therefore this omission from plans' governance rules is not terribly troubling. This same analysis is likely true of other common omissions as well, such as failing to state that trustees shall take into account general economic conditions, liquidity needs, or inflation in making investment decisions. But our second example of an omission – failing to state that the plan must use reasonable actuarial factors to determine plan funding needs – could have a tremendous impact on a plan's financial health. Allowing the use of unreasonable actuarial factors could of course cause a plan to be systemically underfunded. And it is less clear in this situation that any of the broader fiduciary duties would adequately protect against the use of unreasonable factors. Given the complex nature of actuarial calculations, it may be prudent for a trustee to merely rely on an actuary's assertion that the factors used are reasonable. Actuaries are, of course, subject to professional standards that may limit their discretion in determining actuarial factors, but it is not clear that those standards are specific enough to completely safeguard against systemic underfunding.[230] Even if it were the case that professional actuarial standards did adequately constrain the use of improper actuarial factors when followed, the failure to state an affirmative duty for trustees to ensure that reasonable actuarial factors were used would still make it more difficult for an interested party to enforce the use of reasonable factors. Without an affirmative trustee duty, a participant concerned about improper actuarial factors would have to show that a prudent trustee would have questioned the hired actuary's assumptions, under a lay person standard. That cause of action is likely going to be much more difficult to establish than establishing that the trustees failed in their affirmative duty to use reasonable factors.There is in fact anecdotal evidence that plans do play games with actuarial factors in order to "address" underfunding, for example by raising the plan's investment return assumptions.[231]

The other common omission from our studied plans' governance provisions that may be problematic is their silence on consideration of an investment's collateral benefits. Recall that consideration of collateral benefits goes to the heart of one of the main criticisms of public plans – that they may investment money in a manner that is not in the best interest of plan participants and beneficiaries in order to secure political gain. It is possible that a court would find that the duty of loyalty or the duty of prudence prohibits trustees from selecting an investment with collateral

[230]*See* American Academy of Actuaries, Code of Professional Conduct (2000), *available at* http://www.actuary.org/pdf/prof/code_of_conduct.pdf.*See also* note 21, *supra.* In the current low-interest-rate environment, it may be unreasonable to base expected return on the returns achieved over the past few decades, which have benefitted from financial market deregulation and a significant tech boom. Nonetheless, this is the method used by many actuaries.

[231]*See, e.g.,* Eaton & Nofsinger, *supra* note 56.

benefits unless the investment would be chosen absent those benefits, but that outcome is not certain in the absence of a specific provision.

Even with these important omissions in pension plan governance provisions, we believe that our most important finding is that plan funding and governance provisions are very rarely enforced, a phenomenon previously unrecognized in the literature. Revisiting the two types of enforcement actions from our study will help to illustrate this point. The first type of enforcement action in our study was lawsuits to enforce plan funding requirements. In one such case, the Illinois Teachers' Retirement System was being systemically underfunded and participants brought suit to try to force the state to adequately fund the plan. Even though participants had a specific, constitutionally-protected right to their pension benefits, Illinois courts held that they do not have any right to an adequately-funded plan. As a result, participants were essentially helpless to prevent the significantunderfunding that exists in the Illinois Teachers' plan today. Participants in that state can sue only when the plan actually runs out of money to pay benefits. This lack of enforcement gives states the clear ability to act on their inclination to favor current needs over retirees' benefit security. The only possible method by which to avoid such a situation is for participants and beneficiaries to exert political power to force adequate funding, but experience shows that in many instances participants and beneficiaries do not wield the necessary amount of power to safeguard their benefits. Before moving on to our next example, it is important to note that a state has the ability to change this outcome. A state could pass a law or amend its constitution to provide that participants have the right to a plan that is adequately funded on an annual basis. We also saw in our study that state courts have in some instances inferred such a right, even in the absence of a specific statutory or constitutional provision.[232]

