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The "Fandation" of Risk: Does a Banking Client Get Its Money Back After Cyber Theft?

By: Edward H. Klees

On March 12, 2016, the *Washington Post* reported that a nearly $1 billion cyber theft was blocked at the last minute by a bank employee who noticed a typo in the wire instructions at a foreign bank. According to the Post, but for the crooks misspelling the name of the purported recipient, a charitable foundation, as a "fandation," the Federal Reserve Bank of New York would have sent approximately $870 million of assets to a phony account after already transmitting $80 million. **https://www.washingtonpost.com/business/economy/typo-thwarts-hackers-in-1-billion-cyber-heist-on-bangladesh-central-bank/2016/03/11/83466dd0-e7d8-11e5-a6f3-21ccdbc5f74e_story.html**

Although the law seeks a balance between the competing interests of bank and client, the client may face an uphill road to recovery.

As my aunt would have said, "We should all be so lucky." Since March this story has evolved to be part of a hack involving the SWIFT international bank messaging network. Michael Corkery, *Once Again, Thieves Enter Swift Financial Network and Steal*, N.Y. Times, May 12, 2016, **http://www.nytimes.com/2016/05/13/business/dealbook/swift-global-bank-network-attack.html?_r=1**. As news comes in, discomfort grows for both banks and their corporate and institutional clients.

I have published research (*How Safe Are Institutional Assets in a Custodial Bank's Insolvency?*, 68 Bus. Law. 103 (2013) (*"Bank Custody"*) on whether a client can recover its assets after a custodial bank's insolvency. Although one hopes the risk of bank insolvency is relatively remote, hacking attacks are a fact of life. As hacking techniques evolve, anti-hacking vendors release new software to overcome them, and the game of cat and mouse continues.

Where does this leave corporate banking clients? Who bears the loss if a hacker raids their accounts?

This article summarizes the relevant law and the practical challenges for commercial and institutional clients and concludes with items the client might consider in order to improve the likelihood of recovery. Although the law seeks a balance between the competing interests of bank and client, the client may face an uphill road to recovery.

This article does not address rights of consumers, which is covered under different law (the Electronic Fund Transfer Act, 15 U.S.C. § 1693 *et seq.*).

Summary

This area of law is relatively new and is intended to evolve with technology. What this means is that there are guiding principles but not absolute clarity.

A first principle is that, as noted, the law seeks a level playing field between the bank and the commercial or institutional client. The bank has the burden to prove that its security procedure was "commercially reasonable" and that it acted in "good faith," or that the client overruled a commercially reasonable procedure of the bank's for one of its own. If the bank meets this burden, then the client may still shift the risk of loss to the bank if the client can prove it had nothing to do with the hack.

Thus, the law does not impose liability simply on who was hacked – the bank or the client. If the bank can show it acted reasonably and in good faith, however, then the client will be liable unless it can show lack of culpability. This presents the very real question of whether current technology always is capable of "proving a negative" – that is, that the client was not hacked.

Second, the courts seem inconsistent in their "commercial reasonableness" analysis, nor is there a national standard of commercial reasonableness. Courts are permitted to be more forgiving of a local bank's procedures than those of a major financial institution, even though the local bank may have less sophisticated tools. This may draw more clients to big banks, especially clients who do not have internal teams to monitor cash movements in real time.

Third, although the law's focus is on electronic transfers, it also covers oral instructions. In my experience, banks continue to require broad authority to accept oral instructions regardless of client objections. The risk of loss from phony phone orders is a ticking time bomb and, in this case, the law seems to place the risk of liability on the bank.

The Recommendations section that follows offers ideas to corporate and institutional clients and their counsel looking for ways to increase the likelihood that the bank will bear the risk

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of loss from a cyber theft. Ultimately, though, the question is whether technology exists – and is readily available to not just the wealthiest companies – to enable a client to prove it was not responsible for the hack.

The FFEIC guidelines endorse periodic adjustment of bank security procedures in light of technological advances, the sensitivity of customer information, and known threats.

I note that this article does not address the state of law covering liability for cyber attacks at nonbanks, fintech, and other new financial intermediation platforms. This may soon become an even bigger subject than the focus here, and indeed blockchain or other developing technologies may eventually circumvent the risks discussed here.

Legal Principles

Article 4A of the Uniform Commercial Code (UCC), first adopted in 1989, seeks to balance the rights and obligations of banks and commercial clients (referred to in the law as "customers") arising from "payment orders," which include oral, written, and electronic transfers. U.C.C. §§ 4A-103(a)(1), 4A-105(b)(3). It is considered the exclusive source of rights and remedies, although parties may agree to supplement the terms so long as they are not inconsistent with underlying principles. U.C.C. § 4A-202(f); *Patco Const. Co. v. People's United Bank*, 684 F.3d 197, 214 (1st Cir. 2012). The UCC or its federal analog governs payment orders at all U.S. banks.

Although the law seeks to balance competing interests, article 4A initially imposes risk of loss on the bank unless: (a) the bank's security procedure was "commercially reasonable" or the client rejected a commercially reasonable procedure; and (b) the bank accepted the payment order in "good faith" and in compliance with the security procedure and any written agreement or instruction of the client restricting acceptance of payment orders issued in the client's name. If a bank has been commercially reasonable and acted in good faith, or even if the client directed the bank to run a faulty security procedure, article 4A nonetheless relieves the client of responsibility if it can show that the instruction came neither from an authorized representative, nor by way of a source controlled by the client. U.C.C. § 4A-202(b) and (c).

Thus, client culpability is irrelevant as a direct matter. Ultimately, however, the burden will fall back on the client and liability will ensue if, for example, an employee accepted a phishing attack that led to the hack, or the client cannot prove otherwise.

In sum, absent proof of the client's innocence, the key questions under article 4A will be the commercial reasonableness of the bank's security procedure, its good faith in processing the fraudulent payment orders, and whether the client demanded weaker protocols.

Commercial Reasonableness

Under section 4A-202(c), "commercial reasonableness" is a question of law to be determined by considering the customer's wishes and its circumstances, including the standard size, type, and frequency of its banking transactions. As recognized in the leading *Patco* case, commercial reasonableness is an evolving standard that should reflect market conditions and standard practices, including consideration of industry guidance, such as that published in 2005 by the Federal Financial Institutions Examination Counsel (FFIEC). **http://www.ffiec.gov/pdf/authentication_guidance.pdf**. The FFIEC guidelines recommend consideration of one or more of the following three factors:

1. something the user knows, like a password or PIN;
2. something the user has, like an ATM card or smart card; and
3. something the user is, like a person with a unique fingerprint or biometric characteristic.

The FFIEC guidelines endorse periodic adjustment of bank security procedures in light of technological advances, the sensitivity of customer information, and known threats. "Out-of-band" protocols, such as callback verification, are also encouraged. The case law frequently cites the FFIEC guidelines.

Article 4A does not impose a best practice or even one set of standards on all banks. As stated in *Patco*, the "commercially reasonable" analysis does not ask whether the bank has in place the best procedure, but whether the procedure is "reasonable for the particular customer and the particular bank" or whether it satisfies "prevailing standards of good banking practice applicable to the particular bank." In this context, *Patco* and the other leading cases cite section 4A-202(c) to recognize that practices found deficient at a large financial institution could be deemed reasonable at a local bank.

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The facts-and-circumstances nature of the commercial reasonableness test is shown by the disparate outcomes in the two leading cases.

In *Patco*, the First Circuit held that a community bank's security procedure was not commercially reasonable because the bank had the capacity but failed to monitor or report the fraudulent transactions as high risks based on the bank's risk-scoring metric. The court remanded for further consideration. Here, the client was a small business in property development and construction that used the bank's web-based platform mainly for weekly payroll.

If the bank's procedure is commercially reasonable under section 4-202(b), the bank still must act in good faith in order to shift the risk of loss back to the client.

Two years later in *Choice Escrow & Land Title, LLC v. BancorpSouth Bank*, 754 F.3d 611 (8th Cir. 2014), the Eighth Circuit upheld the commercial reasonableness of the security procedure of a regional bank despite the bank lacking any of the risk measures cited in *Patco* and having no means to monitor or report offshore wires. In that case, the bank wired $440,000 to an account in Cyprus. Ironically, the client earlier had asked the bank to block all offshore transfers. The client was a real estate escrow company and, unlike the *Patco* client, routinely wired funds.

So a small bank in *Patco* had insufficient procedures, whereas those of a regional bank in *Choice* were fine despite lacking not only the procedures of the *Patco* bank but even the ability to put a control on offshore transfers, which would seem to be a simple and obvious measure to have in place. Clearly, then, the *Choice* decision is hard to mesh with *Patco*. What led to the opposite result regarding "commercial reasonableness"?

Client Rejection of Bank Security Procedure

Here is where *Choice* can teach a lesson to all companies and institutions. To reach the legal issue of whether a client rejected the bank's procedure, a court must first determine that the bank's procedure was commercially reasonable. If it is not commercially reasonable, then the law looks no further; the client's decision to take a less safe option is irrelevant, as is the client's responsibility, if any, for the hack.

Rejection by bank clients of a commercially reasonable procedure can be unforgiving under article 4A. The client's desire to save costs or simplify usage may be irrelevant. In *Choice*, the court dismissed the client's argument that it was so small that a dual-control procedure would be a hardship. The *Choice* court not only questioned the client's election to keep a single approval procedure, but also noted that an employee of the client had accepted a rather obvious phishing request that probably led to the hack.

