



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 17

MEETING DATE: March 17, 2021

SUBJECT: Fiduciary Standard of Care Policy

SUBMITTED FOR: ___ Consent X Deliberation and Action ___ Receive and File

RECOMMENDATION

Staff recommends the Board (1) adopt the proposed Alternative Asset Investment Standard of Care Policy; (2) adopt the proposed revisions to Section 5.A.V. of the Master Investment Policy Statement; and, (3) replace the current Fiduciary Standard Policy (Policy No. 015).

PURPOSE

This item supports the Strategic Management Plan objective to ensure effective oversight of the investment program.

DISCUSSION

When entering into alternative asset investment funds as a limited partner investor, SCERS negotiates "side letter" contracts with fund general partners and fund management companies (collectively, "fund managers"). In those negotiations, a recurring point of contention is the standard of care to which the fund managers would be held in performing its duties. The proposed Alternative Asset Investment Standard of Care Policy sets out a detailed and comprehensive approach to this recurring issue.

Background

On October 21, 2020, the Board received an in-depth education session on the subject of "Fiduciary Care and Alternative Assets Investing." That education session can be summarized as follows.

Under California law, SCERS trustees and staff must exercise investment discretion "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." Cal. Const. Art. XVI, § 17; Gov. Code § 31595. This is often called a "prudent expert" or "fiduciary" standard of care. When SCERS delegates investment authority to external managers, the people's right to fiduciary handling of system

assets does not disappear. Thus, SCERS always strives to require anyone who exercises investment discretion over system assets to agree to the same fiduciary duty of care to which the Board and staff are subject.

In recent years, alternative assets have become an increasingly important part of public pension investment portfolios, including SCERS'. At the same time, fund managers have consistently demanded contractual concessions from limited partner investors, particularly on the standard of care. This is not surprising. Alternative asset investments have demonstrated a record of strong risk adjusted returns, generating greater demand, which top-performing fund managers have used to leverage more favorable contract terms. Because a contractual fiduciary standard of care is a potent tool for investors in loss-recovery litigation, fund managers are extremely motivated to obtain a lower and/or non-actionable standard of care. In recent years, fund managers have demanded and received standards such as:

- A fiduciary duty of care diluted by an exculpation clause (i.e., a separate clause releasing various causes of action against the fund manager);
- Where the fund manager is a Registered Investment Adviser with the Securities and Exchange Commission, a non-contractual "acknowledgement" that it is registered and therefore subject to fiduciary duties under the Investment Advisers Act of 1940 (duties enforceable only by SEC regulators);
- Where the fund manager is not a registered investment adviser (often the case with venture capital funds), no acknowledgment of a duty of care at all.
- Where the fund is based in Delaware, a fiduciary duty of care under Delaware law, but actionable only by the collective limited partnership and diluted by waivers;
- Where the fund is based outside the United States, a contractual or non-contractual acknowledgment that the fund manager will comply with the duty of care required by local laws.

Although SCERS is not the only California plan to have granted such relaxed standards, doing so presents irreducible legal and reputational risk to SCERS trustees and staff. If a fund manager were to later engage in sub-fiduciary misconduct to the detriment of SCERS, and SCERS is without recourse because the fund manager had been relieved from a more rigorous standard, trustees and staff might be faulted for failing to meet their own prudent expert duties. At the same time, alternative assets have become an important component to institutional investors' strategic asset allocations, given their strong returns and/or diversifying characteristics, and an absolute prohibition on the concession would have a substantial impact on system funding.

The recommended policy sets out a balanced approach for navigating this dilemma. Specifically, the recommended policy requires staff to assess certain factors, consult with experts, and create a record of its deliberations whenever making a concession on the standard of care. Courts that have considered similar investment dilemmas hold plan administrators to a standard of procedural prudence—that is, creating a record of substantial deliberations and

consultation with qualified professionals in support of the investment decision. *Pfeil v. State Street Bank & Trust Co.* 806 F. 3d 377 (6th Cir. 2015). The recommended policy, followed studiously, would allow SCERS trustees and staff to create a robust record of prudent deliberations.