Our second type of enforcement action was lawsuits challenging plan investment decisions. Note at the outset that both of the cases of this type identified by our study were high-profile situations where plan assets were being used to directly help a financially-distressed municipality. This suggests, perhaps, that investment decisions are not generally closely monitored, but rather are challenged only where there is a highly-publicized investment decision that appears to be a clear violation of fiduciary duty. Also important to note is that these cases, even when they present facts that suggest a clear breach of fiduciary duty, are difficult to win. In the New York case, where plan assets were being used to buy bonds at above-market prices in order to help bail out New York City, the court refused to second-guess the investment decision. And in Philadelphia, where plan assets were being used for a similar purpose, the issue was not decided by the court until after the bonds had been repaid, rendering the issue moot according to the court. Even if these courts had

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[232]*See* Bd. of Admin. of the Pub. Employees' Ret. Sys. v. Wilson, 52 Cal. App. 4th1109 (Cal. 1997).

been willing to examine the merits of the underlying investments, it is not necessarily the case that the plaintiffs would have been successful. Generally speaking, where there is a breach of fiduciary duty we look to see whether the trust beneficiaries have suffered any loss as a result.[233] In the context of challenged investment decisions, that typically involves comparing the investment results under the offending investment to that which would have been undertaken in the absence of the breach.[234] This has several effects. First, trustees are essentially permitted to gamble with plan assets. If they make local investments in breach of their fiduciary duties, but the investment is successful, there is no liability for the initial action. Second, investment decisions are very difficult to monitor. An interested party would not only need to establish that the trustee made an improper investment decision at the outset, but also that the rate of return that was achieved on the investment was less than it would have been in the absence of the breach. Establishing both of these facts is intensive, and unlikely to be undertaken by participants who would get no benefit from such lawsuits other than a somewhat more secure retirement benefit. Our two examples, then, paint a bleak picture for public pension plans. In many states, plans can be systemically underfunded and, even when adequately funded, it is unlikely that trustee investment decisions are adequately monitored. Before discussing possible methods to address the challenges inherent in public plan governance, we first review the key differences our study found between state and local plans.

A. Differences Between State and Local Governance

State and local plans are often not differentiated in policy discussions. What our study suggests, however, is that their governance provisions are remarkably different along some key metrics. One of the most striking is that nearly every state plan included in our study required trustees to have investment expertise, or be advised by those with investment expertise, while no local plan contained similar provisions. All of the states require the board to develop and publish a set of investment objectives, consider the total return on investments, diversify unless clearly imprudent to do so, and shielded board meetings from open meetings requirements when investment decisions are being considered. Significantly fewer municipal plans examined require the same. Municipal plans, however, were much less likely to have economically-targeted or social investing requirements and much less likely to have political-majority boards than our state plans. State plans, on the other hand, had much more robust funding and enforcement provisions, with more state plans creating personal liability for trustees and allowing participants or residents to sue.

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[233] *See* Restatement (Third) of Trusts § 95 (2012).
[234] *See id*. *See also* Donovan v. Bierwith, 754 F.2d 1049 (2nd Cir. 1985).

B. Solving the Enforcement Problem

Experts tend to agree broadly about what good governance looks like in the context of public pension plans.[235] Plans should be governed by trustees who are relatively isolated from the political process. Among the group of trustees should be individuals with investment expertise and experience. Investment decisions should be made in the best interests of plan participants and beneficiaries. Processes should be transparent, and disclosures should be made to help interested parties monitor plan trustees and investment performance. Plans should be adequately funded on an ongoing basis so as not to burden future taxpayers. While our study illustrates that many plans fail to live up to even these basic provisions, it also shows that a plan's governance provisions may only be as good as their enforcement mechanisms.

