

Speaker Bios:

Attorney Terren B. Magid



Formerly the executive director of the \$17 billion Indiana Public Employees' Retirement Fund ("PERF"), Attorney Magid now advises institutional investors as counsel with Bingham and McHale LLP. In 2009, under Terry's leadership, PERF was awarded the National Large Public Plan of the Year by Institutional Investor News' Money Management Letter. Prior to joining PERF, Terry spent more than 10 years with Eli Lilly and Company and Great Lakes Chemical Corporation as a tax and benefits professional where he had extensive experience working with federal and state auditors on a variety of matters. Attorney Magid can be reached at tmagid@binghamchale.com or 317-968-5563.

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Susan Mangiero, PhD, CFA, FRM



Susan Mangiero is an independent risk management and valuation consultant. Providing expert witness services, research, analysis and training in the areas of fiduciary investment risks, valuation, fees, suitability, asset allocation and performance, she works with pension trustees, board members, C-level decision-makers and the attorneys, money managers and consultants working with plan sponsors. With over twenty years of experience, including work on several trading desks, Dr. Mangiero is the author of the award-winning pension risk blog, www.PensionRiskMatters.com, and a new blog about due diligence, www.GoodRiskGovernancePays.com.

A Chartered Financial Analyst charterholder, she is certified by the Global Association of Risk Professionals as a Financial Risk Manager. She holds a Ph.D. in finance (minor in math), an MBA in finance, an M.A. in economics and a B.A. in economics and has done post-graduate computational finance work at Carnegie Mellon University. She has written extensively about risk management and valuation for publications such as *Investment Lawyer*, *RISK*, *Risk Review*, *Valuation Strategies* and the *Expert Evidence Report*. Her book entitled *Risk Management for Pensions, Endowments and Foundations* for John Wiley & Sons, Inc. (2005) addresses financial risk management issues for investment fiduciaries. Dr. Mangiero can be reached at 203-261-5519 or contact@fiduciaryleadership.com.

ARE YOU PROPERLY MITIGATING RISK? ASSESS YOUR FIDUCIARY IQ.
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Dr. Susan Mangiero, Speaker - Fiduciary Leadership, LLC
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Susan Mangiero:

Good afternoon everyone. This is Susan Mangiero, author of *Risk Management for Pensions, Endowments and Foundations*, and an independent risk management and valuation consultant. I am very happy to have attorney Terry Magid join me today in this discussion about pension risk management. Attorney Magid is formerly the Executive Director of the \$17 billion dollar Indiana Public Employees Retirement Fund. He now advises institutional investors as counsel with Bingham and McHale, LLC.

In 2009, under Terry's leadership, PERF was awarded a national large plan of the year by Institutional Investor News Money Management Letter. Prior to joining PERF, Terry spent more than 10 years with Eli Lilly and Company and Great Lakes Chemical Corporation as a tax and benefits professional where he had extensive experience working with federal and state auditors on a variety of matters.

Terry is going to start by talking about some of the federal and state mandates. There are quite a few new rules and regulations being put on the table that impact both public and ERISA plans. I will then talk about investment risk governance.

Terry - welcome.

Terry Magid:

Thank you, Susan. It's good to be here. Thank you all for joining us this afternoon, or this morning, if you are out west. What I'd like to talk about today, as Susan mentioned, has to do with the changes going on at the federal and state levels. I will caveat my comments by saying that my comments are largely focused today on the public plan sector although there are a lot of ERISA rules too that have been proposed. If adopted, these mandates can materially impact the fiduciary liability exposure for trustees and executives in both sectors.

I have divided my presentation along three lines. In the first section, I review proposed laws and regulations. The second section pertains to state changes and the third section includes some practical tips that all fiduciaries should consider.

The first slide we will review together summarizes the Public Pension Transparency Act. This is a bill that has been proposed in both the house and the senate this session. In summary, for those funds in the public sector which do not use what is commonly referred to as a "market rate" for discounting pension liabilities, a second report would have to be filed with the Secretary of the U.S. Treasury that explains how funding would differ had a market rate been applied. The market rate is typically associated with a U.S. Treasury bond rate. The goal is to enhance transparency as to how much any particular state pension plan truly owes by reporting liabilities on a more conservative basis. Failure to comply with this requirement, should this law pass, could subject the government sponsor to loss of the federal tax exemption for investors who buy their

municipal bonds. This in turn will raise their cost of capital and lower the rate of return for their investors.

Federal

Public Pension Transparency Act (H.R. 567, S. 347)

- Summary: If not using “fair market value” discount rate, would require two sets of reports: (1) liabilities using existing methods & assumptions (2) liabilities using “uniform” methods & assumptions. Failure to comply will result in loss of tax exemption for municipal bonds.
- Fiduciary Implications:
 - Compliance?
 - How to clarify confusion between the two reports to members and other stakeholders?