Can the fact that the client was foolhardy or foolish, rebalance the equities toward the bank outside the four corners of the written law? The *Choice* court clearly seemed unhappy with the client, noting that the wire should not have "raised eyebrows" (even though it was intended for an account in Cyprus) and, in dictum, without citation, that phishing scams are successful only in "one of out every few thousand recipients." Perhaps the lesson here is simply that, putting aside client blame, the bank offered a customer a commercially reasonable procedure and the customer rejected it. However, the disparity remains between the stronger procedure rejected by *Patco* and the weaker one approved in *Choice*. It is also true that a real estate escrow company, as in *Choice*, is expected to send out wires of large amounts to sellers who may be located anywhere, even though the customer specifically asked not to remit offshore wires. In addition, perhaps the claims made by *Choice Escrow* on appeal were poorly pled, as it may appear.

There is enough in *Choice* to call attention to all clients of the potential risk if they reject the bank's proposed procedure. Even if it means leaving the bank to find more palatable terms elsewhere, the client accepts all risk of staying at its current bank if something goes wrong later.

Good Faith

If the bank's procedure is commercially reasonable under section 4-202(b), the bank still must act in good faith in order to shift the risk of loss back to the client. Case law defines "good faith" as: (i) honesty in fact (what has been called a "pure heart and empty head" standard, see *Experi-Metal, Inc. v. Comerica Bank*, 2011 WL 2433383, slip op. at 11 (E.D. Mich. 2011)), which requires a fairly straightforward factual review; and (ii) "reasonable commercial standards of fair dealing," which not only is more subjective but, as noted in *Choice*, seems similar to the commercial reasonableness standard.

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It has followed that courts have evaluated fair dealing consistently with their finding of commercial reasonableness. This was so in *Choice*, and in *Experi-Metal*, after concluding that the bank's security procedure was not commercially reasonable, the court found that the bank failed to show it had acted in good faith by carrying out the fraudulent payment order. The court cited several factors, including the client's limited prior wire activity, the volume and frequency of the false payment orders, the destinations of the orders, and the bank's awareness of then-current phishing attempts. Again, the good-faith analysis was consistent with the commercial reasonableness analysis.

Unless there is a question of actual honesty on the part of the bank, the good-faith test may simply be a reiteration of a “commercial reasonableness” analysis.

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Client Exculpation

Even if the bank can show its procedure was commercially reasonable and it had acted in good faith, or even if it shows the client demanded a weaker procedure, the client can escape liability if it can prove that the payment order was not caused directly or indirectly by someone either: (i) with authority to act on behalf of the client with respect to payment orders or the security procedure; or (ii) who obtained access to the client's facilities or otherwise obtained access without authority of the bank, regardless of how and whether the client was at fault. U.C.C. §§ 4A-105(a)(7), 4A-203(a).

Although article 4A is intended to keep current with the technology, the official comments to article 4A-203 seem to assume that a client's lack of fault will be fairly easy to establish because each cyber attack on a bank will lead to internal and criminal investigations, the results of which the client can use if they prove the bank was responsible.

I do not know whether the official comments are correct that every cyber-originated bank theft will prompt an investigation, or that each investigation will be fair and thorough. However, based on my discussions with computer scientists, I am not certain that today's more sophisticated hacks will leave a “fingerprint” proving where they originated; if they do, whether current technology can adduce it; and if it can, whether that technology is generally available, inexpensive, and easily usable. Even if there is free and simple technology that does this, however, which again is unclear, what happens if the client's forensics show up with nothing? Does the absence of evidence of a hack prove it did not happen? What if the bank and the company each run the most cutting-edge tests and each shows nothing?

In this respect, article 4A may not account for the increasing sophistication of hackers or the technological and evidentiary challenges facing a client who was not at fault. At the very least, a company or institution is prudent if it can significantly limit employees who may initiate a payment order to a small and responsible group who will be credible witnesses and impose callbacks and other additional controls.

Other Questions

In addition to the tests above, there are other factors for banking clients to consider, especially in terms of documentation, oral instructions, and to the extent article 4A extinguishes other claims against the bank.

What is the parties' “written agreement?” Do client instructions matter? What about bank updates? As part of the article 4A analysis, under section 4A-202(b), the relevant “security procedure” encompasses the parties' “written agreement,” which includes any “written instruction of the customer restricting acceptance of payment orders issued in the name of the customer” so long as the bank has received and has reasonable opportunity to act on it. The law does not similarly embrace a unilateral amendment or announcement by the bank, and so courts have found them not to be binding without client acceptance in writing or by course of conduct. *See Chavez v. Mercantil Commercebank*, 701 F.3d 896, 903 (11th Cir. 2012).

The official comments explain that the written-agreement requirement is there not to give the bank the means to restrict culpability or customize an acceptable security procedure, but rather to allow the customer to impose additional restrictions. U.C.C. Art. 4A-203, Cmt. 3. Hence the different treatment for unilateral action by the client versus that by the bank.

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However, to date the courts have seemed uncomfortable with the asymmetry here. So in *Choice*, the client had explicitly asked the bank to bar foreign wires, yet the court found that that was an "inquiry" and not an instruction or direction. Given that a key element of commercial reasonableness under article 4A is addressing "the wishes of the customer," the court's parsing of the request as an "inquiry" suggests that other courts may interpret the law narrowly.

This underscores that the case law is still evolving and that clients may have a difficult time convincing a court that a bank is bound by a client instruction that the bank did not accept or cannot follow. In fairness, this may be a hard position for a bank to find itself. In this situation, I would advise a client to go to a new bank that can accommodate its needs rather than rely on the rule finding that a client's unilateral instruction or other action is binding on the bank under article 4A.

The common practice of automated group mailings of amendments likely will be valid if the bank can show the client received the information and failed to object or terminate the contract.

What is the "written agreement" specifically? In my experience, a commercial or institutional client's overall agreement with a bank has many parts. In addition to the main agreement, often called the custody agreement, typically there are various addenda that include the website access agreement; the form of client authorization list; possibly a securities lending agreement (although less common after 2008); an FX rider; and perhaps other documents, along with updates the bank may circulate from time to time. In addition, the bank's draft of the overall agreement typically will include a number of terms to be negotiated, including exculpatory provisions to benefit the bank, such as ones excluding recovery of punitive damages or damages in excess of, for example, one year of fees, and indemnification provisions requiring the client to pay the banks costs of litigating suits relating to the client's account, including possibly lawsuits brought against the bank by the client itself. Note that sometimes one document may contain language restricting or expanding rights or duties from another document.

As noted above, courts will not incorporate updates or riders issued from time to time by the bank as part of the client's written agreement unless the client accepted them. The common practice of automated group mailings of amendments likely will be valid if the bank can show the client received the information and failed to object or terminate the contract. The cases are replete with clients disputing receipt of updates. This raises a question of fact whether the updated terms are part of the "written agreement." *See Patco*, 684 F.3d at 214.

Here the client is at a disadvantage. Given that federal regulators encourage banks to adopt uniform agreements, as noted in *Bank Custody*, the bank should be accustomed to mass mailings, whereas clients may not be attuned to them. In addition, although the bank would certainly keep a record of sending the notice to the client's e-mail address, will the client's hard drive or other storage facilities be robust enough to later recover evidence to show the client failed to open the e-mail, or that it got trapped in a spam filter? As with the question whether technology can prove a client's blamelessness for the hack, the client may be hard-pressed to "prove a negative," namely, that it never opened or read the communication. Given that there can be no evidence to prove a nonevent, the issue likely would be one of credibility for the trier of fact. *Chelan County, Wash. v. Bank of America Corp.*, 2015 WL 4129937 (E.D. Wash. 2015), slip op. at 16.

To address this risk and others, I have advised clients to confirm periodically with the bank the full set of documents that the bank has on record for the client. The client should not only review all updates but ask the bank to fill in missing exhibits, delete outdated documents (which sometimes can still be there), and ensure that the bank has the client's current list of authorized representatives and the client's standing instructions and requisites for approvals, especially of money transfers.

Oral instructions. Recently, a leading custodial bank told my client, a billion-dollar institution, that it could not accept language banning acceptance of oral instructions. The bank explained that there are times it must track down someone by phone to approve proxy instructions if no one had responded by the deadline. Although this seemed a reasonable request for proxies or even all noncash transactions, the bank required broader language to accept oral instructions in all instances and be exculpated if it failed to validate the oral instructions in writing. The bank said that this was in all its institutional agreements.

Naturally this language is alarming to any banking client. As risky as written instructions may be, the risks of oral instructions are manifestly greater. This is magnified further by the fact that many bank custody agreements impose low standards (or in this example,

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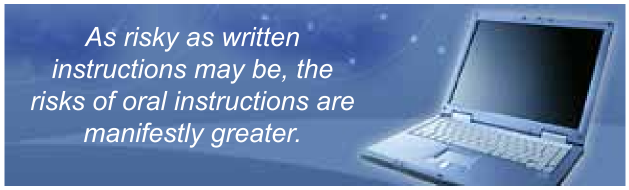
no standards) on the bank for adducing the genuine identity of the people purporting to represent the client by phone.

What is the outcome of a bank's broad authority to accept oral instructions? Assuming it is clear that the authority was sought by the bank and not the client, the key questions will be whether this is a "security procedure" and whether it is commercially reasonable. Under section 4A-201 and the attendant case law, a "security procedure" must be identified as such, and if the overall agreement is silent, then section 4A-204 deems the risk of loss to reside with the bank. So unless the bank can show the existence of a valid security procedure and that this practice is reasonable, the client should be protected here.