Before moving on to discuss possible solutions to the enforcement problem that public pension plans present, it is important to note some limitations of our enforcement hypothesis. While our intuition is that the lack of enforcement is a significant cause of ineffectual governance, there are other possible explanations as well. The first is simply that good governance provisions do not materially impact a plan's financial health, even if we assume effective enforcement. In other words, there may be other factors, such as the political climate in a state, that have much more influence on a plan's success than the content of its governance rules. Another possibility is that a plan's governance provisions may be endogenous. A plan that is poorly funded may enact governance reform in order to counteract the situation, while a well-funded plan with poor governance provisions may not see any need to act. This may explain the apparent lack of correlation that we see between funding and governance provisions in our study. And finally, our relatively small sample size makes it possible that our findings do not reflect the larger state of public plan governance. Nevertheless, we explore in detail what appears, on the basis of our findings, to be the most significant defect in public pension plan governance – the lack of enforceability.

Part I outlined the reasons why it is both difficult to have an effective governance watchdog, and why, even if an effective monitor exists, it is difficult to successfully pursue legal action to enforce governance rules. The problem of inadequate governance provisions is easily solved so long as there is political will to seek reform. What is less obvious is how to solve the monitoring and enforcement problem.

Other commentators have suggested solutions to the public pension plan problem that are either broader than the pension problem itself, or that require eliminating defined benefit pension plans. For example, as part of the debate regarding whether states should have the ability to declare bankruptcy, Professor David Skeel has argued that the mere availability of state bankruptcy as a possible option for fiscally distressed

[235] *See, e.g.*, Model Act, *supra* note 10; Clapman Report, *supra* note 85.

states may help to solve the problem of underfunded pension promises.[236] In particular, if employees are aware that their pension benefits may be cut back in bankruptcy, they may demand adequate funding.[237] It is also possible that the threat of bankruptcy may make state employees more effective monitors of public pension funding and governance. And while it would not automatically solve the enforcement problem, employees concerned about a potential bankruptcy's effect on their pension benefits could lobby for legal changes that make both funding and governance provisions readily enforceable. The availability of state bankruptcy is obviously a solution that would affect far more than pension funding and governance. As a result, while we note state bankruptcy as a potential solution, we leave it to bankruptcy scholars to debate its advisability.

Professor Roberta Romano has suggested that the political economy of public employee pensions is such that interests and incentives will always be mismatched,and in her canonical article on the subject reviewed possible reforms designed to limit or eliminate the politicization of public pension fund investments. She began with perhaps the simplest reform option, reforming the make-up of public pension boards, to include a greater number of independent trustees.[238] She noted, however, that it is not entirely clear that doing so will in fact be effective in removing political influence from boards. She also examined whether subjecting public funds to ERISA-like fiduciary requirements might solve the problem. The Model Act, drafted after Romano's article was published, made this solution one of its major reforms. Romano pointed out that this, too, is an incomplete solution in that it would still allow for conflicted decisionmakers – that is, under ERISA's fiduciary rules, plan sponsors are allowed to also serve as a fund's investment manager.[239] She also examined whether mandating passive investment strategies or constitutionalizing the independence of the fund's board might be effective reforms, and again found both to be suboptimal solutions.[240]

Professor Romano turned, then, to her final solution – moving public retirement systems to a defined contribution plan design (i.e., some type of individual account plan). She was clearly sensitive to the potential weakness of defined contribution plans as they relate to employees' retirement security, but nevertheless concluded that taking investment control away from the plan's trustees, and giving it instead to individual employees, is the best way to prevent the many problems that stem from the political control of pension assets.[241] Professor Romano made a compelling case for this solution, and states would be wise to give careful consideration to her arguments.

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[236] Skeel, *supra* note 6, at 692-94.
[237] *Id*. at 693.
[238] Romano, *supra* note 8, at 840-41.
[239] *Id*. at 841-42.
[240] *Id*. at 844.
[241] Romano, *supra* note 8, at 844-47.