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There is significant debate under way as to whether the federal government has the constitutional authority to regulate state level pensions in this way. Setting that issue aside for the moment, I think the bill raises interesting strategic and tactical questions. Specifically, the law is written in a permissive way that requires state pension fund fiduciaries to decide whether or not they are actually going to comply. Obviously, there are significant consequences to not complying which may lessen the benefits of making a real choice. It seems to me that states and municipalities which may be subject to this rule will favor the preservation of tax advantages for municipal bond investors over being able to report only one set of books for their pension plan(s). If true, government pension plan decision-makers will soon bear the cost of filing two reports or change the discount rate used to value liabilities. I recommend that fiduciaries start preparing for the eventual passage of this law even though it may be a long time before it become U.S. law. More broadly, state, city and county pension executives are urged to stay on top of what is occurring in Washington.

Turning to the next slide, the U.S. Securities and Exchange Commission (“SEC”) has adopted a temporary rule under the auspices of the Dodd-Frank Wall Street Reform Act which was passed in 2010.

Dodd-Frank Wall Street Reform and Consumer Protection Act*

- Summary: Would establish registration requirements for certain “municipal advisors” which may include appointed pension trustees
- Fiduciary implications:
 - Will public fund trustees have to register?
 - If so, is there a potential conflict of fiduciary duties?

*SEC Proposed Rules (Interim Final Temporary Rule 15Ba2-6T and SEC Release No. 34-63576) on, (PL No. 111-203)

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In essence, what these rules would do is to require registration as a municipal advisor for certain people who otherwise have not been registered before, including those who provide advice about municipal security issuance, use of municipal derivatives and/or investment strategies.¹ Municipal employees are exempted. A question remains as to whether appointed pension trustees would be required to register as a municipal advisor.

I know the SEC is interested in hearing more comments from individuals and organizations that are likely to be impacted. Fiduciaries who are appointed to their respective positions should pay attention as they may be more exposed from a liability perspective than in the past.

In particular, if you read these rules closely, you will see that it makes references to the definition of fiduciary duties for municipal advisors under the Municipal Securities Rule-Making Board (“MSRB”). The MSRB rules describe fiduciary duty as having an allegiance to the issuing entity, i.e. the municipality. This could create real conflicts for a pension fiduciary in many ways. By extension, it could create confusion and potentially harm pension plan participants if trustees are torn between two parties that may not always have the same interests.

¹ [“SEC Adopts Temporary Rule Requiring Municipal Advisors to Register With Agency,”](#)
U.S. Securities and Exchange Commission Press Release, September 2, 2010

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My advice, once again, is for public plan fiduciaries to monitor this situation closely. If you do have comments, I would encourage you to get those to the appropriate individuals at the SEC. I think it's still 50/50, whether this rule ends up being finalized in its current form.

Susan Mangiero:

Terry, do you think that it is likely, in the event that municipal bond issuers are asked about their pension disclosures, that public companies will likewise be vulnerable to issues about pension risk disclosures?

Terry Magid:

Yes. While energy is being expended now to enhance public plan economics and related municipal bond disclosures that reflect unfunded defined benefit plan liabilities, ERISA plans could present problems for taxpayers as well. To the extent that those liabilities play an important role in the financial stability of an organization that issues stocks or bonds, ERISA fiduciaries and company board members are certainly subject to review.

Terry Magid:

Turning to the next slide, I thought it would be helpful to spend a few minutes talking about some recent enforcement activity by the SEC. There has been tremendous publicity in the last twelve to eighteen months. Those who fear negative headlines and worry about reputation risk should pay heed.

Federal

SEC Enforcement and Municipal Bond Pension Disclosures

- Fiduciary Implications:
 - Who prepares pension disclosures and is the pension information in the disclosure accurate?
 - Process should be documented and include –
 - description of responsibilities
 - periodic updates
 - review process
 - training on the process

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One of the first prominent cases I reviewed relates to the State of New Jersey. If you have not yet read the SEC's cease and desist order, I encourage you to take a look at it from a fiduciary perspective.² I think it lays out a very nice roadmap for ways to ensure that the SEC will be less likely to worry about whether pension plan disclosures are incomplete and therefore potentially injurious to municipal bond buyers. The document seems to suggest that the SEC expects to see a well-documented process in place for communicating the funded status of all municipal defined benefit pension plans. This process ought to very clearly describe who is responsible for developing the disclosures, the roles they play, whether conflicts of interest are present and how disclosures will be periodically updated.

Another critical issue is whether those individuals who are responsible for putting disclosures together are adequately trained and aware of what investors need to know. Keep in mind that the processes of issuing municipal securities as well as determining the pension plan assets and liabilities are each fairly complex and intricate processes. Specialized knowledge is required in order to do a good job of assembling information.

² ["Order Instituting Cease-And-Desist Proceedings Pursuant to Section 8A Of The Securities Act Of 1933, Making Findings, And Imposing A Cease-And-Desist Order,"](#) Administrative Proceeding In the Matter of State of New Jersey, Respondent, August 18, 2010

The next two slides deal with the U.S. Department of Labor (“DOL”) and their concerns about fiduciary duties. First, there is the issue of broadening the definition of who is an ERISA plan fiduciary. I am not going to spend a whole lot of time describing the rules as many others have already put together white papers on the topic. What I want to emphasize is that fiduciary liability is likely to expand in terms of scope and universe of individuals who work with pension plans, notably those investment advisors who have not heretofore been treated as fiduciaries. If adopted, costs will go up of servicing employee benefit plans and all sponsors - public and private - will bear the brunt of higher expenses to purchase services and products from outsiders.