My concern is the reasonableness peg. If many large banks still insist on accepting oral instructions, could doing so be "commercially reasonable?" I urge my clients to ban oral instructions. If a bank insists, however, I seek to ring-fence the authority as narrowly as possible to require at least dual approvals by written or electronic action prior to any movement of cash or assets.

As noted, the bank in my client's situation sought exculpation for its transfers under oral instructions. Does exculpation survive under article 4A?

Do contractual claims survive an article 4A litigation? As explained in *Bank Custody*, the custody agreement must have certain provisions to adequately protect the client. Among them is a fiduciary level of duty. On the other hand, as noted, banks typically insert provisions to limit their liability and cover their indemnification.

Given that article 4A is deemed the "exclusive" source of rights and remedies in a cyber theft, several cases have addressed whether article 4A supervenes client claims for breach of contract or of fiduciary duty, or bank exculpation or indemnification claims.

As stated in *Patco* and confirmed in *Choice* and *Wright v. Citizen's Bank of East Tennessee,* __ F.3d __, 2016 WL 97673 (6th Cir. 2016), article 4A precludes other claims only to the extent that they "create rights, duties, and liabilities inconsistent with Article 4A." Therefore, claims may be made under contractual duties that impose a higher standard than article 4A or from common law remedies for injuries or misconduct not addressed in article 4A. As such, *Patco* reversed the district court's dismissal of the client's claims for breach of contract and breach of fiduciary duty. Although it admitted it was a "closer question," the court affirmed dismissal of negligence claims based on the jurisprudence of negligence. The Sixth Circuit drew a similar conclusion in *Wright*.

Thus, case law would support claims that a bank is in breach of an obligation to prevent fraud or of the requisite fiduciary duty.

On the other hand, bank exculpation and limits on recovery would seem to be blocked. *Patco* did not address the bank's argument to this effect or its disclaimer of liability under the bank's website access agreement. In remaining silent on this question while approving the client's prosecution of the breach claims, however, *Patco* can be read to hold contractual exculpation to be inconsistent with article 4A.

Similarly, *Choice* held that bank indemnification claims were barred by article 4A. The court ordered the client to pay the bank's attorney fees, however, even though the right to recover fees came from the contract's indemnity provision. The provision stated that the client will "indemnify and hold [the bank] harmless from any and all … costs and expenses, including reasonable attorney's fees." As I read it, the award of fees here seems closer to that of an indemnity award than the court acknowledged.

Although I think it unlikely that a court will honor a bank's exculpatory provisions in a cyber theft case, the case law may not yet be so strong as to mandate this outcome, especially if a court believes that the client was more at fault than the bank.

Note that banks have not pressed force majeure as a contractual defense. It will be interesting to see whether this happens and how a court responds. Force majeure does not seem to be consistent with the principles of article 4A.

Conclusions from the case law. There does not yet seem to be a clear principle for evaluating the central question under article 4A: the commercial reasonableness of a bank's security procedure. The security procedure in *Choice* seemed significantly less robust than those in *Patco* and *Experi-Metal*, for example, yet *Choice* is the only one that found them to be commercially reasonable. As the newest case, the *Choice* court clearly had the capacity to contrast those controls with those described in the earlier cases. Client culpability is not a factor under article 4A,

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but I suspect it played a part in the decision in *Choice* and, thus, cannot be ignored when a client contemplates action against the bank for losses arising from a hack.

Recommendations

Following the recommendations in *Bank Custody*, commercial and institutional clients can take positions to protect against risk of loss from cyber theft, including the following:

First, article 4A's client protections fly out the window if the client insists on a separate security procedure if the one offered by the bank is "commercially reasonable." If the client cannot afford the bank's procedure, or otherwise wants to lower the standards, it should stop and find a bank whose plan comports with its needs. Otherwise, if something goes wrong, the bank, seeing it is not at risk, may be uninterested in discussing a settlement to avoid litigation.

Second, on the flip side, a client should leave a bank that cannot offer the protection it requires. Choice Escrow stayed with its bank even though the bank could do nothing to address the client's request to block wires to offshore accounts. If a bank cannot address the client's needs, the client should seek another bank.

Third, although available technology may not help prove a client's lack of responsibility, it makes sense to permit only a small group of highly professional employees to have wire authority. Likewise, using dual or triple controls with out-of-band controls and imposing other fortifications is appropriate, both as a business matter and to help the effort to prove lack of responsibility for the hack. These practices should defray any effort by the bank to paint the client as a negligent or improvident partner. Clients should also have an effective compliance manual and engage in regular internal training. For more ideas, see Patco Owner on Fraud Settlement, (Nov. 29, 2012), **http://www.bankinfosecurity.com/interviews/patco-i-1726/op-1**. Given that IT forensics may never be manageable, the client should at least be able to show that old-fashioned means of theft – an office break-in or a crooked employee – are not a factor.

Next, clients should resist the bank's insistence on accepting oral instructions of any kind. If any are permitted, they should be limited to noncash activities such as proxy voting. In addition, as discussed in *Bank Custody*, the client should ensure that the contract satisfies legal requirements for validity and enforceability, and knows what its "agreement" consists of. The client should go back periodically to ratify all relevant documents and exhibits and update and confirm current authorizations. In sum, the contract process can aid a bank's defense of liability. A client should make sure there are no surprises that could limit article 4A remedies or enforceability.

Last, insurance can ease risk of loss and experts can assist in selecting and negotiating cyber security coverage. Many plans have exceptions that can obliterate coverage for mistakes made by employees or offer less protection than meets the eye. In addition, policy limits on cyber insurance for institutional accounts may come nowhere near the total loss suffered in an attack on the company's bank account. Bank insurance should be examined too.

When I first studied the question of bank custody law a few years ago, I was disturbed to discover that many bank custody contracts failed to address legal requirements enabling institutional investors to protect their assets in the event of the bank's insolvency. This remains an important issue and must be addressed in contract negotiation. Even more urgently, however, clients should review their cyber security rights and their security procedures to increase their chances of recovery of losses from bank cyber theft.

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Additional Resources

For other materials on this topic, please refer to the following:

Business Law Section Program Library

Cyber Criminals: What They Do, How They Do It, and How It Effects Your Company (PDF)
Presented by: White-Collar Crime, Cyberspace Law
Location: 2015 Annual Meeting

Business Law Today

What Banks Should Know About the Eighth Circuit's Decision in Choice Escrow & Land Title, LLC v. BancorpSouth Bank
By: Lori A. Desjardins and Katie Hawkins
Vol. 24, No. 2 October 2014

Everything New is Old Again: A Framework for Economically Targeted Investments and ESG Factors Under the DOL's New (Old) Guidelines

By: Suzanne M. Dugan and Raymond M. Sarola

Public pension funds increasingly look to Economically Targeted Investments (ETI) and Environmental, Social, and Governance (ESG) factors in making investment decisions, both to obtain collateral social benefits and as part of their fundamental risk-return economic analyses. But what fiduciary standards apply to these types of investments? Concerned that its guidance from 2008 had "unduly discouraged" pension funds from making ETIs and considering ESG factors, the U.S. Department of Labor (DOL) last year issued a new Interpretive Bulletin that "reinstated" language from 1994 and took a more favorable view of such investments. The DOL's Interpretive Bulletin 2015-01 does more than simply revert to an earlier time, however – it demonstrates a more evolved and nuanced understanding, particularly of the multiple ways in which ESG factors can be considered in an investment decision. This current guidance acknowledges that factors associated with ETIs and ESG can, in some instances, be properly incorporated into an economic analysis without requiring additional procedural or substantive steps to ensure compliance with fiduciary obligations.

The DOL's updated guidance comes at a critical time, as broadly defined ESG investments are becoming a greater focus of investors across the globe. It has been reported that ESG assets have grown to over $6 trillion, and the signatories of the United Nation's Principles for Responsible Investing have over $59 trillion in assets under management.[1]

This article provides a history of the DOL's guidance on ETIs and ESG factors, explains the 2015 Interpretive Bulletin, and lays out a framework for pension funds' consideration of these investments and investment considerations that includes economic, fiduciary, legal, and governance aspects. While the most appropriate approach to a particular ETI or ESG factor will ultimately be driven by its specifics, this framework highlights best practices and provides courses of action that will allow pension funds to consider ETIs and ESG factors consistent with their fiduciary obligations.[2]

The DOL's Pre-2015 ETI Guidance

In 1994 and again in 2008, the DOL issued Interpretive Bulletins that applied the fiduciary standards of the Employee Retirement Security Income Act (ERISA) to economically targeted investments. Interpretive Bulletins are not legally binding on governmental plans, which are not covered by ERISA, but nonetheless provide the most discrete and useful guidance for public plan fiduciaries in considering ETI[3] and ESG[4] investments. A review of the 1994 Bulletin and the 2008 Bulletin that superseded it, reflects a perspective on ETIs that draws a bright-line distinction between financial investment factors and the "collateral benefits" that ETIs seek to provide. This was the prevailing perspective of the DOL until the 2015 Bulletin was issued last year.

