



MEMORANDUM

To: Annuity and Pension Board of the City of Milwaukee

From: Keith L. Johnson, Alicia R. Mohn and Hrishikesh H. Shah

Cc: Jerry Allen, Executive Director  
Beth Cleary, Deputy Director

Date: June 21, 2012

Subject: Fiduciary Duties and ERS Employee Compensation

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EXECUTIVE SUMMARY

Reinhart Boerner Van Deuren s.c. ("Reinhart" or "we") has been asked to advise the Annuity and Pension Board ("Pension Board") of the City of Milwaukee ("City") regarding fiduciary duty implications of the Pension Board's limited authority and flexibility to manage human capital resources of the City Employee Retirement System ("ERS"). Based on applicable fiduciary law, recent ERS employee turnover and studies done by advisors to the Pension Board, we believe the Pension Board and City are exposed to increasing fiduciary duty liability risks due to constraints on the Pension Board's authority and the limited resources available to the Pension Board to implement investment policy and pursue management practices necessary to meet ERS' funding and the Pension Board's fiduciary duty obligations.

While not the only aspect of ERS' resource constraints, below market employee compensation levels, resulting staff turnover, and challenges in recruiting experienced personnel for key staff positions illustrate the fiduciary liability risks attendant in the current situation. Unless this situation is addressed, it appears that the level of exposure to legal risks is likely to increase.

We note that similar constraints on the State of Wisconsin Investment Board ("SWIB") were removed by the Legislature in 2011. SWIB was granted independent authority to establish and monitor its own operational budget, create positions and set employee compensation, subject to legislative oversight. This is consistent with leading authority on implementation of fiduciary responsibilities.

## BACKGROUND

The ERS is a government retirement system sponsored by the City to provide retirement and other benefits to employees of the City and City agencies.<sup>1</sup> The Pension Board oversees general administration and operation of the ERS.<sup>2</sup> The Pension Board members are fiduciaries of the ERS and, as such, must fulfill certain fiduciary duties when performing their roles on the Pension Board.<sup>3</sup> The Pension Board is obligated as an ERS fiduciary to take reasonable steps to implement investment and management practices to ensure that the ERS is able to meet its benefit payment obligations to its participants. As explained below, however, the Pension Board's limited resources, particularly constraints on its ability to hire and retain experienced key personnel, appear to be compromising its ability to fulfill fiduciary obligations.

1. Staff Civil Service Status. The ERS staff members are City employees and generally subject to City Civil Service Rules. However, positions can be identified as exempt,<sup>4</sup> and the City Service Commission (the "Commission") can also exempt specific positions from the Civil Service Rules for hiring and firing on an individual basis. An individual Commission exemption is only valid for the person serving in the position when the exemption is granted. Once that individual leaves the position, the position reverts back to a regular Civil Service position.

ERS staff member salaries are set by the Common Council via the City's Salary Ordinance. Positions are assigned to a salary grade, with the individual in a position receiving a salary within that salary grade range. The Common Council must approve the reclassification of a position to a different salary grade. In addition, the salary of any City official may not exceed that of the Mayor, as dictated in the City's Salary Ordinance.<sup>5</sup> The City Attorney has opined that this limit applies to all ERS positions, whether or not they have been exempted from Civil Service Rules.<sup>6</sup>

2. Staffing Issues - Compensation Case Study. We have been advised that the Pension Board has become concerned about the effect its lack of authority to meet market compensation levels for key staff positions is having on its ability to fulfill fiduciary obligations to the ERS. It is increasingly difficult to retain key employees and attract the quality of personnel necessary to implement ERS' sophisticated investment strategy. The restrictions on compensation levels under the Salary Ordinance contribute to this retention and hiring problem.

In particular, we have reviewed a confidential Competitive Pay Level Analysis Report (the "Report") that was prepared by McLagan for the Pension Board in 2011. The Report compared compensation for ERS staff member positions to those at both public and private funds, recognizing that the ERS must compete with both for talented employees. The Report concluded that "ERS' aggregate salary spend falls in the low quartile versus all peer groups and virtually all ERS' incumbents are paid below the market median." McLagan advised that incumbents in most ERS key positions are paid substantially below market salaries in the bottom quartile of peers, some by as much as 40 percent. Compared to median peer salaries, the Report states that salaries for key ERS positions are as much as 53 percent below median. [Emphasis added.]