Federal

Expanded Definition of ERISA Fiduciary*

- Summary: Broadens the types of activities included as “covered [investment] advice” such as valuations, appraisals, fairness opinions and investment manager selection
- Fiduciary Implications (even for non-ERISA plans):
 - Have provider costs increased as a result of service provider having increased fiduciary risk?
 - Is consultant providing truly independent advice if concerned about own liability?

*29 C.F.R. 2510.3-21; Proposed Regs. 75 Fed. Reg. 65263 (proposed Oct. 22, 2010)

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Second, there is the issue of heightened fee disclosures. I would suggest that executives of plans operating in a fiduciary capacity be mindful of that reason for fee increases from various advisors. As we will talk about on the next slide, better reporting offers more opportunities to review what goes into the making of fees and really challenge any investment advisor during the course of fee negotiations.

Federal

Interim Final Regulations on Fee Disclosure Under ERISA 408(b)(2)

- Summary: Requires investment managers and other service providers to provide more information than currently required on fees and conflicts of interest
- Fiduciary Implications:
 - Are public pension fund fiduciaries unintended beneficiaries?
 - Public plans moving to DC will have access to more information.
 - Even though service providers are required to provide information to ERISA clients, public funds ought to have the leverage to get the information also.

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My take in reading the various comments on this proposed rule are as follows. If a service provider is concerned about his or her own fiduciary liability, particularly if that person doesn't believe they truly are a fiduciary, one needs to question whether that person really has the plan's best interest at heart. Further disclosure places a bigger burden on executives and trustees of plans to understand the motivations of the advice one is getting from its investment advisor(s). While new rules under ERISA 408(b)(2) specifically apply to defined benefit and defined contribution plans alike, expect emphasis of implementation for the 401(k) and 403(b) market.

The import of these rules, when they become effective at the beginning of next year, is that advantages accrue to non-ERISA plans too. Pension consultants and investment advisors are going to be required to provide a lot more information than they traditionally have before. Since numerous advisors frequently service both ERISA and non-ERISA plans, public plans will have access to expanded information that is provided to non-government plans. More and better information makes it easier to select and review advisors and asset managers.

I would like to now turn to some changes happening at the state level. This next slide has less to do with reform measures and more to do with the policy dynamic underway throughout the nation. Even prior to the financial crisis of 2008 that materially impacted pension plans throughout the world, there were anecdotal stories of U.S. sponsors not paying the full amount they owed to plans. This failure to pay the Actuarially Required

Contribution (“ARC”) worsened already bad situations for many plans and exacerbated the economic fallout of the credit and sub-prime crisis. A key question is what, if any, fiduciary liability applies to plan trustees and other fiduciaries if they do not collect what is owed on behalf of participants. The liability associated with a failure to collect for any one fiduciary pales in comparison to the aggregate IOUs of underfunded public pension plans. However, the exposure is large for individuals who find themselves in trouble for failing to fulfill their fiduciary duties.

State

Failure to Pay Actuarially Required Contribution (ARC)

- Fiduciary Implications:
 - Do trustees have an obligation to collect?
 - If so, how far do trustees have to go?
 - Fund executives should raise the issue with trustees and facilitate a discussion on the proper course of action. Document any discussion and actions taken.

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In an ERISA context, I think the cases are fairly clear. The trustees do have an obligation to collect that money. What is unclear is how far fiduciaries have to go. Is simply sending a demand letter to the plan sponsor enough or do fiduciaries actually have to take a sponsor to court? More attention must be paid to this issue. For those plans in this situation, where the government sponsor has chosen not to fully fund the ARC - because (a) it is incapable of doing so or (b) due to budgetary constraints or (c) it elects to prioritize other government expenditures - fiduciaries must ensure that a thorough discussion of this issue takes place and is documented accordingly.

The next slide addresses the topic of benefit reductions, an area of pension reform that continues to receive a great deal of attention for both economic and political reasons. Here too, there are fiduciary implications when states choose to scale back benefits, whether it be for prospective and/or current employees, through tier benefit structures or formula reductions.

State

Benefit Reductions

- Fiduciary implications when states scale back benefits(e.g. reduce/eliminate COLAs, create tiered benefits, formula reduction, retirement age, etc)
 - Consider state constitutional issues
 - Must administer the plan in accordance with plan terms

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Fiduciaries need to consider what role they play. First among many important priorities is to follow the law. Problems occur when a law conflicts with existing statutes or, more importantly, with state constitutions. It is incumbent upon every fiduciary to educate lawmakers, particularly those who might be proposing such conflicting and/or confusing language. If new laws get passed that end up being in conflict with other laws or the constitution, it is important to get legal counsel to determine the next course of action. In many cases, the plan fiduciary is going to be caught in the middle of these political debates and it is important to be educated and protected from a fiduciary standpoint.

Susan Mangiero:

Terry, are all state plans covered under their respective state constitution?

Terry Magid:

No. Perhaps one third of state sponsors may be bound to explicit provisions in their constitutions that dictate benefit levels and terms. Another one third of plans follow pension-centric statutes. For the final third set of states, both statutes and the state constitution are silent on the pension issues.

Susan Mangiero:

For those situations where pension issues are not addressed or they are not protected, does that mean that there is going to be more vulnerability for politicians and fiduciaries alike?