Interpretive Bulletin 94-1: The "All Things Being Equal Test"

Interpretive Bulletin 94-1 ("IB 94-1")[5] was issued on June 23, 1994 and was the DOL's first comprehensive guidance on ETIs. Prior to this bulletin, the DOL had issued responses to specific questions raised by plan fiduciaries regarding the consideration of "non-economic" factors in investment activities, but those responses were largely limited to their particular facts.[6] IB 94-1 was published to "correct a popular misconception" that ETIs were wholly incompatible with ERISA's fiduciary requirements.

Beginning with the baseline fiduciary principles under ERISA — that plan investments be prudently managed for the exclusive benefit of plan participants[7] — the DOL set forth in IB 94-1 what has come to be known as the "all things being equal test" for ETIs:

> [T]he requirements of [ERISA] sections 403 and 404 do not exclude the consideration of collateral benefits in a fiduciary's evaluation of a particular investment opportunity. However, existence of such collateral benefits may be decisive in evaluating an investment only if the fiduciary determines that the investment containing the collateral benefits is expected to provide an investment return to the plan commensurate to alternative investments having similar risks.

This "all things being equal test" expressly permitted the consideration of collateral benefits while reaffirming that the interests of plan participants remain paramount. Only where there was a "tie" between the economic aspects of two potential

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investments could the consideration of collateral benefits from an ETI function as the "tie-breaker" and permit a plan fiduciary to select the ETI because of those collateral benefits.

Interpretive Bulletin 08-1: All Things Are Rarely Equal

In 2008, the DOL issued Interpretive Bulletin 2008-01 ("IB 08-01")[8], which superseded IB 94-1 and expressed the Department's perspective at that time that the situations in which collateral benefits may be used as a "tie-breaker" will be "very limited." The bulletin's language was overtly skeptical of ETIs and viewed the consideration of collateral benefits to be entirely distinguishable from a fund's more traditional financial analysis of potential investments:

At the highest level, pension funds that wish to consider ETIs and ESG investing should set forth in their Investment Policy Statement or similar governing document their investment philosophies and goals with respect to such investments.

> ERISA's plain text thus establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan except in very limited circumstances enumerated below.

In this way, IB 08-01 was an application of the "tie-breaker" rule from IB 94-1, but limited by the belief that alternative investment options will rarely be economically equivalent. IB 08-01 directs plan fiduciaries to undertake "a quantitative and qualitative analysis of the economic impact on the plan" of competing investment alternatives before concluding that such alternatives are equal.

The likely motivation for IB 08-01 was the DOL's concern that absent express restrictions on fiduciaries' consideration of collateral benefits, plan assets could be diverted from the exclusive benefit of plan participants to "promote myriad public policy preferences."

The 2015 Interpretive Bulletin

The DOL issued Interpretative Bulletin 2015-01 ("IB 15-01")[9] on October 26, 2015, out of a stated concern that IB 08-01 had "unduly discouraged" the consideration of ETIs and ESG factors. Specifically, the DOL believed that "the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent." Accordingly, it withdrew IB 08-01 and reinstated the language from IB 94-01, while providing insight into how and in what circumstances plan fiduciaries can consider ESG factors in investment decision-making.

The language and tone of this bulletin was markedly different from the two prior, and uses the term "ESG" for the first time. Notably, the DOL did not restrict its characterization of historically "non-economic" factors to "collateral benefits," but spoke in terms of environmental, social, and governance issues that affect the "economic merits" of investment analysis:

> Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.

In acknowledging that ESG factors are not always "collateral" to economic analyses but may instead be important components of such analyses, the DOL informed fiduciaries that the consideration of ESG factors does not automatically trigger "special scrutiny" or cause otherwise reasonable investments to become "inherently suspect."

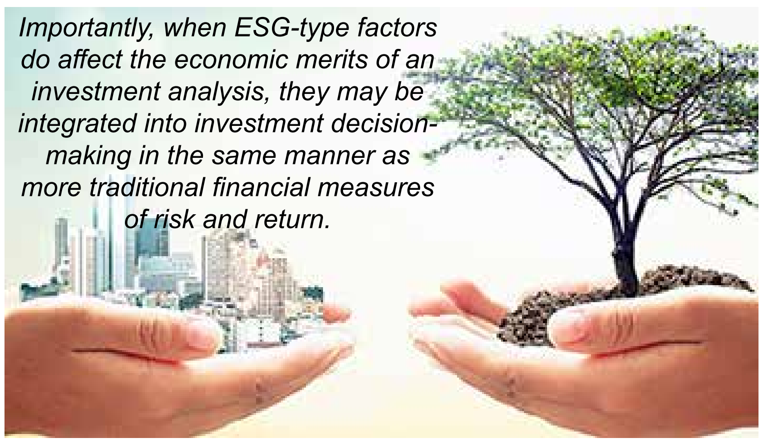
The DOL's guidance as expressed in IB 15-01 has evolved along with the global investment community's understanding of ETIs and the proper role of ESG factors. No longer are environmental, social, and governance factors summarily relegated to "non-economic" status and demanding of additional substantive and procedural requirements. Instead, where these factors influence the economic merits of a potential investment, they can and should be considered in the same manner as other, more traditional financial aspects.

Everything New is Old Again: A Framework for Economically Targeted Investments and ESG Factors Under the DOL's New (Old) Guidelines *(continued)*

A Framework for ETI and ESG Investments

Pension funds looking to invest in ETIs and to incorporate ESG factors into investment decision-making will benefit from the guidance provided by the DOL in IB 15-01, but in order to implement this guidance will likely need to clarify and make more precise their processes for considering these investments.

At the highest level, pension funds that wish to consider ETIs and ESG investing should set forth in their Investment Policy Statement or similar governing document their investment philosophies and goals with respect to such investments. These policies should be explicit about which fund investments are considered ETI and what collateral benefits they target. When ESG factors are considered, funds should be clear about whether they are seeking to obtain collateral benefits or whether they are seeking to use ESG factors to augment and improve their economic analysis of an investment option.



The reinstated language of IB 94-01 provides the proper consideration of collateral benefits when they do not affect the economic merits of an investment – they may be used only as "tie-breakers" between economically equivalent options. While IB 15-01 has replaced the earlier directive that plan fiduciaries must in all cases document their conclusion that two investment alternatives are equal with a more flexible "facts and circumstances" standard, the best practice for pension funds using collateral benefits as "tie-breakers" is to create a contemporaneous record of their investment decision-making that includes the basis for concluding that the alternatives have equivalent economic merits.

Importantly, when ESG-type factors do affect the economic merits of an investment analysis, they may be integrated into investment decision-making in the same manner as more traditional financial measures of risk and return. IB 15-01 makes clear that in these instances, "there is no need to evaluate collateral goals as tie-breakers." At the same time, pension funds should note that IB 15-01 did not conclude that all ESG factors will always have a direct relationship to the economics of a given investment. Accordingly, pension funds should in these cases be sure to document their basis for determining that one or more ESG factors are sufficiently related to the expected financial performance of a particular investment option.

Attaining the maximum benefit from ETIs and the consideration of ESG factors requires the coordination among many aspects of public pension fund governance. Boards of trustees will set big-picture ETI and ESG goals, and investment staff and consultants will analyze potential investments in light of those goals. General Counsel and outside attorneys will advise as to the necessary considerations and procedures to comply with fiduciary requirements and other relevant laws. In addition, those responsible for pension funds' corporate governance and shareholder activism programs can provide critical expertise on specific ESG factors and their relationship to the financial performance of a company. The more coordinated these efforts are, the greater the ability of a pension fund to realize the full range of economic, social, and governance benefits it seeks.

Conclusion

IB 2015-1 is the latest addition to the DOL's evolving guidance on ETIs and ESG factors. The 1994 bulletin clarified that ETIs are not automatically excluded from consideration and that collateral benefits can be considered as "tie-breakers." The 2008 bulletin warned plan fiduciaries that the situations in which equivalent investments may be distinguished on the basis of collateral "tie-breakers" will be rare. The DOL now recognizes the more complicated overlap between ETI and ESG factors on one hand, and what was historically considered a purely "economic" analysis on the other. Accordingly, the nuanced approach of IB 15-01 directs plan fiduciaries to identify the exact way in which ESG factors are being considered, and states that when applied as part of an economic analysis, ESG factors should be treated just like other financial considerations.

While the 2015 bulletin is welcome news for plans that view ETI and ESG as important aspects of their investment policy, it also

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demands attention and precision in the way pension funds treat ESG factors. This article presents a framework for pension funds that wish to continue or expand their ETI and ESG programs. In so doing, they may recognize that certain aspects of this new approach are familiar, even while improving their policies and practices for the future.

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ENDNOTES

[1] See Principles for Responsible Investment, "*Signatory base AUM hits $59 trillion*," available at **https://www.unpri.org/page/signatory-base-aum-hits-59-trillion**; The Forum for Sustainable and Responsible Investment, "Fast Facts," available at **http://www.ussif.org/content.asp?contentid=40**.

[2] This article focuses on the implications of Interpretive Bulletin 2015-01 for defined benefit public pension plans. The standards set forth in IB 2015-01 similarly apply to the selection of "socially-responsible" investment options offered by defined contribution plans.

[3] The 2015 Interpretive Bulletin notes that a consistent definition for ETI remains elusive and sometimes overlaps with terms like "socially responsible investing," as well as ESG. Nonetheless, the bulletin provides an appropriate definition of ETI: "any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor."