Recommended Policy

The recommended policy makes clear that SCERS generally expects fund managers to be willing and accountable fiduciaries—i.e., to accept a fiduciary standard of care enforceable by a private right of action. (This contractual fiduciary language could, but need not, refer specifically to “prudent expert” or recite the duties thereof.) Although SCERS may on rare occasions grant some other standard, in order to do so, staff must create a written record consisting of the following:

First, staff must establish the importance of the at-issue investment to the Strategic Asset Allocation plan and that comparable investments would likely come with similar standard of care terms. To be clear, the nature of alternative asset investing is such that perfect apples-to-apples comparisons are not possible; nor is perfect information ever available about the potential contract terms that would accompany each fund. Some conjecture and generalization would be unavoidable. Nevertheless, staff would, with assistance from experts, work towards the goal of not overlooking comparable investments that could serve a similar function and come with better terms.

Second, staff must establish that the at-issue investment presents advantages and benefits that compensate for the risk of the lower and/or non-actionable standard of care. In particular, staff would look to whether the fund has a track record of strong performance relative to peer funds and the fund manager’s targets; whether the fund has a track record of fair treatment of limited partners; whether the fund has a process for addressing conflicts of interest; and the experience of key persons associated with the fund managers.

Third, the investment contract must contain terms whereby the fund manager agrees to disclose any action they take that would amount to a conflict of interest or a deviation from the fiduciary standard for Registered Investment Advisers under the 1940 Act. Investment counsel must confirm the existence of such a term.

Fourth, staff must take into consideration SCERS’ overall record of past concessions on the standard of care. Specifically, SCERS should engage qualified investment counsel to periodically review SCERS’ overall record on standard of care negotiations, and provide advice about whether the portfolio is “over-weighted” in investments with non-fiduciaries relative to peers and market dynamics. Staff should create a record that it has considered and implemented counsel’s advice in that regard.

Creating this record has two legal advantages. First, the record would show that SCERS used prudent expertise in designing and monitoring an overall portfolio and strategy, of which the at-issue investment was an important component, justifying the acceptance of a “market” standard of care term even if less favorable. Second, even if the at-issue investment is viewed in isolation (which is a less fair way of judging “prudent expertise”), the record would show that SCERS

prudently weighed the non-fiduciary term against the various risk-mitigating advantages reflected in the fund manager's reputation, ethics, and track record.

The recommended Alternative Asset Investment Standard of Care Policy (Attachment A) would replace and supersede the current Fiduciary Standard Policy (Policy No. 015) (Attachment B), which has proven to be ambiguous and outdated in the context of the current marketplace. The same is true of the current Section 5.A.V. of the Master Investment Policy Statement, which should be revised to reference the new policy (Attachments C and D).

ATTACHMENTS

- Attachment A: Alternative Asset Investment Standard of Care Policy
- Attachment B: Fiduciary Standard Policy (Policy No. 015) to be replaced
- Attachment C: Amendments to Section 5.A.V. of the Master Investment Policy Statement (redlines)
- Attachment D: Amendments to Section 5.A.V. of the Master Investment Policy Statement (clean)

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ALTERNATIVE ASSET INVESTMENT STANDARD OF CARE POLICY

PURPOSE

The purpose of this policy is to require that Alternative Asset Investment fund managers and general partners agree to a fiduciary duty of care when entering into an investment contract with SCERS. A further purpose of this policy is to set forth the narrow circumstances in which it is permissible for such contracts to contain a different duty of care.

DEFINITIONS

As used in this policy, the term “Alternative Asset Investment” shall mean an investment strategy, fund, or fund manager SCERS identifies as Absolute Return (Hedge Funds), Private Equity (including venture capital), Private Credit, Real Estate, or Real Assets.

POLICY

A. Contractual Fiduciary Duty of Care

In entering into an Alternative Asset Investment contract as a limited partner or similar capacity (including, but not limited to, side letters with fund managers and general partners), SCERS shall require anyone who exercises investment discretion over system assets to be subject to the same duty of care to which the Board and staff are subject. Such a duty of care shall be contractual in nature and enforceable by a private right of action by SCERS.