But as Professor Romano points out, there are real costs to employees with respect to moving from a defined benefit plan to a defined contribution plan. The most notable of these is the fact that, as we have seen in the private sector, defined contribution plans rely on employees to make optimal savings and investment decisions, and many individuals are unable to do so.[242] As a result, we do not wish to simply reiterate Professor Romano's proposal, but instead to examine possible reform options for states that wish to retain a defined benefit pension plan. The alternatives we explore below are all solutions that would allow states and cities to maintain their defined benefit pension plans, while creating both better incentives to monitor plan funding and performance and near-term consequences if plans are underfunded or underperform. By discussing these solutions we do not mean to imply that these proposals are necessarily politically viable. Indeed, there is reason to suspect that many if not all of these proposals would face significant political opposition. There is nevertheless value in discussing potential solutions, for at the very least they help illustrate the real trade-offs that must be made when benefit promises are not adequately funded.

1. Automatic Benefit Haircuts

As previously mentioned, there are two fundamental problems with respect to the enforcement of defined benefit plan governance provisions. The first is the lack of direct harm that results to participants if plans are not adequately funded on an ongoing basis or if investment decisions deliver suboptimal results. The second is that any harm that does result from underfunding or investment underperformance is typically felt several years in the future, creating a significant temporal disconnect. Public plan governance reform would ideally create enforcement provisions that solved these two problems.

One potential method of doing so is to put in place immediateconsequences that follow from a plan failing to meet specified funding or investment performance targets. The law could provide, for example, that if a trigger (such as underfunding or underperformance) occurs, cost-of-living increases for current retirees will be suspended, or benefit payouts reduced by specified percentages. Alternatively, it could provide that all future accruals are suspended until the problem is rectified.[243]This approach would create an enormous incentive for both participants and retirees to closely monitor government actions with

[242] *See, e.g.,* Jack Vanderhei, *Retirement Income Adequacy for Boomers and Gen Xers: Evidence from the 2012 EBRI Retirement Security Projection Model®*, EBRI Notes, Vol. 33, No. 5, at 2 (2012), *available at* http://ebri.org/pdf/notespdf/EBRI_Notes_05_May-12.RSPM-ER.Cvg1.pdf (finding that 44% of Baby Boomers and members of Generation X were at risk for inadequate income in retirement).

[243] The term "future accruals" refers to pension benefits that have yet to be earned. A participant's accrued benefit is what they have earned to date – in other words what they would be entitled to if they terminated employment as of today. Changes to future accruals affect only benefits that are not yet earned, not a participant's accrued benefit.

respect to plan funding and investing. And it may help solve the current temporal problem with respect to pension funding by making the consequences felt now rather than thirty years in the future.

While such an approach might appear to be severe, it is attractive for the very reason that it makes explicit the tradeoffs that must be made if plans are not adequately funded and invested. There are several ongoing lawsuits challenging unilateral reductions in public plan benefits that were justified by the relevant statesas ways to address underfunding.[244]While automatic benefit haircuts would have the advantage of being explicit about the unilateral reductions that will follow from underfunding, it is possible that in some states a law providing for such haircuts would be held to be an impermissible change to benefits, particularly if they affected benefits that had already been earned.[245]In most states, however, it should be possible to apply automatic benefit haircuts prospectively, where only benefits not yet earned would be affected.[246]

Assuming that state law would permit the adoption of such provisions, automatic haircuts have the benefit of quickly putting pensions back on course to complete funding. Rather than have underfunding or underperformance persist for years, and result in lengthy and uncertain litigation, automatic haircuts would make clear the results that follow from suboptimal funding and underperformance, and likely would create significant political pressure on the state to live up to their benefit promises.

2. Automatic Tax Increases

If one did not want to burden participants and retirees with both the responsibility to monitor plan trustees and the consequences of underfunding, another approach would be to have underfunding or underperformance trigger specific, automatic tax increases at either the state or local level, as appropriate. This is consistent with the haircut approach described above, but would place the burden on taxpayers to monitor and challenge plan governance. It would essentially function as a pre-commitment to adequately fund the plan on an ongoing basis and invest plan assets in a manner that at least matches investment

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[244]*See, e.g.*, Rhode Island Council 94, AFSCME, AFL-CIO Locals v. Chafee, No. 12-3168 (Sup. Ct. R.I. filed June 22, 2012); Justus et al. v. Colorado, No. 2010CV1589 (Dist. Ct. Colo. 2010) ,*appeal docketed*.