The Report identified the following roles and positions (the "Key Staff Members") as particularly vulnerable: administrative roles (including the Executive Director and Deputy Executive Director), senior non-administrative roles (including CIO, CFO and Chief Technology Officer), and other key non-administrative roles (including Pension Investment Analyst, Retirement Plan Manager,

Lead Pension Specialist, Records Management Team Lead, Pension Accounting Lead, Functional Applications Manager, Network Manager and Java Developer/Analyst).

We were also advised by ERS that Key Staff Members have recently been recruited for opportunities elsewhere at substantial compensation increases. Since 2005, ERS has experienced 100% unwanted turnover of the investment staff, including the CIO and analyst positions. For example, a Pension Investment Analyst left the ERS in November 2011 for a reported 38% pay increase at a new job in a similar role as he served at ERS. Because the ERS staff is not large, this alone constituted a loss of one-third of its investment staff.

When filling vacancies for the Senior IT Manager and CFO jobs, those positions had to be moved to higher pay classifications to facilitate attracting and hiring individuals to fill the vacancies. ERS Staff Members have reported being aggressively recruited for positions elsewhere with substantially higher salaries. At least one Key Staff Member recently interviewed elsewhere and was chosen as a finalist for a position with compensation approximately twice the salary currently paid by the City for the same position.

We understand that the Pension Board considers the McLagan Report to be a warning that the ERS is vulnerable to loss of Key Staff Members and will be at a serious disadvantage in recruiting replacements with comparable expertise. From our experience with other public pension fund clients, we are aware that loss of Key Staff Members can be disruptive and the time required to train inexperienced new recruits to advanced skill levels can present increased exposure to investment and monitoring risks. Furthermore, the Pension Board has expressed concern that, once trained, new recruits would also become subject to poaching by other peer organizations that are able to pay closer to median compensation.

3. Investment Implications. Given that current compensation limits imposed on the ERS (including a pay freeze) are expected to increasingly widen the pay gap with competing employers over time, the Pension Board is worried that this problem will only get worse. In fact, a 2009 organizational review by L.R. Wechsler, Ltd., cautioned:

"Unless ERS dramatically improves the cash compensation of its investment staff, it should be prepared to deal with recurring staff vacancies. ERS should not use any investment strategy whose success depends on uninterrupted support from a high quality investment staff, unless it also has the ability to exit the strategy quickly."<sup>7</sup>

However, we have also been advised that the Pension Board received recommendations from Mercer Investment Consulting, after a 2008 asset liability modeling study, that the ERS adopt a strategic asset allocation which requires doubling its exposure to alternative investments (private equity, infrastructure, hedge funds, commodities and real estate), while maintaining its current exposure to public equities. The Pension Board accepted the recommendation and has devoted several years to implementation of it. We understand that this requires an experienced and high quality investment staff but is projected to provide better returns with less volatility.

An internal ERS study also found that active management by ERS staff added value to the portfolio of approximately \$539 million for the ten year period 2001 through 2010, compared to passive management strategies. In addition, a 2011 cost effectiveness study done by RV Kuhns reported that ERS investment costs are 39 basis points below the average of peer funds.

We recognize that the Pension Board believes this demonstrates the benefits to both ERS participants and City taxpayers of the strategic asset allocation adopted by the Pension Board. However, the Pension Board has also noted the caution about risks associated with staff turnover that were expressed by L.R. Wechsler, Ltd., in the organizational review, cited above.

In short, the current situation appears to place the Pension Board in a 'catch 22' dilemma. It has demonstrated the ability to generate added returns under the investment strategy recommended by its advisor. However, it has also been advised that current resource and authority restrictions present increasing risks to successful future implementation of that strategy.

Unless the compensation problem is addressed, the Pension Board believes it must choose between taking on the risks associated with exposure to increased Key Staff Member turnover or abandoning its current investment strategy for an approach that is projected to involve greater volatility and produce lower returns. We have been advised by the Pension Board that such a change could be expected to reduce annual returns by as much as 40 to 90 basis points, equivalent to \$16 million to \$36 million annually.