California law calls for the Board and staff to discharge their duties “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.” Cal. Const. Art. XVI, § 17; Gov. Code § 31595. Accordingly, SCERS’ Alternative Asset Investment contracts shall include a provision setting out an actionable, contractual fiduciary standard of care, similar to the following:

Each of Manager and the General Partner agrees that it and any person acting on its behalf under the Partnership Agreement owe fiduciary duties to all Limited Partners in accordance with applicable law governing the Partnership. As such, each of the General Partner and the Manager agrees that it will act in good faith in the best interests of the Partnership and the Limited Partners with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a like character and with like aims, will not place its interests above the interests of the Limited Partners, and with respect

to all investment opportunities and investment allocation decisions, will allocate such opportunities among the Limited Partners and the entities managed by the General Partner, the Manager and its Affiliates on a fair and equitable basis and consistent with its duty of loyalty to the Partnership and the Investor with respect to its investment in the Partnership. Each of Manager and the General Partner acknowledges the applicability of Article XVI, Section 17 of the California Constitution and Government Code Section 31595(b) to the Investor's investment in the Partnership.

In addition, SCERS' Alternative Asset Investment contracts shall include a provision designating Sacramento County or the Eastern District of California as the jurisdiction and venue for any dispute regarding such standard of care.

B. Other Standards of Care

Experience has shown that, in negotiating Alternative Asset Investment contracts, some fund managers and general partners refuse to agree to a prudent expert or fiduciary duty of care, or to a Sacramento-based venue and jurisdiction. Experience has also shown that such fund managers and general partners may insist on a lower or non-actionable standard of care. For example:

- A fiduciary duty of care diluted by an exculpation clause (i.e., a separate clause releasing various causes of action against the general partner or manager);
- Where the general partner or manager is a Registered Investment Adviser with the Securities and Exchange Commission, a non-contractual "acknowledgement" that it is registered and therefore subject to the regulator-enforced fiduciary standards applicable to registered advisers under the Investment Advisers Act of 1940;
- Where the general partner or fund manager is not a registered investment adviser (e.g., in connection with a venture capital fund within the Private Equity asset class, or an energy partnership within the Real Assets asset class), no acknowledgment of a duty of care at all.
- Where the fund is based in Delaware, a fiduciary duty of care under Delaware law, but actionable only by the collective limited partnership and diluted by modifications and waivers (which are permissible under Delaware law);
- Where the fund, general partner, or manager is based outside the United States, a contractual or non-contractual acknowledgment that they will comply with the duty of care as required by the laws of their local jurisdiction.

Such standard of care terms, and a non-Sacramento jurisdiction/venue, are highly disfavored, as SCERS expects its investment delegates to be willing and accountable fiduciaries to SCERS. Nevertheless, and notwithstanding the foregoing Section A, SCERS may in rare circumstances accept such disfavored terms if staff complies with Section C.

C. Mandatory Protective Steps

In connection with any Alternative Asset Investment contract in which SCERS accepts a standard of care similar to those identified in Section B, or a non-Sacramento jurisdiction/venue in connection with standard of care disputes, staff shall take all of the following steps:

Importance to SCERS' Strategic Asset Allocation: Staff shall create a written record that:

- The at-issue Alternative Asset Investment belongs to an asset class of investments (with reference to sub-asset class, geography, strategy, and/or sector) that is important for SCERS to invest in in order to implement the alternative asset investment strategy under the Master Investment Policy Statement and the Growth/Diversifying/Real Return/Opportunities Investment Policies;
- The at-issue Alternative Asset Investment would play an important role in helping SCERS meet the investment objectives of that asset class;
- A written opinion from investment counsel, which may be based on general experience and familiarity with the market and industry, that:
 - SCERS would be unlikely to obtain better terms on the duty of care from similar funds (e.g., funds that would serve a function within SCERS' alternative asset investment strategy similar to the one identified above); and
 - Further negotiations are unlikely to yield a better duty of care term for that particular Alternative Asset Investment.
- A written opinion from SCERS' investment consultant explaining why the at-issue Alternative Asset Investment is important to (1) implementing the strategy set forth in the applicable asset class investment policies, including with respect to sub-asset class, geography, strategy, and/or sector, and (2) meeting the investment objectives of the asset class where the at-issue investment will reside.