[245] The argument for such protection would be that employees enjoy contractual rights to their pension benefits, and passing an automatic benefit haircut law that substantially impairs those rights would be an unconstitutional impairment of contract.

[246] The ability to make prospective changes to benefits varies by state. *See* Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework,* 5 EDUC., FIN. & POL'Y 617 (2010). There are, however, arguments that such prospective changes should be allowed absent explicit agreements to the contrary. *See* Amy B. Monahan, *Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1042, 1076-79 (2012).

assumptions over time. As above, it would begin to solve the underfunding problem immediately upon implementation.

It is not as clear that it would create a strong enough incentive for taxpayers to monitor the pension fund. Because the full cost of monitoring must be paid by each taxpayer who monitors the fund, but the benefit of monitoring is shared among all tax payers, individual taxpayers may not have enough incentive to monitor. Instead, they may rely on the automatic tax increase to notify them that the fund has not been effectively managed, and react to the tax increase, rather than mismanagement. However, this may place increased political pressure on the state to effectively fund and manage its retirement system. It is interesting to note that the only plan in our state and municipal sample that allowed for a dedicated tax to bring pension funding up to acceptable levels was a relatively well-funded municipal plan – the City of Milwaukee Employees' Retirement System.

3. Low-Risk Investing

Another possible solution to the public fund governance problem is to move to a model that essentially mimics the federal employees' retirement plan. This would involve passing strong laws that require full funding of a plan on an annual basis, and require plan assets to be invested in low-risk investments such as Treasury bonds. In many ways, this appears to be the simplest approach of all. It takes care of the governance issues by taking most of the funding and investment risk out of the equation. It does, however, require that funding requirements are both strong and enforceable.[247] One approach might be to amend the state constitution to provide that public pension plans receive an automatic appropriation equal to the annual funding cost so that the legislature cannot simply underfund the plan.

The downside of this approach is clear. It would raise the cost of public pensions, and as a result it may not be politically viable or fiscally viable, given that it would require states and cities to contribute larger amounts to the plans than they currently need to fund the same amount of benefits. Indeed, public plans historically were conservative investors, but adopted their current equity-based investment strategies in order to lower required contributions.[248] By eliminating securities that have higher rates of return than investments that are considered to be "risk free," states and local governments will have to make larger contributions to end up with the same amount of money to pay benefits when they are due. Political viability aside, it is attractive in that it (1) makes governments feel the full cost of the benefits they have offered to employees and (2) takes away what can be politicized investment decisions. In order to be fiscally viable,

[247] For an example of a recently-enacted public pension funding provision that appears to have both strong requirements and enforceability, see N.J. Pub. L. 2011, ch. 78, *available at* http://www.njleg.state.nj.us/2010/Bills/PL11/78_.PDF.

[248] *See* Hess, *supra* note 8, at 194.

this solution would likely have to be phased in over a period of years in plans that are substantially underfunded.

4. Modified Pension Obligation Bonds

Pension obligation bonds are issued by states or localities to cover pension contributions. They operate like other state and local government general obligation bonds, with a few important exceptions: in many states they do not require voter approval and they are taxable.[249] Generally, they appeal to state and local governments because they help cover immediate pension costs, providing budget relief, and they pay a relatively low interest rate due to the fact that they are backed by the taxing authority of the jurisdiction, creating an opportunity for arbitrage. Because pension portfolios can have a relatively higher risk/reward tolerancethan state and local governments, there is a possibility that the money borrowed through pension obligation bonds can be invested and earn a higher return than what the government pays to borrow. Any additional spread made on the bonds can help defer additional pension costs. However, research suggests most pension obligation bonds end up costing governments more than their investments yield.[250]

If pension obligation bonds were tied to the performance of public pensions, they may create a mechanism through which the market can monitor pension funds. For example, the coupon paid on the bonds could be tied to the pension's realized returns, such that investors share in gains from obtaining returns higher than those that were projected and share in losses when returns are lower than projected.