[4] "ESG" is also difficult to define, and perhaps can be done most usefully by including examples of considerations that fall under its heading – transparency and disclosure; corporate governance; human rights and civil liberties; energy efficiency; discrimination based on personal characteristics; workers' rights; etc. (See e.g., CalSTRS Investment Policy for Mitigating Environmental, Social and Governance Risks (ESG), at A-23).

[5] 59 Fed. Reg. 32606 (June 23, 1994).

[6] See e.g., IB 94-1 at n. 7.

[7] ERISA Section 403 requires that the assets of a retirement plan be held in trust for the "exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." 29 U.S.C. § 1103(c). Section 404 further requires that fiduciaries administering a retirement plan act with prudence and diversify plan investments to minimize the risk of large losses. 29 U.S.C. § 1104(a). These requirements are consistent with the general statutory and common law fiduciary obligations of those charged with administering public pension plans.

[8] 73 Fed. Reg. 61734 (Oct. 17, 2008).

[9] 80 Fed. Reg. 65135 (Oct. 26, 2015).

A Look at Recent Demographics and Other Statistics in Securities Fraud Class Actions

By Reed R. Kathrein

Ever wonder about who winds up leading securities fraud class actions and whether it matters? Unless you are a law firm, damages expert, or an insurance company, you probably rarely see this information.

The Private Securities Litigation Reform Act (PSLRA) mandates that anytime a securities fraud class action is filed, the judge must appoint as lead plaintiff, the person or group that has the largest financial interest in the relief sought by the class, to be the negotiator. The lead plaintiff is the "largest loser" who asks to be appointed. The lead plaintiff then oversees the litigation in the best interest of the class and sits at the negotiation table when it comes time to settle.

Roughly 200 companies---or about 4% of all domestically traded public companies---are sued each year in securities fraud class actions.

Roughly 200 companies – or about four percent of all domestically traded public companies – are sued each year in securities fraud class actions. This number has been largely unchanged over the two decades after the PSLRA was passed. While this means that approximately 4,000 have been filed since the passage of the PSLRA, only 21 have gone to trial and only 15 reached a judgment or verdict. Odds are, then, that a given securities fraud class action will be dismissed by a judge or settled by someone else representing you as a class member.

The investment losses at issue in these lawsuits are not trivial. Recent statistics gathered by Cornerstone Research reveal lost market capitalization based drops, at the end of the class period, to be around $100 billion annually. Losses, measured from the highest stock value in the class period, are about four times greater or about $400 billion.[1] NERA Economic Consulting, using their own unique proxy for damages, estimates that the investor losses on all cases filed in 2015 total $183 billion.[2]

Actual losses tied to the alleged frauds are much less, but rarely collected or calculated. Settlements are even less. Cornerstone reports that the total value of settlements in 2015 was $3 billion, similar to the annual average of $2.8 billion for the prior five years, but still well below the historically high levels of $20 billion and $8 billion seen in 2006 and 2007.[3]

Suits are being filed faster than ever. In 2009, it took 79 days on average for the first suit to be filed from the time of a disclosure causing the stock to drop, according to Cornerstone. In 2015, the pace quickened to 10 days on average. Thus, investors now need to make decisions faster than ever as to whether and how to participate; often with only imperfect information available.

A review of court filings for the past several years reveals some interesting statistics about the kind of investor that has been appointed to lead these claims and whether it makes a difference.

Despite the PSLRA's intent to attract institutional investors, they are appointed lead in less than half of the cases. A sample of the 24 lead plaintiff appointments occurring in the first two months of 2016 reveals only 10 institutional investor appointments. The remainder were retail investors usually representing losses of less than $1 million.

The kind of institutional investor was also diverse: three large state retirement systems, and a mix of nine smaller county, city, municipal, labor or police and fire funds. Only one non-public institutional lead plaintiff appointee was appointed lead.

The majority of lead plaintiff appointees – 14 – were individual retail investors or small conglomerations of retail investors thrown together by attorneys. Not a single mutual fund, hedge fund or investment manager moved to be a lead plaintiff. This mix is consistent with historic data. It reflects the fact that the bulk of class action litigation is still left to retail plaintiffs. Similarly, most institutional plaintiffs are smaller city, municipal or labor funds.

While the days of the professional retail investor are gone, some institutional investors seek appointment on a regular basis. For example, over the past five years, one large public pension fund moved to be the lead plaintiff approximately 35 times. Similarly, one smaller police and fire fund and one foreign asset manager each filed almost 30 motions. Forty city, county, police and fire and Taft-Hartley funds, one large state pension fund and five foreign funds each filed between five to fifteen motions.

A Look at Recent Demographics and Other Statistics in Securities Fraud Class Actions *(continued)*

Almost completely absent from all lead plaintiff movants are the mutual funds, the ETFs, the hedge funds and the corporate pension funds. Rather, mutual fund families, and non-public funds, are opting out of the class actions more frequently and bringing direct actions in cases like AIG, American Realty, British Petroleum and Pertrobras.

Finally, the data shows that while less than half of the cases settle – most end with a dismissal – those that do settle appear to have their settlement amounts significantly amplified by leadership from an institutional investor. Both NERA and Cornerstone confirm this benefit.

NERA's recent reports provide no data, but state as fact that an institutional lead plaintiff historically has been significantly correlated with the variation in the settlement amounts. Cornerstone tells us, that of the 60 or so cases settled annually between 2011 and 2015, institutional investors increased their share of the settlements from 22 to 39 percent. Also, during this time, the median settlement of cases lead by institutional investors has been up to seven times greater than those of retail investors. In 2015 alone, the median settlement for cases lead by a retail investor was $6.4 million compared to $18 million for cases lead by an institutional investor.

While this information is helpful, more data is necessary to fully understand the impact of the role of institutional investors. For example, the data does not look at whether the type or size of the fund matters, or whether the recoveries are proportionately greater given the actual losses. Regardless, these statistics do show that institutional investors of all kinds and sizes are having an increasing role in, and impact on, PSLRA cases.

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ENDNOTES

1 *See*, Cornerstone Research, *Securities Class Action Filings, 2015 Year in Review*, **http://securities.stanford.edu/research-reports/1996-2015/Cornerstone-Research-Securities-Class-Action-Filings-2015-YIR.pdf**

2 *See*, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review, Record Number of Cases Being Filed Faster than Ever,* **http://www.nera.com/content/dam/nera/publications/2016/2015_Securities_Trends_Report_NERA.pdf**

3 *See*, Cornerstone Research, *Securities Class Action Settlements, 2015 Review and Analysis*, **http://securities.stanford.edu/research-reports/1996-2015/Settlements-Through-12-2015-Review.pdf**

Summary of Article Statistics

- Roughly 200 companies – or about four percent of all domestically traded public companies – are sued each year in securities fraud class actions.
- Approximately 4,000 have been filed since the passage of the PSLRA, only 21 have gone to trial and only 15 reached a judgment or verdict.
- Recent statistics gathered by Cornerstone Research reveal lost market capitalization based drops, at the end of the class period, to be around $100 billion annually.
- Losses, measured from the highest stock value in the class period, are about four times greater or about $400 billion.
- NERA Economic Consulting, using their own unique proxy for damages, estimates that the investor losses on all cases filed in 2015 total $183 billion.
- Cornerstone reports that the total value of settlements in 2015 was $3 billion, similar to the annual average of $2.8 billion for the prior five years, but still well below the historically high levels of $20 billion and $8 billion seen in 2006 and 2007.
- In 2009, it took 79 days on average for the first suit to be filed from the time of a disclosure causing the stock to drop, according to Cornerstone. In 2015, the pace quickened to 10 days on average.
- A sample of the 24 lead plaintiff appointments occurring in the first two months of 2016 reveals only 10 institutional investor appointments.
- Cornerstone tells us, that of the 60 or so cases settled annually between 2011 and 2015, institutional investors increased their share of the settlements from 22 to 39 percent.
- In 2015 alone, the median settlement for cases lead by a retail investor was $6.4 million compared to $18 million for cases lead by an institutional investor.

You Can Cram a Pension Into a Suitcase: Pension Forfeiture in Massachusetts After *Bettencourt*

By: Judith A. Corrigan

Following a decision issued in the Superior Court of Massachusetts in February of 2014, I wrote an article for the April 2014 issue of *The NAPPA Report* (Volume 28, Number 1), entitled *Cramming a Pension Into a Suitcase: The Inapplicability of the Eighth Amendment to Pension Forfeitures*. The premise of that article was that the Excessive Fines Clause of the Eighth Amendment to the United States Constitution is not applicable to pension forfeitures, a premise which has now been rejected by the Supreme Judicial Court of Massachusetts ("the SJC"). For what appears to be the first time in the nation, a state's highest court has held that the Eighth Amendment does indeed apply to pension forfeitures, and has halted a pension forfeiture on that basis.

For what appears to be the first time in the nation, a state's highest court has held that the Eighth Amendment does indeed apply to pension forfeitures, and has halted a pension forfeiture on that basis.

Since 1998, many retirement plans have had to grapple with whether the Eighth Amendment would have any applicability to a statutory pension forfeiture, when the Supreme Court of the United States ("SCOTUS") first halted a statutory forfeiture on Eighth Amendment grounds.

The Eighth Amendment to the United States Constitution, which was ratified in 1791, provides that "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." Although the Excessive Bail Clause and the Cruel and Unusual Punishment Clause were much litigated following their ratification, the Excessive Fines Clause was not utilized to halt a particular forfeiture until SCOTUS issued its decision in *United States v. Bajakajian*, 524 U.S. 321 (1998). *Bajakajian* did in fact involve cramming money into a suitcase.