Compensating Factors: Second, staff, with written input from investment consultants, shall assess whether the at-issue Alternative Asset Investment can demonstrate the ethical governance and likely performance that would proportionately compensate for the lower standard of care. Specifically, staff shall obtain written opinions from its consultant, including:

- Whether there is a track record of strong performance relative to the fund manager's or general partner's targets, and relative to peer funds;
- The experience of key persons associated with general partners and fund managers;

- A track record evidencing the fair treatment of limited partners historically, including during stressful times or circumstances when the fund performance has been less than optimal;
- A history and process for dealing with conflicts of interest (such as investing in companies held by prior or successive funds); and/or
- Other factors bearing on ethical governance and future performance.

Transparency and Notice: Third, staff shall obtain a written confirmation from investment counsel that, as a part of the investment contract or side letter, the general partner and/or fund manager have agreed to provide transparency and notice regarding any action they take that would amount to a conflict of interest or a deviation from the fiduciary standard for Registered Investment Advisers under the 1940 Act.

Periodic Global Review: Fourth, staff shall periodically engage investment counsel to review its Alternative Asset Investment portfolio and confirm that SCERS' overall record with respect to duty of care negotiations meets or exceeds the industry norms and the prudent expert standard. In addition, staff shall obtain and implement advice from such counsel with regard to market trends and whether SCERS has become "over-weighted" in sub-optimal negotiated standards of care.

BACKGROUND

When SCERS enters into an Alternative Asset Investment, fund managers and general partners acquire investment discretion over system assets and effectively become delegates of the Board. When negotiating side letters, SCERS always seeks to hold such delegates contractually responsible for the same duty of care to which the Board is bound. Experience has shown that SCERS' success in negotiating for that term can turn on sheer market supply and demand.

This policy continues SCERS' historical custom, practice, and policy of requiring Alternative Asset Investment fund managers and/or general partners to agree to a fiduciary standard of care. This policy also sets forth narrow circumstances in which SCERS may accept a lower standard, and the analytical and evidentiary record that staff must create before accepting such a standard.

RESPONSIBILITIES

Executive Owner: General Counsel

POLICY HISTORY

Date	Description
03-17-2021	Board approved new policy to replace Fiduciary Standard Policy
08-01-2018	Renumbered from Policy No. 041

01-17-2018	Board renamed and amended in revised policy format
01-16-2013	Board approved Resolution 2013-05

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FIDUCIARY STANDARD POLICY

PURPOSE

The purpose of this policy is to establish the standard of care to which an investment manager, investment fund, or any other entity or person offering to invest SCERS' assets must agree in writing prior to receiving SCERS assets, or receiving SCERS' commitment to provide assets, for investment.

DEFINITIONS

For purposes of this policy, the following definitions apply:

"Preferred Fiduciary Standard of Care" means the standard of care set forth in the California Constitution, Article XVI, Section 17 and California Government Code section 31595.

"1940 Act Standard of Care" means the standard of care applicable to registered investment advisors who have a fiduciary duty to their investors under the federal Investment Advisors Act of 1940 ("1940 Act").

"Private Market Investment" means an investment strategy, fund, or fund manager SCERS' identifies as venture capital within the Private Equity asset class, or as an energy partnership within the Real Assets asset class.

POLICY

Under Article XVI, Section 17 of the California Constitution, the Board has sole and exclusive fiduciary responsibility over the assets of the system and shall discharge its duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims. This is often referred to as the "prudent expert rule."

The Board contracts with external investment managers, advisors, and consultants for the investment of system assets and, as the Board's delegates, seeks in its written agreements for investment management and consulting services, to hold these service providers to the same fiduciary standard of care to which the Board itself is subject.

A. Contractual Standards of Care

1. SCERS will include terms for the Preferred Fiduciary Standard of Care In negotiating all of its contracts for investment management and consulting services. It is anticipated all public markets investment managers will agree in writing to this fiduciary standard.
2. In the alternative, SCERS may accept terms specifying the fiduciary standard of care set forth in the 1940 Act for Registered Investment Advisors. It is anticipated that most private market investment managers will be Registered Investment Advisors and subject to the standard of care specified in the 1940 Act.
3. On a case-by-case basis if and as necessary, SCERS may accept an alternative, lower contractual standard of care pursuant to the guidelines and application specified in this Policy. It is anticipated this will arise in connection with private market investments (as defined herein) that typically offer a lower standard of care as the industry standard.