4. City Liability Exposure. The City and its employees and taxpayers are also in a difficult position. In the event the Pension Board determines it must adopt a more conservative investment approach, there is potential for future increases in employer and employee contribution levels to the ERS. However, in the event the Pension Board decides to continue with the strategic asset allocation it has adopted, there is potential City exposure under its existing indemnification agreement with the ERS to cover Pension Board fiduciary liability associated with knowingly taking on risks of increased Key Staff Member turnover.

The Pension Board has requested this legal analysis of fiduciary obligations to assist it in deciding how to approach this dilemma.

#### OVERVIEW OF PENSION BOARD FIDUCIARY DUTIES

The Pension Board members serve as fiduciaries with strict legal duties in their role overseeing the ERS. Section 36-09-1.d-7 of the City Charter establishes the Uniform Prudent Investor Act (promulgated by the National Conference of Commissioners on Uniform State Laws and interpreted in accordance with the Restatement of Trusts (Third) as guiding authority for application of Pension Board fiduciary duties. Relevant portions of s. 36-09-1 include the following:

(a) Standard of care. The Pension Board and its delegates must exercise reasonable care, skill, and caution in investing and managing ERS assets, considering the purposes, terms, distribution requirements and other circumstances of ERS;

(b) Investment strategy. Investment and management decisions must be considered not in isolation, but in the context of the entire portfolio, and as part of an overall investment strategy with risk and return objectives reasonably suited to ERS' needs;

(c) Loyalty. ERS trust assets must be invested and managed solely in the interests of participants and beneficiaries.

(d) Delegation. The Pension Board must exercise reasonable care, skill and caution in selecting, instructing and monitoring delegating its functions and, thereafter in supervising its delegated agents, the Pension Board must exercise fiduciary discretion and act as a prudent person would in similar circumstances.

### APPLICATION OF FIDUCIARY DUTIES

There are several sources of authority to which the courts look when interpreting fiduciary duties. We first examine the sources explicitly identified in s. 36-09-1.d-7 of the City Charter.

1. Restatement of Trusts and Uniform State Laws. As mentioned above, the Restatement of Trusts (Third) and the Uniform Prudent Investor Act (the "UPIA") are referenced in the City Charter as persuasive authority. Section 227 of the Restatement of Trusts (Third) discusses fiduciary duties in delegation. It states that, with regard to prudent delegation involving alternative investments, a trustee "must possess or have available the requisite competence to devise and implement a prudent plan of delegation; otherwise it would be imprudent to proceed even if the resources and other circumstances of the trust would justify an undertaking of this type."<sup>8</sup>

Section 227 of the Restatement also cautions, "Without the competence to select managers and to work out proper terms of a prudent delegation . . . the trustees may not proceed with their desired [direct-investment] alternative for accomplishing their objection through program managers. To do so would violate the proper conditions of such a delegation and thus the requirement of caution imposed by the prudent investor rule of this Section."<sup>9</sup>

Official comments to the UPIA provide additional guidance on application of the duty of loyalty and on standards for delegation to agents. "A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries. . . . The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interests of any third person."<sup>10</sup> Similarly, "[i]f the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries."<sup>11</sup>

Another authoritative source established by the National Conference of Commissioners on Uniform State Laws is the Uniform Management of Public Employee Retirement Systems Act ("UMPERSA"), model legislation targeted specifically to the duties of public retirement system trustees. UMPERSA was adopted by the Commissioners in 1997 and has been endorsed by the American Bar Association.

Section 5 of UMPERSA advises that public retirement system trustees be given exclusive authority to "establish an administrative budget sufficient to perform the trustee's duties" and "obtain by employment or contract the services necessary to exercise the trustee's powers and perform the trustee's duties . . ." The official comments to section 5 explain, "[t]his section is intended to ensure that retirement system trustees have a level of independence sufficient to permit them to perform their duties and to do so effectively and efficiently. Trustees are different from other [state] actors because they are subject to an extensive and stringent set of fiduciary obligations to retirement system participants and beneficiaries. These obligations both require and justify some level of trustee independence."