In 1994, Hosep Krikor Bajakajian, his wife, and two daughters, were at Los Angeles International Airport waiting to depart the country, on their way to Cyprus. The Bajakajian family, in checked luggage, wallets, purses and on their person, was attempting to leave the United States with a total of $357,144 in currency. It was then illegal to take over $10,000 in currency out of the country without declaring you were doing so.[1] The penalty for the failure to report was the loss of all of the currency which one was attempting to transport out of the country. SCOTUS halted this forfeiture in reliance on the Excessive Fines Clause, and in so doing announced a three prong test for determining if a fine will be subject to Eighth Amendment protections. As noted in the Massachusetts case of *MacLean v. State Board of Retirement*, 423 Mass. 339, 346 (2000), *Bajakajian* requires "us to consider first, whether there was an extraction of payments, second, whether any extraction was punitive, and third, whether any punitive extraction was excessive."

On April 6, 2016, the SJC issued a determination in the matter of *Bettencourt v. PERAC*, 474 Mass. 60. This decision concluded an eight year legal battle involving six separate courts. Edward Bettencourt ("Bettencourt"), formerly a Police Officer for the City of Peabody, had sought to keep his pension despite convictions which triggered Massachusetts' pension forfeiture statute. The Public Employee Retirement Administration Commission ("PERAC"), the Commonwealth agency charged with regulating and overseeing the 104 separate retirement systems in Massachusetts, had insisted that the Eighth Amendment should not apply to pension forfeitures.

In 2004, Bettencourt, then a Lieutenant in the Peabody Police Department, while acting as Watch Commander, hacked into the Commonwealth's Human Resources Division's website. He created 21 bogus accounts on the website to view the Civil Service examination scores of other police officers, including his competitors for the Captain's exam. He was convicted in 2008 of 21 counts of violating M.G.L. c. 266, Section 120F, *Unauthorized access to [a] computer system*. The judge fined him $500 per count, for an aggregate fine of $10,500, and did not impose any jail time. Bettencourt also lost his job because of his convictions.

Massachusetts General Laws, Chapter 32, Section 15(4) provides that a member may not receive a retirement allowance if he has been convicted of a criminal offense related to his position. The statute does not differentiate between a "misdemeanor" and a "felony." When Bettencourt applied for his superannuation retirement allowance in 2008, the Peabody Retirement Board ("the Board") granted his request, a majority of the Board finding that his crimes were not related to his position. PERAC, reviewing the approval, reversed the Board's decision, concluding that Bettencourt had been convicted of criminal offenses related

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to his position and consequently was not eligible to receive a retirement allowance. Bettencourt sued PERAC in Peabody District Court, arguing both that these crimes were not related to his position and that the forfeiture of his pension would constitute an excessive fine prohibited by the Eighth Amendment.

PERAC prevailed on the issue of whether the crimes were related to Bettencourt's position. When the Appeals Court made that determination in 2012, it returned the case to the Peabody District Court on the sole issue of whether the forfeiture of Bettencourt's pension constituted an excessive fine under the Eighth Amendment. After the Superior Court found in favor of PERAC in February of 2014 on the Eighth Amendment issue, Bettencourt appealed to the Massachusetts Appeals Court, and the SJC brought the case up on its own initiative.

Previously, in three cases, Massachusetts appellate courts had rendered decisions in pension forfeiture matters by "assuming, without deciding," that the Eighth Amendment would apply to a pension forfeiture. The analysis had been limited to the third prong of *Bajakajian*, which concerns whether the forfeiture in question would be grossly disproportional to the crime committed.[2]

Previously, in three cases, Massachusetts appellate courts had rendered decisions in pension forfeiture matters by "assuming, without deciding," that the Eighth Amendment would apply to a pension forfeiture.

PERAC made two distinct arguments to the SJC about why pension forfeitures should fail as "statutory fines" at the first prong of *Bajakajian*. First, bolstered by cases from other jurisdictions,[3] PERAC argued that Bettencourt had only a future interest in a retirement allowance, an interest that was contingent on him not being convicted of a crime related to his position. The SJC rejected this argument, finding "a public employee who is a member of a retirement system holds an interest in retirement benefits that originates in a 'contract' and in substance amounts to a property right." *Bettencourt*, at 67. The SJC further found:

> If an employee has a protected contract right and, derivatively, a property interest in retirement benefits, the fact that the benefits may be subject to forfeiture on account of misconduct does not change the fundamental character of the contract right or property interest. Rather, it simply means that the employee will lose his or her right and interest as a result of the misconduct. *Bettencourt*, at 69.

PERAC next argued that there was no "extraction" because there was nothing to extract. Bettencourt was merely precluded from receiving *future* payments. This was not a payment to the sovereign of money already possessed by the member. The SJC disagreed:

> … We disagree with PERAC that the phrase "extract payments ... in cash or in kind," as used by the Supreme Court in *Austin*, 509 U.S. at 609–610, 113 S.Ct. 2801, and *Bajakajian*, 524 U.S. at 328, 118 S.Ct. 2028, means that there literally must be a physical transfer of tangible property from the individual to the State; "property" exists in tangible and intangible form. *Id.*, at 69.

The SJC also determined that a pension forfeiture under M.G.L. c. 32, § 15(4) constitutes punishment, thus satisfying *Bajakajian's* second prong. The forfeiture happens following a conviction "and it cannot be imposed on an employee who is not convicted of committing such an offense." *Id.*, at 71. Further, SCOTUS has "made clear that unless the sanction at issue – here, forfeiture – can be said to serve "solely" a remedial purpose, it qualifies as punishment." *Id.*, at 71. (Emphasis in original). PERAC had argued, based on the *MacLean* case, that the mandatory forfeiture would serve remedial, non-punitive purposes.

Finally, the SJC decided the amount of the forfeiture[4] [5]was grossly disproportional to the gravity of Bettencourt's criminal offenses. As noted in *Bajakajian*, "The touchstone of the constitutional inquiry under the Excessive Fines Clause is the principle of proportionality: The amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish." *Bajakajian*, 524 U.S. at 334.

The SJC decided this third and final prong of the analysis based upon principles first outlined in *Bajakajian*. The SJC considered "the nature and circumstances of his offenses, whether they were related to any other illegal activities, the aggregate maximum sentence that could have been imposed, and the harm resulting from them." *Bettencourt*, at 72. The SJC found that there was no evidence Bettencourt had benefited from his crimes, that they

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appeared to be unrelated to any other criminal enterprise, and there had been no harm to the public fisc. The Court also found that the maximum sentence which could have been imposed indicated that the Legislature did not "view this crime as a grave, serious offense." *Id.,* at 73.

The SJC then turned its attention to the "appropriate remedy." As Massachusetts law contains no provision for a partial forfeiture, the SJC ruled that Bettencourt would keep his entire pension, and invited the Legislature to act in the wake of its decision.

Whatever recommendations will be made, it is apparent that the Bettencourt decision is already impacting the Massachusetts public pension community.

In response, the Massachusetts Legislature has enacted legislation. Chapter 133 of the Acts of 2016 was signed into law by Governor Charlie Baker on July 8, 2016. Section 151 of the Act provides in pertinent part as follows:

> There shall be a special commission on pension forfeiture to review the decision of the Supreme Judicial Court in Public Employee Retirement Administration Commission v. Edward A. Bettencourt, 474 Mass. 60 (2016)…. The special commission shall make recommendations, including proposed amendments to section 15 of chapter 32 of the General Laws. The special commission shall file its recommendations, including any proposed legislation, with the clerks of the senate and house of representatives not later than March 1, 2017.

Whatever recommendations will be made, it is apparent that the *Bettencourt* decision is already impacting the Massachusetts public pension community. The Contributory Retirement Appeal Board ("CRAB"), recently issued a determination in a case involving a termination retirement allowance under M.G.L. c. 32, §§ 10(1) and 10(2). The allowances provided for in these two subsections will be lost if a member is found to have acted "with moral turpitude" but do <u>not</u> require as a prerequisite the conviction of a crime prior to forfeiture. This case involved a harbormaster who had housed his boat rent free for a certain period of time, which a magistrate of the Division of Administrative Law Appeals ("DALA") found constituted "moral turpitude" and deprived him of his right to a pension. CRAB reversed this finding on jurisdictional grounds, but then went on to discuss *Bettencourt*:

> Moreover, in light of the recent decision in Bettencourt, 474 Mass. at 74, in which a pension forfeiture under G.L. c. 32, § 15(4) was held unconstitutional under the Excessive Fines Clause of the Eighth Amendment, the forfeiture of a superannuation allowance under § 10(1) could implicate constitutional questions that we may not reach, and that the Legislature is likely to be considering. [footnote omitted]. *Barnstable County Retirement Board v. PERAC*, CR-12-572 (7/25/16).

If analogies to *Bettencourt* are to be made in regards to situations where a conviction has not occurred, another area where such an analogy may possibly arise is in a situation where a retiree with statutory earnings limits has excess earnings following his or her retirement, and may owe an amount to a retirement board which is "grossly disproportional" to the amount of retirement allowance he or she has received from the retirement board.[6]

Unless and until the Legislature amends M.G.L. c. 32, § 15, how future pension forfeiture cases in Massachusetts will unfold seems clear. In the past such battles were usually fought in regard to whether a member's crime was related to his or her position, but it is now inevitable that all such cases will proceed under both that argument, and the argument that the forfeiture violates the Eighth Amendment.