B. Guidelines for Assessing and Accepting a Lower Contractual Standard of Care for Private Market Investments

Rather than simply accept the lower standard of care typically offered in the terms for private market investments, SCERS will attempt to negotiate inclusion of the Preferred Fiduciary Standard in each of its side letters for such investments.

When SCERS is unable to negotiate the Preferred Fiduciary Standard in a side letter for a private market investment, and the private market investment manager represents that it is not a Registered Investment Advisor, SCERS will assess on a case-by-case basis whether to proceed with the investment, and will seek the following in its consideration:

1. Written affirmation from SCERS' Investment Counsel that the private market fund/manager will agree in its side letter with SCERS to provide sufficient transparency and notice regarding any action taken by the fund/manager that would otherwise amount to a conflict of interest or deviation from the fiduciary standard under the 1940 Act for Registered Investment Advisors.
2. Written affirmation from SCERS' alternative assets investment consultant that the consultant has reviewed the investment risks of the private market investment, the risks of private market investments more generally, and the limited fiduciary standard offered by the specific fund/manager, and that based upon the consultant's due diligence, the standard of care offered by the fund/manager is consistent with other similarly situated investment funds/managers who manage institutional assets in similar investment types and strategies.

3. Assessment by SCERS' Staff and consultant of the characteristics, processes and track record of potential private markets investments that will mitigate the risk of a lower standard of care, including:
 - a. A track record of multiple funds performing in the top quartile of its peer group across the cycle.
 - b. Experienced general partners and partners.
 - c. A track record evidencing the fair treatment of limited partners historically (including during stressful times or circumstances when the fund performance has been less than optimal).
 - d. A history and process for dealing with conflicts of interest (such as investing in companies held by prior or successive funds).

C. Investment Protocol

The assessment of the fund terms for standard of care is one important element in a mosaic of factors in determining whether to make or maintain a private market investment. However, since it involves both a quantitative and qualitative evaluation of many factors, flexibility, rather than rigid rules or hard limits, is warranted. This Policy sets forth the considerations that will impact how a conclusion is reached for any specific private market investment opportunity.

The evaluation of the potential risk and risk mitigation of the standard of care provided by a private market investment's fund terms will be incorporated in SCERS' due diligence process and reports that outline the basis for the investment decision.

BACKGROUND

It has been SCERS' practice to hold its investment managers to the same standard of care to which the Board is held. However, this past practice is difficult to maintain as alternative investment managers in general are reluctant to agree to the Preferred Fiduciary Standard of Care. This is an industry wide challenge for public pension plans.

Fortunately, since the Dodd Frank Act, most alternative investment managers are Registered Investment Advisors (RIAs) under the 1940 Act. The 1940 Act fiduciary standard of care requires registered investment advisors to act and to serve a client's best interests with the intent to eliminate, or at least to expose, all potential conflicts of interest which might incline an investment adviser--consciously or unconsciously--to render advice which was not in the best interest of the investment adviser's clients. Among public pension plans nationwide, the fiduciary standard of care required of RIAs by the 1940 Act is generally held to be acceptable.

Unfortunately, private market investments as defined herein are not subject to the Dodd Frank Act, and thus are not RIAs. Instead, these managers present themselves as fiduciaries under Delaware law. The challenge is that under Delaware law, investment

managers can expressly contract with limited partners not to be held to certain fiduciary practices as required by ERISA and the 1940 Act. Such exempted practices include, but are not limited to, allocation of assets among sub-funds and arms-length transactions. To date, public pension plans have had very limited, if any, success in negotiating a higher standard of fiduciary care with these private market investment managers.