Taken together, the references identified by s. 36-09-1.d-7 of the City Charter as sources for authoritative guidance raise a red flag about exercising caution in selecting agents and employees with appropriate expertise and competence when delegating responsibilities. In fact, in the event of future losses by ERS, the current situation could be viewed as a prima facie case for a breach of the fiduciary standard of care due to the fact that McLagan advised the Pension Board that ERS' compensation practices do not meet similar investors' standards. Opponents could argue that losses were caused by the staffing situation. The fact the Pension Board has been advised of the salary situation without taking remedial action could be cited to demonstrate the Pension Board's violation of the reasonableness standard under the fiduciary standard of care.

In addition, model legislation adopted by the same Commissioners to which the City Charter defers advises that public retirement system trustees should be given broad budgetary and civil service autonomy sufficient to allow them to perform their duties effectively and efficiently. These provisions would likely be cited as precedent by the plaintiffs in any litigation which involves allegations that ERS participant interests were damaged by intentional disregard of the need for high quality Key Staff Members and sufficient trustee independence to allow the Pension Board to fulfill its fiduciary responsibilities.

2. Wisconsin Precedent. In the 2011 State Budget Act, previous statutory limits on budget authority of the State of Wisconsin Investment Board ("SWIB"), the investment management fiduciary for the Wisconsin Retirement System, were removed.<sup>12</sup> Act 32 grants SWIB the authority to annually assess the funds it manages for the costs of management, allowing it to establish and monitor its own operational budget. It also transferred all remaining classified civil service positions at SWIB to the unclassified service and authorized SWIB to create positions and set compensation levels for all its employees. New reporting requirements to legislative oversight committees were included in Act 32, to provide transparency and accountability for the exercise of this authority.

The legislative changes contained in Act 32 implement principles set forth in both UMPERSA and the UPIA. The statutory amendments also address issues associated with application of the fiduciary duties of loyalty, prudent delegation and adherence to the standard of care in implementing investment strategy, as discussed above. It is likely that the legislative determinations which lead to enactment of these amendments to chapter 25 of the Wisconsin Statutes would be cited in any litigation involving similar fiduciary issues at ERS.

However, Act 32 also provides a potential model for resolution of the fiduciary liability dilemma facing the Pension Board. Greater Pension Board flexibility to set staff compensation at market levels would help address the drivers of increased fiduciary liability exposure.

3. Academic Research Findings. The May 2012 issue of The NAPPA Report, a publication of the National Association of Public Pension Attorneys, cites a 2011 study done by researchers at the University of Toronto's Rotman School of Management which found that the ability of pension funds to "attract, retain and incent high performance talent within their respective organizations" is associated with higher investment returns.<sup>13</sup>

Two earlier academic studies out of the University of Toronto also concluded that "competitive compensation policies" was one of the factors that distinguished better performing pension funds from their less fortunate peers.<sup>14</sup> Similar conclusions are discussed in an academic paper focused on the structure of the compensation plan used for internal staff at the Canada Pension Plan.<sup>15</sup>

Again, this growing collection of academic studies that link pension fund performance to compensation practices that allow fiduciaries to attract and retain talented staff needed to implement an optimal investment strategy would lend support to any future claims brought against the Pension Board and the City based on intentional use of uncompetitive compensation and staff retention practices. It also potentially implicates compliance with the duty of loyalty, as Pension Board members owe a fiduciary duty to act in the interests of ERS participants and beneficiaries. That duty is based on best net investment results rather than lowest costs.<sup>16</sup>

#### 4. Case Law.

Additional analysis of fiduciary duties applicable to ERS can be found in case law dealing with benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). Although ERS is not subject to ERISA, the UPIA (referenced by s. 36-09-1.d-7 of the City Charter as a guide for interpreting the Pension Board's fiduciary duties) cites ERISA as persuasive authority for application of UPIA principles.<sup>17</sup> See also *Roebke v. Newell Co*, 177 Wis.2d 624, 635 (Ct. App. 1993) (examining in detail federal ERISA cases to decide whether a Wisconsin pension fiduciary had breached its obligations).