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Terry Magid:

Politicians are reluctant to rescind benefits but there is a lot of pressure to make changes. Drawing from ERISA legal precedent, benefit cuts may be difficult for sponsors to implement. Right now, people do not see any other way to reduce state or local budgets. Rightly or wrongly, proposals to cut benefits are being made. It will be interesting to see how these initiatives develop. Benefit cuts for existing retirees are being challenged in court in three different states right now. I know that the public plan community is closely watching the outcome of these cases to see how they get settled.

Susan Mangiero:

How is the threat of municipal bankruptcy likely to impact the payment of retirement benefits?

Terry Magid:

In some states, the pension funds would be protected from a bankruptcy filing. If the federal government goes as far as to allow states to declare bankruptcy, the fallout will go well beyond pension plans. Many negative consequences will flow from a state or locality should it declare bankruptcy. However, it is too soon to tell what the exact aftermath of a bankruptcy will look like.

Yet another proposal that is getting a lot of publicity these days among state legislatures is the conversion of a defined benefit plan(s) to a defined contribution plan(s), or supplementing an existing defined contribution plan(s) and reducing the benefits associated with a more traditional scheme.

The advice on this slide is really much more practical than it is legal. Given that this may become a reality for some in the near future, I would recommend that plan fiduciaries take into consideration the following thoughts.

As everyone is well aware by now, the defined contribution plan predominates the private sector market. As a result, and as this tends to happen in these situations, there is a vibrant industry developed around defined contribution plans. Therefore, I think that every defined benefit plan faced with the decision to implement a defined contribution plan for the first time ought to fully embark on a build versus buy decision. In other words, decide whether it makes more sense from a cost efficiency standpoint to build the capability to provide a defined contribution plan in-house versus going out and buying an existing solution from the market place.

Implementing a DC Plan

- Requires full understanding of resources required
- Fiduciaries are advised to consider:
 - outsource vs. in-source analysis
 - if outsource, RFP process
 - vendor management and fiduciary oversight

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From personal experience, I think it is hard to build something from scratch to include full recordkeeping and disclosure requirements. That said, if a fund does end up deciding to outsource, the Request For Proposal (“RFP”) process requires great care. There are so many issues such as how to detect hidden fees and service provider due diligence.

Once a vendor is chosen to help with the defined contribution plan implementation, the other thing I would strongly recommend, and this doesn’t necessarily always happen in the private sector in my experience, is that you create a strong vendor management and/or fiduciary oversight function. What tends to happen a lot is that an expert is hired and assumed to fully handle everything. It is not that easy in this business in my experience. Building a good fiduciary oversight function, particularly a vendor management function, is one of those things that is an ounce of prevention that avoids the pound of cure later.

Turning to the next slide, I want to hit a couple of topics that I suspect most of the participants on this call are very well aware of but worth touching on anyway. It is a very good practice to engage in periodic fiduciary audits. The scope of those audits ought to include at least three general areas: (1) plan governance documents (2) investment policy and (3) plan administration. From a governance document standpoint, some of my bulleted items such as the role of placement agents and corporate governance

policies are receiving a lot of attention in the media these days. Best practices go beyond compliance and need to focus on having a full-fledged process in place.

Other Issues to Consider – Part One

- Fiduciary Audits
 - Governance Documents
 - Ethics Policies (Conflicts of interest? Placement agents?)
 - Social Investing and Corporate Governance Policy
 - Committee Structure
 - Board performance review and education policies
 - Actuarial processes and assumptions
 - Process and timing for review
 - Investment Policy Statement
 - Asset Allocation and process for review
 - Delegation of responsibilities
 - Manager selection and performance evaluation procedures
 - Securities Lending Policy
 - Plan Administration

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Regarding the investment policy statement, a thorough review needs to be undertaken on a regular basis as things change. In particular, one of the things that I added to this slide recently was a bullet about securities lending which created much grief for more than a few plans. In some cases, this strategy was billed as an extremely safe pursuit with exposure that turned out to be anything but. As a result, I am now seeing a lot of plans spending more time in developing a robust securities lending policy.

Plan administration is another issue. Pay attention to the fact that administration practices and processes reflect changing rules and regulations, especially if the plan design has changed. Regular reviews also allow for improved and further efficiencies in how a plan(s) is run. An audit should seek to verify compliance and room for how to do things better.

The next slide considers a few miscellaneous items such as RFP processes, vendor contracts and insurance policy reviews. With respect to RFP processes and standards, a lot of plans in the public space are subject to their states' procurement policies. When that occurs, things are fairly well prescribed. For those plans that have the opportunity and the ability to create their own RFP processes and standards, I would encourage

them to be reviewed annually, updated to reflect the latest changes in law and to streamline who does what in order to avoid redundancy.

Other Issues to Consider – Part Two

- RFP Processes and Standards
- Investment Manager and Vendor Contract Reviews
- D & O Policy Review

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In my experience, investment management and vendor contract reviews are hugely important but sometimes given scant focus. In my role at the Indiana Public Employees' Retirement System ("PERF"), we would periodically go out and look at contracts that are in the execution phase to make sure that terms had not expired and that all renewal clauses had been complied with. Investment manager agreements must likewise be reviewed to make sure that names and risks of investment managers and advisors are current and adequately vetted.