Investing in venture capital and private energy partnerships remains an important component in the construction of SCERS private equity portfolio. Venture capital funds provide unique return profiles by investing in higher growth, early stage companies that benefit from developing breakthrough technologies. Investments in these companies helps to provide diversification from more mature companies prevalent in the investments of other private equity strategies such as buyout or distressed debt. Investment in private energy partnerships provides diversification from other private real assets strategies such as infrastructure. Given both the importance of venture capital and private energy partnership investing and factors unique to each fund which can mitigate risk, the guidelines in this Policy highlight the circumstances and assessments that SCERS will undergo for private market investments before agreeing to a lower standard of fiduciary care.

RESPONSIBILITIES

Executive Owner: Chief Investment Officer

POLICY HISTORY

Date	Description
08-01-2018	Renumbered from 041
01-17-2018	Board renamed and amended in revised policy format
01-16-2013	Board approved; Resolution 2013-05

ATTACHMENT C
Amendments to Section 5.A.V. of the
Master Investment Policy Statement (Redlines)

V. Investment Managers

A. Investment Managers of Custodied Assets

Managers of custodied assets (assets owned directly by SCERS and held at SCERS' custodian) The System's assets are to be managed by external investment organizations that serve as fiduciaries under applicable state and federal laws and comply with all legal requirements and System guidelines.

Subject to this IPS and their specific contractual obligations to the System, Investment Managers are responsible for making investment decisions on a discretionary basis (unless stated otherwise within their investment contracts subject to this IPS and their specific contractual obligations) regarding assets placed under their jurisdiction, and will be accountable for achieving their investment objectives. Decisions include the purchase, sale and holding of investments in amounts and proportions that are reflective of the stated investment mandate. Such investment managers will maintain proper and adequate insurance coverages including errors & omissions, surety bond and fiduciary liability. In addition, SCERS' investment managers agree to notify the Board Chairman and/or Investment Staff, in writing, if they are unable to continue acting in the capacity of a fiduciary or investment advisor. As stated above, investment managers are expected to act as prudent experts in the management of account(s) for SCERS, and agree to be fiduciaries to the System. In fulfilling their roles, investment managers will continually educate the Board about capital market developments that pertain to their area of investment expertise.

B. Fund Managers and General Partners

Managers and General Partners of commingled funds in which SCERS is a limited partner have the responsibilities and duties set forth in their respective limited partnership agreements and side letters. With respect to such fund managers and general partners, SCERS will strive to obtain their contractual agreement to a fiduciary duty of care, in accordance with and subject to the provisions of the Alternative Assets Investment Standard of Care Policy.

The complete version of SCERS' Master Investment Policy Statement can be found here: https://www.scers.org/sites/main/files/file-attachments/master_investment_policy_and_objectives.pdf?1583433491.

ATTACHMENT D
Amendments to Section 5.A.V. of the
Master Investment Policy Statement (Clean)

V. Investment Managers

A. Investment Managers of Custodied Assets

Managers of custodied assets (assets owned directly by SCERS and held at SCERS' custodian) are responsible for making investment decisions on a discretionary basis (subject to this IPS and their specific contractual obligations) regarding assets placed under their jurisdiction, and will be accountable for achieving their investment objectives. Decisions include the purchase, sale and holding of investments in amounts and proportions that are reflective of the stated investment mandate. Such investment managers will maintain proper and adequate insurance coverages including errors & omissions, surety bond and fiduciary liability. In addition, SCERS' investment managers agree to notify the Board Chairman and/or Investment Staff, in writing, if they are unable to continue acting in the capacity of a fiduciary or investment advisor. As stated above, investment managers are expected to act as prudent experts in the management of account(s) for SCERS, and agree to be fiduciaries to the System. In fulfilling their roles, investment managers will continually educate the Board about capital market developments that pertain to their area of investment expertise.

B. Fund Managers and General Partners

Managers and General Partners of commingled funds in which SCERS is a limited partner have the responsibilities and duties set forth in their respective limited partnership agreements and side letters. With respect to such fund managers and general partners, SCERS will strive to obtain their contractual agreement to a fiduciary duty of care, in accordance with and subject to the provisions of the Alternative Assets Investment Standard of Care Policy.

The complete version of SCERS' Master Investment Policy Statement can be found here: https://www.scers.org/sites/main/files/file-attachments/master_investment_policy_and_objectives.pdf?1583433491.