Courts have consistently held that, in circumstances where ERISA trustees lack the requisite knowledge, expertise, or experience necessary to make prudent decisions to carry out plan investment functions themselves, they have a fiduciary duty to hire qualified professional advisors. See, e.g. *Liss v. Smith*, 991 F.Supp. 278, 297 (S.D.N.Y. 1998); *Harley v. Minnesota Mining and Mfg., Co.*, 42 F.Supp.2d 898, 907 (D.Minn. 1999). Courts have described the scope of the duty pension plan fiduciaries have to ensure that the advisors they hire are qualified. For example, when relying on expert advice to carry out plan functions, fiduciaries are obligated to:

- (a) Investigate the expert's qualifications;
- (b) Provide the expert with complete and accurate information; and
- (c) Make certain that reliance on the expert's advice is reasonably justified under the circumstances.<sup>18</sup>

Whether hiring outside advisors or internal staff, the same principles regarding selection of delegates with appropriate expertise and knowledge apply. The court in the *Liss* case noted that "[t]he need for independent advice will depend on the factual circumstances of each case," and that this advice "can come in many forms."<sup>19</sup> According to the court, such independent advice can "encompass an overall investment strategy; advice with respect to particular proposed investments or delegation of day-to-day investment authority with appropriate oversight."

Accordingly, the fiduciary duties set forth in ERISA jurisprudence regarding reliance on expert advice also inform application of fiduciary obligations to the Pension Board in selecting ERS Key Staff Members with the required level of expertise.

### CONCLUSION

The Pension Board's challenge in meeting its fiduciary obligations raises the potential for increased ERS fiduciary liability exposure, as well as added financial obligations for the City, its

employees and its taxpayers. If ERS negligence or other breach of its fiduciary duties were to result in losses to the trust fund, participants could file lawsuits against the Pension Board and other responsible delegates. For example, an error by inexperienced staff in accounting for investment returns, in conducting due diligence on selection or evaluation of a third party manager, or in monitoring a manager's compliance with established risk and investment parameters could generate liability in the tens or hundreds of millions of dollars.

The City, as plan sponsor and under its indemnification agreement with the ERS, would be implicated in any such litigation. The City is not only exposed to potential increased employer contributions needed to make up any investment shortfall if the Pension Board were forced to adopt a suboptimal investment strategy; it has also agreed to indemnify members of the Pension Board and employees of ERS against liabilities, costs and expenses arising from a breach of or failure to perform their legal (i.e., fiduciary) duties. Even if a lawsuit for ERS breach of fiduciary duty were ultimately unsuccessful, the City would still be responsible for attorneys' fees and costs in defense of the suit.

Although it is impossible to eliminate all exposure to liabilities that could arise from a breach of fiduciary duties, the potential for breaches resulting from knowingly taking on the increased legal risks associated with unnecessary turnover of Key Staff Members is something that could be proactively minimized. Accordingly, we recommend that the Pension Board and City confer on resolution of Pension Board authority and Key Staff Member retention and recruitment issues that have created the current dilemma.

If a prudent resolution of the issues cannot be reached, the Pension Board will be faced with a Hobson's choice that presents increased exposure to either liabilities or costs for the Pension Board, City, ERS participants and taxpayers, regardless of the ultimate decision. In that event, the Pension Board's fiduciary duties will require it to favor interests of the fund's participants and beneficiaries in balancing risk and return considerations.

If we can be of further assistance, please do not hesitate to contact us.

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<sup>1</sup>City Charter section 36-01.

<sup>2</sup>City Charter section 36-15-1-a.

<sup>3</sup>City Charter section 36-09-1.

<sup>4</sup>See Wis. Stat. section 63.27 for the list of City positions that are exempt appointments from the civil service rules.

<sup>5</sup>The Mayor's current salary is \$147,336.

<sup>6</sup>November 10, 2003 City Legal Opinion authored by Grant Langley, City Attorney.

<sup>7</sup>L.R. Wechsler, Ltd., Organizational Review: Final Report (May 14, 2009) at s. 8.6.7.

<sup>8</sup>Restatement of Trusts (Third) § 227 cmt. k, illus. (1992).