Lastly, a lot of state funds have indemnification policies built into their statutes for officers and trustees. Given the current environment, it is wise to review whether those statutory provisions are adequate. If not, consider whether or not it is cost effective to procure an additional insurance policy for D&O protection for all trustees. If you already have such additional protection, look at it periodically to make sure that you are getting the best rate.

Susan, that concludes my remarks. I'll turn it over to you if there are no other questions.

Susan Mangiero:

Terry, should the expanded definition of fiduciary take hold, do you see a changing relationship between pension plan trustees - and here, I'm using the term generically regardless of plan design - and their staff, investment consultant and/or attorney? Would you comment on what that relationship looks like now. Is it separate and distinct and going forward, do you see more working together across disciplines?

Terry Magid:

First, my experience is that the consultant relationship tends to be stronger, at least with the plans that I'm familiar with, between the consultant and staff and not so much the trustee and the investment committee. There are certainly exceptions to this rule. I do believe that there will be some changes in behavior should this expanded fiduciary definition take hold and actually become final. If that will have a significant effect, I don't know.

I do think that just merely educating those individuals who have not traditionally thought of themselves as fiduciaries is important. They need to understand their obligations, how to avoid conflicts of interest and what has to be done from start to finish on behalf of beneficiaries. For those relationships that are already very good, changes in behaviors should be minimal. For those relationships in which there might be a little bit of distrust, I can certainly see where a larger wedge might be drawn between parties as a result of new rules.

Susan Mangiero:

Like you, I have been tracking responses about the expanded definition of fiduciary. The DOL has extended the comment period because they have had so much push back about the expanded proposal. My understanding is that some state are considering the creation of an ERISA look alike for public plans. Do you envision public plans as being impacted by the DOL's expanded definition of fiduciary, if promulgated?

Terry Magid:

I'll be honest with you Susan, I've not seen any concrete proposals in that regard, but I do think it is very consistent with other activities at the state level we have seen with things like "pay to play" legislation and other conflict of interest initiatives at the state level. So, it would not surprise me to see something at the state level that mirrored the DOL's efforts.

Susan Mangiero:

Thank you very much Terry. Your comments are informative and important. I am going to start off by saying that investment risk management has always been important, but it is getting a lot more attention in recent months. In large part, the last few years have laid bare more than a few significant risk management oversight failures.

My definition of risk management goes beyond investment risk management. I would like to emphasize this point by considering various qualitative and quantitative risk factors. The slide entitled Investment Risk Alphabet Soup is far from exhaustive but does illustrate that there are many areas of importance. Some issues relate to operations. Others relate to regulations. Some relate to investment performance. Some risk factors are easier to measure than others. What they have in common is their importance in terms of a fiduciary's oversight of the uncertainties that can potentially create pain for retirement plan beneficiaries.

Investment Risk Alphabet Soup

Fiduciary Risk	Actuarial Risk	Cash Flow Risk	Legal Risk	Operational Risk	ERISA Liability Insurance Risk
Market Risk				Downgrade Risk	
Correlation Risk	Plan Design Risk	Accounting Risk		Systems Risk	Asset Allocation Risk
Human Capital Risk	Reputation Risk	Suitability Risk			
Statutory Funding Risk	Demographic Risk	Litigation Risk		Tax Risk	Liquidity Risk
Vendor Risk	Hidden Risk	Cost of Capital Risk		Contagion Risk	D&O Risk
Complexity Risk	Model Risk	Headline Risk		Opportunity Risk	Political Risk
M&A Risk	Compliance Risk	Counterparty Risk		Collateral Risk	Excess Risk

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Let me emphasize that these risk factors are frequently interrelated. Left unchecked, the damage can be severe. Let me provide a few examples. In late 2008 when there was near panic in the marketplace, allocations in place that reflected correlations among industries, countries and types of assets veered from historical pairings. Worldwide flights to quality and great uncertainty led to what economists refer to as contagion during which time assets thought to be uncorrelated or independent in terms of their price movement were instead similarly moving down in value.. Bad news became worse

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news. Any fiduciary that relied on what happened in the past instead of assessing current and projected conditions was faced with the risk that a plan's mix of assets was no longer optimal (if it ever was) because of correlation risk. In turn, their selection of various asset managers and related plan fees were thrown off kilter.

Another example of this compound risk issue might involve allocation to hard-to-value instruments that are used for hedging purposes. Let's say a pension plan buys or sells over-the-counter derivatives that do not readily trade in a secondary market. Incorrect pricing could lead to a hedge that is too big or too small and expensive to the plan as a result. Poor credit conditions could worsen the situation if model risk leads to an improper assessment of counterparty risk and asking for more collateral as a result. The point is that the risk of a poor model could lead to problems elsewhere in terms of hedging, credit risk mitigation and/or collateral monitoring. A pension fund could end up with worse problems than just bad mark-to-model numbers because the imputed prices impact other actions (or lack thereof).

So, whether it is counter party risk, or collateral risk, or the two taken together, derivatives can be extremely helpful. Whether a pension fund uses derivatives directly or indirectly - via an allocation to an asset manager that employs derivatives - it is critical to understand how default risk, non-performance, assessment of counterparties and so on is to be assessed.