Alternatively pension obligation bonds could be constructed as a reverse catastrophe bond. Catastrophe bonds are used by insurance companies to help manage catastrophe risk, and part of the principal or coupon is not paid if a pre-defined catastrophe occurs.[251]In the case of pension funding, the catastrophic event may be defined as the pension reaching a specific level of underfunding or returns falling substantially short of projections. Instead of suspending payments of principal or interest in the event of a catastrophe, the coupon rate could increase, creating an immediate and unavoidable cost for pension underfunding.

This could create an opportunity for markets to monitor pension plans, and strong financial incentives for states and localities to adequately fund their pensions. The adoption and use of these securities would depend on how they are constructed and priced.Additionally, the current market for pension obligation bonds is relatively thin, and would need to be greatly

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[249] Pension Obligation Bonds were once tax-exempt, offering a much stronger arbitrage opportunity. This was changed in the Tax Reform Act of 1986. ALICIA H. MUNNELL ET AL., PENSION OBLIGATION BONDS: FINANCIAL CRISIS EXPOSES RISKS (2010).

[250] *Id*. at 4.

[251] For general discussion of catastrophe risk and the use of catastrophe bonds, see Greg Niehaus, *The Allocation of Catastrophe Risk* 26 J. OF BANKING & FIN. 585 (2002).

expanded in order to create a meaningful market-based monitoring mechanism for public pension funds.

CONCLUSION

While there is broad consensus that public pension plan governance is deeply flawed, our study does not suggest that merely adopting good governance provisions helps ensure a plan will be well-funded. Based on the results of our study, we believe that governance in many cases becomes a non-issue due to the lack of enforcement of governance provisions. It is simply too easy in nearly all states and cities to ignore funding requirements when other needs that appear to be more pressing arise. And when investment targets are not met, plan underfunding can be "solved" by simply raising the expected rate of return on assets and then chasing return. In difficult economic times, political pressure can be brought to bear so that assets that should be invested solely for participants and beneficiaries are instead invested to try to aid a local economy. And under our current system, the effects of these actions are not felt for decades. If public pension plans are to succeed, we need to get serious not only about reforming plan governance, but also ensuring that there is a reliable method to enforce plan funding requirements grounded in realistic assumptions.

APPENDIX A
KEY STATE FINDINGS

	Board composition	Trustee expertise	Prudent person standard	Unrestricted investment	Provisions regarding collateral benefits	Explicit cause of action against fiduciaries	Fiduciary or funding lawsuits	Successful enforcement
CALPERS	Majority political		X			X	Funding	X
Florida RS	Majority political	X	X			X		
Washington PERS	Majority political	X	X					
Illinois TRS	Majority political	X	X			X	Funding	
New York State & Local ERS	Majority political	X	X			X	Both	Mixed
Ohio STRS	Majority elected representatives	X	X			X		

APPENDIX B
KEY LOCAL FINDINGS

	Board composition	Trustee expertise	Prudent person standard	Unrestricted investment	Provisions regarding collateral benefits	Explicit cause of action against fiduciaries	Fiduciary or funding lawsuits	Successful enforcement
Milwaukee Employees' Retirement System	Even split		X					
San Antonio Police & Fire	Majority elected representatives		X	X				
Tampa General Employee Retirement Fund	Majority political		X			X		
Philadelphia Pension System	Majority political		X				Fiduciary	
State-Boston Retirement System	Even split + 1 independent		X			X		
Teachers' Retirement System of NYC	Majority political							