<sup>9</sup>Restatement of Trusts (Third) § 227 illus. 23 (1992).

<sup>10</sup>Official comments to § 5 of the UPIA.

<sup>11</sup>Official comments to § 9 of the UPIA.

<sup>12</sup>See ss. 25.16 (2), 25.16 (7), 25.17 (13m), 25.17 (13r) and 25.187, Wis. Stats., as amended by 2011 Wisconsin Act 32.

<sup>13</sup>Dyck, I. J. Alexander and Pomorski, Lukasz, *Is Bigger Better? Size and Performance in Pension Plan Management* (June 1, 2011). Rotman School of Management Working Paper No. 1690724, available at SSRN: <http://ssrn.com/abstract=1690724> or <http://dx.doi.org/10.2139/ssrn.1690724>.

<sup>14</sup>Ambachtsheer, Capelle and Lum, *The Pension Governance Deficit: Still with Us*, Rotman International Journal of Pension Management, 1: 14-21 (2008).

<sup>15</sup>Ambachtsheer, K., *How Should Pension Funds Pay Their Own People?*, Rotman International Journal of Pension Management, Vol. 4 Issue 1, Spring 2011.



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<sup>16</sup> City Charter section 36-09-1.d-4 provides that costs incurred by the Pension Board in investing and managing trust assets must be "appropriate and reasonable in relation to the assets for the purposes of the trust and the skills of the trustee." A reasonableness standard does not mean that fiduciaries must always select the lowest cost alternative. Rather, costs are evaluated based on whether they are reasonable when compared to net results. When discussing the reasonableness of investment costs, the Restatement of Trusts (Third) states that, "The trustee can properly incur expenses appropriate to the collection and protection of the trust property...and to making the property productive." Restatement of Trusts (Third) § 88 cmt. b (1990). In the case of the ERS, the "trust property" in question is its investment portfolio. In its discussion of active investment strategies, which are generally associated with higher costs than passive strategies, the Restatement provides that a trustee's fiduciary duty of only incurring reasonable costs "does not preclude the use of active management strategies" when "these added costs and risks [are] justified by realistically evaluated return expectations. Restatement of Trusts (Third) § 90 cmts. e(1), h(2).

<sup>17</sup> For example, see official comments to sections 1, 3, 5 and 9 of the UPIA.

<sup>18</sup> See, e.g., *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 430 (6th Cir. 2002); *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996); *Keach v. U.S. Trust Co.*, 313 F.Supp.2d 818, 867 (C.D.Ill. 2004).

<sup>19</sup> *Liss*, supra, 991 F.Supp. at 297.



City of Milwaukee  
Employees' Retirement System

**Bernard J. Allen**  
Executive Director

**Thomas A. Rick, CFA**  
Chief Investment Officer

**Martin Matson**  
Deputy Director

April 23, 2012

Keith L. Johnson  
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Dear Mr. Johnson,

Per our previous phone conversation with Rudy Konrad and Beth Cleary of the City Attorney's Office, the ERS Board of Trustees is considering the implications as a qualified plan fiduciary regarding limitations on governance resources made available to the Board to discharge its fiduciary obligation to Plan members and beneficiaries. We are requesting your firm's opinion regarding the issues identified below and any others that may need to be considered.

The City of Milwaukee salary ordinance and civil service rules limit staff compensation such that the ERS is not able to pay anywhere near market levels in seeking to attract and retain competent managerial, technical and professional staff. On this point please refer to the survey data previously forwarded from McLagen, the Board's independent compensation consultant which indicates ERS professional, technical and managerial staff compensation generally is at 4<sup>th</sup> quartile levels as compared to its peers. Also, cash compensation has been permanently frozen for several years and we anticipate the comparison to peers will continue to deteriorate as a result. Further, total compensation has actually begun to decline with retrenchment in health care and other welfare benefit provision, as well as City-imposed mandatory furlough days.

Please advise whether you require any further documentation or have questions as you undertake this engagement.

Sincerely,

A handwritten signature in black ink, appearing to read "Bernard J. Allen".

**Bernard J. Allen**  
Executive Director