Now, a lot about over-the-counter derivatives is destined to change as the Dodd-Frank Wall Street Reform and Consumer Protection Act starts to manifest itself in terms of standardized clearinghouse procedures.

Terry earlier cited disclosure risks as a problem with some securities lending managers. Investors deemed the risk to be lower than reality suggests. In those cases, disclosure risk was interrelated with liquidity and price risks, not to mention legal risks for those defined benefit plans that incurred a loss and put them in a statutory funding red zone.

The bottom line is that a lot of these risks do not exist in isolation. They really need to be evaluated as not only important in and of themselves, but also because they can make other risks more severe in terms of loss to a plan.

One of the things that I recommend to pension fund decision-makers is to not only embark on a scenario analysis where one is perturbing various inputs such as interest rate levels or equity market volatility and also allowing different risk factors to change simultaneously. Someone does not have to be a rocket scientist to embark on a risk management exercise of creating a matrix of what might go wrong. Even if someone is unable to get to very precise quantitative assessments of what the damage might look like if two or more risk factors change against at the same time, at least decision-

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makers have a general idea as to the directional move should two or more different risk factors changed.

The other thing I would like to really convey to the audience is that many times we look for risk to be quantified and while there are some terrific risk metrics that allow for measuring some of these risks, there are also quite a few risks that need to be assessed but are not going to show up in a numerical risk report.

I say this having done a fair amount of forensic finance, going in after the fact to see what went awry. Let me give you an example. I recently worked on a situation where a pension plan had invested in a hedge fund and the hedge fund ended up going south. One of the things that came to be known was that one person was making decisions for several different subsidiaries of the parent entity and there were no checks and balances to mitigate conflicts of interest. The key person risk and key person risk is hugely important as is an absence of internal controls. A value-at-risk number or downside variance of returns will not directly capture key person risk. Someone has to be on the lookout for key person risk as part of an ongoing due diligence initiative.

Another type of risk that is not going to be captured by standard risk measures relates to trading limits and the related method by which traders are compensated. Pension fund fiduciaries (and/or their agents, if applicable) should meet with the Chief Investment Officer of a particular provider as well as the Chief Risk Officer, if one exists. Some fiduciaries have said that they like to meet with each person separately and then together as a way to make sure that everyone has the same approach to risk management. Ask if key players are getting compensated on the basis of risk-adjusted return or instead are getting compensated for reported gross returns only. Not every dollar of return is going to be equal. The cost of risk can be different from dollar-to-dollar.

If a pension plan is investing in hard-to-value instruments, ask about who values various instruments and on what basis. Is an independent third party being used? Is there a sit-down with private equity and other types of alternative fund managers to understand how they generate their FAS 157 (or international equivalent) numbers?

An answer to the question about the use of a third party pricing service is not going to show up in a point in time number nor will information about whether numbers are generated on the basis of mark-to-market or marked-to-model. The issue of compensation is a risk factor because traders often get paid more when reported performance is higher than would be the case if risks are taken into account. However, well-intentioned, it is not always going to be in their best interest to report something, let's say with a lower, perhaps more realistic market-to-model number. So, there's an inherent conflict of interest. How traders get compensated is covered in part by new financial market laws so hopefully any bad practices will soon improve and those with

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excellent risk-mitigation practices will be rewarded by existing and prospective clients for their prudence.

Again, compensation is an important element of the risk assessment process that is not going to be captured in a single number.

The concept of procedural prudence is that many factors comprise a good process, the work of vigilance never ends and there has to be evidence of thoroughness and consideration on the part of relevant decision-makers.

I'm going to stop for a moment Terry and ask you to comment on that concept of procedural prudence.

Terry Magid:

I would agree whole-heartedly that the outcome is not as important as the process, particularly when one is talking about fiduciary duty. Fiduciaries must ask the right questions about controls, operations, credit risk and so much more. I agree wholeheartedly, from the legal perspective, that it is not necessarily the outcome that count. It is the process. Susan, you have mentioned a galaxy of risks. How is a pension fund fiduciary to make sense of all this and ensure that the process that he or she has developed will address all of these risk factors?

Susan Mangiero:

It is a good question. The answer I would give is to start first and foremost with creating a risk management policies and procedures that serve as a companion piece to the investment policy statement. This is true regardless of plan design. So many times, when I've looked at pension plans investment policy statements, they will list overly objectives that make sense in terms of mitigating risks, but fail to address the nuts and bolts needed to build a strong risk mitigation foundation. Sometimes, a plan's investment policy statement is silent on risk other than a general statement about not wanting to take on too much of it.

So far, at least anecdotally, what I have found is that not too many plan sponsors have specific and complementary risk management policies and procedures in place. The belief seems to be that the statements about risk which are part of an investment policy statement are sufficient. In some situations, a comprehensive risk management policy may not exist as a separate document but is reflected in numerous meeting minutes.

You cannot really manage risk unless you first and foremost identify risks. Some risks are going to be more important to a particular plan than others. For example, I worked on one situation where the pension plan was an older plan with waning contributions because more people were retiring and not being replaced with younger workers.