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ENDNOTES

1. Changes in the law have made the smuggling of mass amounts of currency out of the country more than a mere reporting crime.
2. *MacLean v. State Board of Retirement*, 423 Mass. 339, 346 (2000), *Maher v. Retirement Board of Quincy*, 452 Mass. 517, 522 (2008), and *Flaherty v. Justices of the Haverhill Division of the District Court*, 83 Mass. App. Ct. 120, 123 (2013).
3. See, *Hopkins v. Oklahoma Pub. Employees Retirement Sys.*, 150 F.3d 1155, 1162 (10th Cir. 1998). *Hames v. Miami*, 479 F. Supp. 2d. 1276, 1288 (S.D. Fla. 2007) (11th Cir. 2008) and *Scarantino v. Public School Employees Retirement Board*, 68 A.3d 375, 385, (Pa. Commw. Ct. 2013).
4. The amount of pension to be forfeited in this case was $659,000, plus an undetermined amount of health insurance payments.
5. Now that public employees in Massachusetts who commit crimes related to their office or position will not necessarily be forfeiting their pensions, a focus on the <u>amount</u> of the forfeiture raises the possibility that those whose pensions are smaller will be more likely to forfeit their pensions than those whose pensions are larger.
6. See, M.G.L. c. 32, § 91.

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Public Pension Plans Under the New Partnership Audit Rules

By: Karen Grenon, Yuliya Oryol, Douglas Schwartz, and Robert Scott

Until now, public pension plans did not need to worry about their fund documents' audit provisions. The reason is that, under the Tax Equity and Fiscal Responsibility Act of 1982 ("**TEFRA**"),[1] the fund controls the audit but its *investors* pay back taxes and interest (and any penalties) based on their pass-through shares of the fund's income and other tax attributes. Public pension plans, being tax-exempt under Internal Revenue Code ("**IRC**") sections 501 and 115, are largely indifferent to an adverse audit.

Public pension plans must now scrutinize and negotiate fund documents (and amendments to existing fund documents) to protect their investment returns from the financial consequences of an adverse audit.

Everything changed on November 2, 2015, when President Obama signed the Bipartisan Budget Agreement of 2015 ("**BBA**"),[2] which radically revamped the IRC's partnership audit rules.[3] The BBA did not change the exempt status of public pension plan investors, but it can make them indirectly responsible for an adverse audit because the *fund* may now pay back taxes, interest and penalties. Public pension plans must now scrutinize and negotiate fund documents (and amendments to existing fund documents) to protect their investment returns from the financial consequences of an adverse audit.

BACKGROUND OF TEFRA

Congress passed TEFRA in 1982 to require that most partnership returns, for years beginning after September 3, 1982, become subject to unified partnership audit and litigation procedures. This unified system is embodied in current IRC sections 6221 through 6234. Before TEFRA, there were no consistent procedures for treating partnership items at the entity level. The IRS had to separately audit each partner (while heeding each partner's statute of limitations), and calculate that partner's adjustment. The settlements by or decisions against one partner could not bind other partners. "TEFRA procedures were designed to streamline examinations of partnerships by requiring that partnership issues be handled in a single, unified partnership-level proceeding instead of multiple proceedings at the partner level."[4]

The TEFRA audit rules applied to partnerships with more than 10 partners and mandated tax treatment of partnership items at the entity level. "Large" partnerships, with 100 or more partners, could elect simplified audit procedures. Under TEFRA, a partner was generally required on such partner's individual or corporate return to treat all "partnership items" consistently with their treatment on the partnership returns as reported on the partner's K-1 schedule, unless the partner notified the IRS of the inconsistency.[5] The IRS would then coordinate an audit of the partnership through the partnership's Tax Matters Partner ("**TMP,**" which had to be a partner, and not an accountant or financial advisor) and proceed to assess each audited-year partner based on a partner's share of any adjustment.

WHY CONGRESS SWITCHED FROM TEFRA TO BBA

The IRS had difficulty auditing partnerships, even with TEFRA, largely because of the increase in the number of partnerships and the complexity of the organization of partnerships.[6] As to the latter factor and according to the Government Accountability Office, the IRS had found it difficult to identify the correct TMP in a given partnership.[7] The general partner in limited liability partnerships typically serves as the TMP. However, a partnership under TEFRA is not required to designate a TMP. As a result, the IRS could spend months requesting that a partnership identify the TMP and, absent identification, proceed to designate a TMP to complete the audit. The IRS also encountered difficulties trying to collect taxes, penalties and interest from each partner after it had concluded the partnership audit.[8]

As a result, the IRS was not auditing as many partnerships as it was auditing corporations. The IRS examined approximately 0.5% of partnerships but three times as many "C" corporations,[9] and the audit rate for large partnerships was only about 1%, when compared to 30% for large corporations.[10] The IRS also made fewer adjustments to partnership income. In 2012, the no-change rate for partnership audits was 42% -- over three times the no-change rate for corporations.[11]

THE NEW BBA RULES

The BBA repeals the TEFRA and electing large partnership audit rules effective for years beginning after 2017.[12] Among other changes, the BBA:

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- replaces the TMP with a "partnership representative" who still controls the audit but need not be a partner;[13] and
- sharply reduces partners' rights to monitor and affect the course of the audit (instead, partners will need to negotiate these rights in the fund documents).[14]

The BBA's most significant change is that the partnership – not its partners – pays back taxes, interest and penalties unless the partnership elects to pass on these financial burdens to the partners.[15] "According to the Congressional Budget Office, the partnership audit and adjustment provisions will increase federal receipts by approximately $9 billion over 10 years as a result of improved tax compliance and the use of a streamlined process for auditing complex partnerships."[16] The BBA leaves many open issues and Congress has given the IRS the task of resolving these.[17]

The BBA's most significant change is that the partnership – not its partners – pays back taxes, interest and penalties unless the partnership elects to pass on these financial burdens to the partners.

Default Rule: Partnership Pays

Under the default rule, adjustments to partnership items are determined at the partnership level and the partnership pays any tax (and interest and penalties) resulting from such adjustment.[18] Thus a partnership, otherwise a flow-through entity for tax purposes, effectively becomes a taxable entity like a corporation.

The IRS under the new audit rules examines a partnership's income and other tax items and the partners' distributive shares for the year being audited (the "**reviewed year**"), and the partnership takes into account any assessment in the "**adjustment year**" (*i.e.*, the year that the final determination is made).[19] This approach creates potential inequity between partners that received the economic benefit or detriment from the partnership items for the reviewed year, and the partners in the adjustment year who are indirectly responsible for any additional tax liabilities from the assessment.

The new audit rules require the partnership to pay, in the adjustment year, any "**imputed underpayment**" with respect to any assessment. An "imputed underpayment" generally is determined by netting all adjustments and multiplying such net amount by the highest rate of tax in effect for the year under review.[20]

The new audit rules do consider certain partner-level tax consequences, such as a partner's tax-exempt status and lower effective tax rates for "C" corporations. Therefore, for example, a partnership (under rules to be promulgated by the IRS) can demonstrate to the IRS that a portion of an adjustment is allocable to a tax-exempt partner, potentially resulting in a decrease of an imputed underpayment.[21] However, the new audit rules do not provide any relief for a tax-exempt partner whose return might be reduced if the partnership pays the imputed underpayment as so reduced. Such an investor instead will need to negotiate relief provisions as part of the fund documents or a side letter.

Alternative Procedure: Partners Pay

Instead of the default rules, a partnership can elect to pass the adjustment through to its partners for the reviewed year within 45 days after a notice of final partnership adjustment (the "**alternative procedure**").[22] Under the alternative procedure, the partnership issues adjusted Schedule K-1s for the reviewed year, and partners must reflect the adjustment on their own returns in the adjustment year. All related interest, penalties, additions to tax and additional amounts are imposed at the partner level. There is a cost to taxable partners for electing this procedure, however. The interest rate is increased by 200 basis points over what it would otherwise have been under the default rules, and the potential tax rates and overall adjustments can be higher for other reasons as well.

WHAT TO DO?

Public pension plans and other institutional investors need to prepare now for the impact of these new rules on new and existing funds, and in particular to ensure that fund documents reduce or eliminate any partnership-level tax liability.

General Considerations

For new funds, public pension plan investors should consider, as their first option, requiring that the fund *always* elects the alternative procedure in order to shift responsibility for taxes, interest and penalties to the partners. Doing so accomplishes two goals: *first*, ensuring that persons who were not partners in the reviewed year are not adversely affected by assessments for the adjustment year; and *second*, ensuring that a public pension plan

Public Pension Plans Under the New Partnership Audit Rules *(continued)*

investor cannot be adversely affected by the partnership's payment of an imputed underpayment attributable to taxable partners. It has been the authors' experience that fund managers are resisting any provision requiring them to elect the alternative procedure in all circumstances, and prefer to elect the alternative procedure on a case-by-case basis, perhaps because of the greater tax hit to taxable partners under the alternative procedure.

Public pension plans and other institutional investors need to prepare now for the impact of these new rules on new and existing funds, and in particular to ensure that fund documents reduce or eliminate any partnership-level tax liability.