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The asset allocation mix for this plan was arguably too risky given their specific circumstances of being a mature plan with fewer cash inflows and greater outflows. Stability of investment return became increasingly important because the plan was not going to have contributions to offset check-writing requirements. Everything else being equal in terms of benefit levels, sponsor credit worthiness and so on, their risk tolerance factor would logically differ from that of a younger plan. So, there is no “one size fits all,” but in terms of procedural prudence, I strongly recommend that a plan sponsor have a risk management policy for each of its plans and then, a set of procedures that accompany the risk management policy which is compatible with the investment policy statement itself.

Terry Magid:

As a quick follow-up question Susan, you had earlier mentioned stress testing these policies and procedures. How frequently should a fund consider those stress tests?

Susan Mangiero:

Frequency will depend on a variety of factors. You could stress test the policies and procedures and also stress test the different components of the portfolio. They are somewhat different exercises. Risk tolerance is one factor. The financial health of the plan sponsor is another factor. If a plan sponsor is in distress, an “appropriate” pension risk management has to take that into account since a company may be vulnerable to an acquisition or filing for bankruptcy or something else that is nevertheless material. Fiduciaries for a distressed plan may not have as much of a comfort zone and/or latitude to effect changes.

Market volatility is another factor. Sometimes volatility in the market can be a good thing but it can also alter the structure of trading, asset class premiums or discounts and/or correlations. High levels of volatility could invite new regulations and rules that must be taken into account.

We are both in agreement that a pension plan should not decide on a particular approach and never adjust its policies and procedures. Many organizations are looking reviewing their asset allocation mix every three to five years. With a global market that is changing so radically and the onslaught of so many new rules and regulations, even an annual review may put a plan at risk. Again, it really depends on a host of factors that fiduciaries should discuss at length as often as makes sense for their given situation.

Terry Magid:

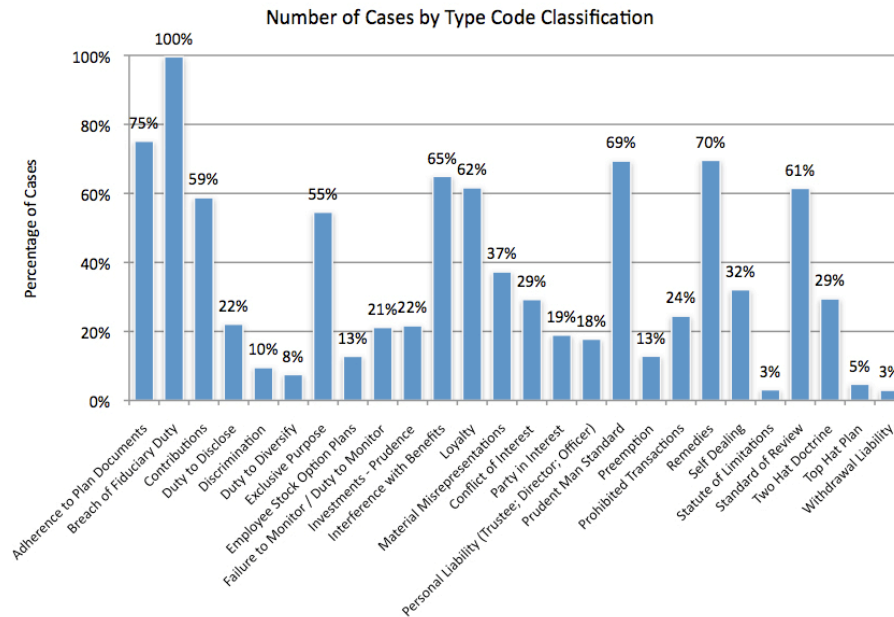
I agree. Based on my experience, we are starting to see, at least in the public context, plans looking at asset allocations, or complete asset allocation restructures more frequently. Similarly, I think you are starting to see more focus on risk too.

Susan Mangiero:

Whether change occurs because of market volatility, new laws or something else, we both agree that needed reform is a good thing. Sometimes dire outcomes drive change as is the case increased litigation and regulatory enforcement.

A few years ago, my colleagues and I studied ERISA litigation to understand how it was increasing and why. We examined over 2,500 investment oriented cases and classified the lawsuits on the basis of up to 100 different codes. As shown in the slide below, we identified fiduciary breach as the number one common complaint, followed by an alleged failure to adhere to plan documents, assuming they exist.

Soaring Pension Litigation



Source: www.pensionlitigationdata.com

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The tricky part comes about in the situation where, let's say, you don't have documents in place. As an attorney Terry, what your thoughts about not having documents in

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place? Which is worse? To have documents that are good but not followed or have no documents in place at all to guide investment and risk management decisions?

Terry Magid:

A fundamental principal in ERISA and probably in public pension land as well is to comply with the terms of the existing document(s). It is always the first source a plan fiduciary should look to in trying to make a determination on something that on its face may seem unclear. What does the document say? If the document is silent or no document exists, that indeed is a problem. It does not surprise me as well to see that nearly every case in your study involved a breach of fiduciary duty allegation. If a plaintiff did not see things the same way as the plan fiduciaries, obviously, breach is a sort of a catch all claim to make.

Susan Mangiero:

As we have seen in these last couple years, it takes time for litigation to make its way through the legal system. All indications point to more lawsuits now with no end in sight. As you indicated earlier, expanding the DOL's definition of fiduciary could add to liability and legal filings. It behooves everybody to make sure that they have got a good process in place and are reviewing that process on a regular basis.

Anecdotally, there seems to be a lot more attention being paid to selecting a service provider(s) but perhaps not as much work being done thereafter to continue the due diligence process from a holistic risk perspective. Your point about reviewing contract terms is a good one. Some institutional investors assumed that someone along the service provider food chain was vetting hard-to-value instrument marks only to find out later on that no one had taken the responsibility for asking questions. The unhappy outcome of partial or full losses is one result.

So, one thing that seems to be more pronounced now is the need for institutional investors to review contracts for any and all of their relationships with asset managers, banks, consultants and so on. Does that make sense?

Terry Magid:

Susan, I do think that makes sense. You know, what you have described reminds me of something that I've seen a lot of press about recently and that is with respect to brokers, banks and trading prices.

Susan Mangiero:

It seems as if all aspects of investment management are being scrutinized. The actions of the DOL, SEC and others are expected to impact the broker-dealer community as well as investment consultants, advisors and appraisers, among others.

Susan Mangiero:

I know we are running short on time. I want to further comment on hard-to-value investing since numerous pension plans are ratcheting up their exposure to risk in anticipation of higher returns that may help them play catch up, post 2008 losses. As an aside, not all hedge funds should fall in the hard-to-value bucket, a point I made when I testified before the ERISA Advisory Council.³ Indeed some money market funds and balanced mutual funds that report a daily Net Asset Value may be investing in hard-to-value instruments and face a variety of risks as a result. In contrast, a pension plan may allocate to a hedge fund that is putting money into actively traded stocks and bonds. The concept of hard-to-value must be reviewed for any type of asset management pool being considered by plan sponsor fiduciaries.

Allocating more money to hard-to-value investments is not necessarily a bad thing as long as a good assessment of what the lack of liquidity means for that particular pension plan is being conducted. Fiduciaries need to understand the pricing model, how the model “tires” are getting kicked and whether an independent appraiser or third party pricing service is being used. Quality and quantity of collateral is another factor to consider.

I know of some defined contribution plans that have started offering hard-to-value options in the form of financially engineered products. This means that those fiduciaries too must examine pricing issues thoroughly or risk failing to do their job properly. Moreover, models can be compound in nature where inputs themselves might be a function of a model. The classic example is the mortgage backed security which requires inputs such as interest rates and prepayment projections which are first estimated and then input in an asset-backed security pricing model. The risk governance of monitoring a nested model or model within a model cannot be ignored.

Many of the regulators in the U.S. and abroad have provided guidance as to how to properly implement, create and implement policies and procedures relating to “hard to value” investments. Expect more guidance and more pain inasmuch as billions of dollars fall into this category.

The next slide lays out some elements of a good pricing model.

³ [“ERISA Advisory Council Working Group on Hard to Value \(“HTV”\) Assets,”](#) Testimony Presented by Dr. Susan Mangiero, CFA, FRM,” September 11, 2008

Characteristics of a Good Model

- **Computationally Plausible**
- **Consistent Results**
- **Cost-Effective**
- **Data Availability**
- **Quality of Data**
- **Easy to Explain**
- **Generalized Assumptions**
- **Extreme Value Immunity**
- **Logical**



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I want to make another comment about hedge funds and something called a side pocket. A side pocket refer to a situation when certain holdings are set aside and not included in monthly or quarterly portfolio performance reports. Side pockets are not usually considered good or bad unless underperforming instruments are specifically excluded in order to generate higher fees, falsely allay investors' concerns about bad returns and/or something else equally as nefarious. I just read about an enforcement case that alleges fraud.⁴

The existence of FAS 157 and international accounting valuation and disclosure rules should make it harder to justify an unwarranted side pocket but I will defer to legal experts for an opinion.

⁴ [“SEC Charges Georgia-Based Hedge Fund Managers With Fraud in Valuing a ‘Side Pocket’ and Theft of Investor Assets,”](#) U.S. Securities and Exchange Commission Press Release, October 19, 2010

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Terry, you and I could talk about any of these topics for hours on end. Given that we are close to the 75 minute end time for this webinar, would you please wrap up with some words of advice for the audience?

Terry Magid:

Sure. We are in a dynamically changing environment, particularly for public plans these days. Public plans seem, for whatever reason, to be in the cross hairs of state and local governments, the federal government and various taxpayers' rights groups. There are going to be changes. Those changes are going to impact fiduciary duties of plan executives and plan trustees.

My best cautionary advice to fiduciaries is to monitor proposals closely. Keep the dialogue open among peer trustees and frankly, among each other. As issues arise, address them head on, document them, and understand that so long as fiduciaries continue to keep their duties foremost as they make decisions, they have half the battle addressed.

Susan Mangiero:

These are good points. I would add that we are likely going to start to see a lot more pain applied to the ERISA plans as well. I say this because ERISA litigation is increasing and Congress is unlikely to address public plan underfunding in isolation. The confluence of Social Security and Medicare problems and longer life spans are undeniable realities. Politicians want Corporate America and the states to each do their part in addressing the pension gap.

To Terry and audience members, thank you for your time. Feel free to contact Terry and me with comments and questions.

Terry Magid:

Thank you all.

Susan Mangiero:

Bye-bye.