If the fund does not agree (as is likely) to an "all events" alternative procedure election, a public pension plan investor must mitigate the partnership's imputed underpayment so that the financial burdens are shifted to taxable investors as much as possible. For example, the fund can offset the payment against future distributions to taxable partners; obtain further capital contributions from taxable partners toward the imputed underpayment; claw back prior distributions to taxable partners; or obtain indemnities from taxable partners. It has been the authors' experience that fund managers are amenable to these provisions but are binding themselves to only "reasonable" efforts to protect tax-exempt investors. Public pension plan investors will probably need to accept these provisions because no protection is bulletproof (an indemnity, for example, is only as good as the partnership's ability to collect the same). The only bulletproof protection is an "all events" alternative procedure election.

A public pension plan investor will also want to be able to monitor the course of an audit because an audit can now indirectly affect such plan's returns. TEFRA provided these protections as a matter of statute but the BBA does not. Fund documents should require the partnership representative to give partners notice of an audit, and regular reports on the audit's progress and how the fund plans to address an adverse result (for example, appeal; pay the imputed underpayment at the partnership level; or elect the alternative procedure). Public pension plan investors also should be sure that, in the case of a fund that invests in other funds, the upper-tier fund makes similar demands on lower-tier funds and there are procedures for reducing and allocating tax liability in such multi-tier structures (including the application of adjustments from lowest-tier partnerships to ultimate partners).

Additional Considerations for Existing Funds

Similar considerations apply for existing funds but there are additional ones. The real challenge for public pension plan investors will be to ensure that existing funds amend their fund documents. Public pension plan investors who are members of a Limited Partner Advisory Committee ("**LPAC**") should bring this issue to the attention of the LPAC; in other cases, investors should contact the general partner or fund counsel. The authors expect that most funds are well-advised and will decide without prompting to amend fund documents so that the fund at least has the ability to elect the alternative procedure rather than revert to the default rule, and also can take steps to protect tax-exempt investors from the financial burden of an entity-level payment. However, public pension plan investors cannot so assume.

Amending fund documents in this manner will be especially important for open-ended funds because investors change over time, and for funds that provide a lock-up period such as hedge funds. Newly-entering investors should always ask for an indemnity against such costs as may arise from an imputed underpayment. Further, in an open- or close-ended fund, the fund documents should provide that if an investor exits a fund for whatever reason, the general partner or fund manager holds back a percentage of the exiting investors' distributions to cover any potential tax liability and that the existing investors indemnify the remaining investors and the fund in connection with any tax liability resulting from or arising after the exit.

CONCLUSION

In revamping the partnership audit rules, the BBA has suddenly made audits of direct concern to tax-exempt public pension plan investors. All investors need to now scrutinize existing fund documents and be mindful when negotiating new fund documents in order to prepare for the new landscape starting in 2018.

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Public Pension Plans Under the New Partnership Audit Rules *(continued)*

ENDNOTES

[1] Pub. L. No. 97-248.

[2] Pub. L. No. 114-74, 129 Stat. 584.

[3] All section references are to the IRC unless otherwise indicated. For US tax purposes, the term "**partnership**" includes a Limited Liability Company ("**LLC**") and the audit regimes we discuss (both TEFRA and BBA) pertain to LLCs as well as partnerships in the non-tax sense.

[4] Publication 541-Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), *available at* **http://taxmap.ntis.gov/taxmap/archive2014/taxmap/pubs/p541-008.htm.** An example of a partnership matter that must be litigated in a partnership-level proceedings is whether a Notice of Final Partnership Administrative Adjustment ("FPAA") was issued by the IRS within the three-year statute of limitations. 4B Tax-Advantaged Securities §23:77, *Tax-Advantaged Securities*, August 2016 Update, Robert J. Haft and Peter M. Fass, p.4.

[5] 4B Tax-Advantaged Securities §23:77, *Tax-Advantaged Securities*, August 2016 Update, Robert J. Haft and Peter M. Fass, p. 4.

[6] Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015, New York State Bar Association Tax Section, May 25, 2016, Section III A, p. 17.

[7] *Id.*

[8] New Partnership Audit Rules: Concepts and Issues, Part 1, By Christian Brause, Tax Notes, May 2, 2016.

[9] 2 Tax Advantaged Securities §11:7, Tax-Advantaged Securities, June 2016 Update, Robert J. Haft and Peter M. Fass, p. 1.

[10] The Impact of the New Partnership Audit Rules On Hedge Funds and Private Equity Funds, dated Dec. 1, 2015, *available at* **http://www.kkwc.com/publications/the-impact-of-the-new-partnership-audit-rules-on-hedge-funds-and-private-equity-funds/**.

[11] 2 Tax Advantaged Securities §11:7, *Tax-Advantaged Securities*, June 2016 Update, Robert J. Haft and Peter M. Fass, p. 1.

[12] BBA § 1101(g)(1). A partnership may elect to have the BBA procedures apply earlier, *see* BBA § 1101(g)(4), and the IRS has issued temporary regulations on how to do so. T.D. 9780 (*available at* **http://federalregister.gov/a/2016-18638**). The authors are not aware of any new or existing fund that has made this election or announced an intention to do so.

[13] IRC § 6223(a) (as enacted by BBA § 1101(c)(1)).

[14] *See generally* IRC §§ 6223(b), 6231, 6234 (as enacted by BBA § 1101(c)(1)).

[15] Certain "small" partnerships can elect entirely out of the BBA audit rules, as a result of which election the IRS would audit on a partner-by-partner basis. However, no fund with a public pension plan investor could ever be eligible for this election. *See* IRC § 6221(b) (enacted by BBA § 1101(c)(1)).

[16] 2 Tax Advantaged Securities §11:7, Tax-Advantaged Securities, June 2016 Update, Robert J. Haft and Peter M. Fass, p. 1.

[17] The IRS has issued Notice 2016-23 (*available at* **https://www.irs.gov/pub/irs-drop/n-16-23.pdf**) requesting comments.

[18] IRC § 6221(a) (enacted by BBA § 1101(c)(1)).

[19] IRC § 6225(d) (enacted by BBA § 1101(c)(1)).

[20] IRC § 6225(a), (b) (enacted by BBA § 1101(c)(1)). If an adjustment involves a reallocation of distributive shares of a partnership item from one partner to another, the IRS will not net the adjustments (which would result in a net adjustment of zero), but instead will take into account only increases to income or gain and decreases to deduction, loss or credit. For example, if the partnership allocates $10 of income to partner A in the year under review, and the IRS later determines that partner B should have been allocated such $10, the imputed underpayment only will include income of $10 to partner B in the adjustment year. Thus, even though partner A may have paid taxes on the $10 of income in the year under review, the partnership will have to pay taxes on the same $10 of income in the adjustment year.

[21] IRC § 6225(c)(3), (4) (enacted by BBA § 1101(c)(1)).

[22] IRC § 6226 (enacted by BBA § 1101(c)(1)). Electing the "alternative procedure" is not the same as electing entirely out of the new BBA audit rules, *see* note 12 *supra*. "Electing out" is not available to any fund with a public pension plan investor, but electing the alternative procedures always is.

The Changing Landscape for Governmental Plans – Recent Developments From the IRS

By: Mary Beth Braitman and Robert L. Gauss[1]

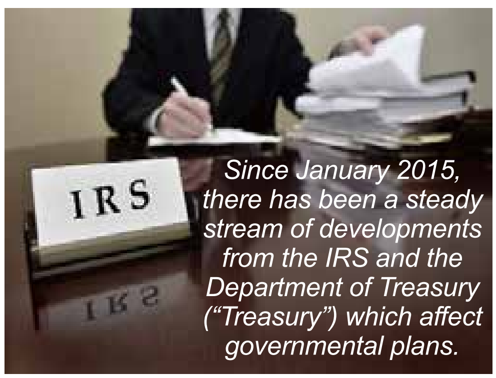
Despite the pressure on its resources, the IRS has been busy. Since January 2015, there has been a steady stream of developments from the IRS and the Department of Treasury ("Treasury") which affect governmental plans.

Definition of Governmental Plan and Pick-up Rulings

It started with Notice 2015-07 and the proposed regulations related to whether a State or local retirement system which covers employees of a charter school is a governmental plan within the meaning of Internal Revenue Code ("Code") § 414(d).[2] Next were a series of private letter rulings related to pick-ups under Code § 414(h) and the further development of what constitutes an impermissible cash or deferred arrangement under Revenue Procedure 2006-43.[3]

Determination Letter Program Shut Down

Significantly, changes to the determination letter program, including the elimination of the staggered five-year remedial amendment cycle for individually designed plans (most governmental defined benefit plans are individually designed plans), started with Announcement 2015-16 and have continued with a steady stream of developments. Based upon Revenue Procedure 2016-37 and Announcement 2016-32, developments will continue as the IRS recently requested the submission of comments regarding ways to improve plan qualification compliance in light of the significant changes (comments are due on or before December 15, 2016). As part of these developments, governmental plans should consider Revenue Procedure 2016-6 which provided that, in part, effective as of January 4, 2016, **determination letters issued to sponsors of individually designed plans would no longer contain an expiration date**. Additionally, governmental plans should consider Notice 2016-3 which announced, in part, that **expiration dates on determination letters issued prior to January 4, 2016 no longer would be operative**.



Since January 2015, there has been a steady stream of developments from the IRS and the Department of Treasury ("Treasury") which affect governmental plans.

Given the issuance of determination letters which dated back to Cycles C-1 and E-1, as well as developments on private letter rulings which had been pending for a number of years, governmental plans and practitioners reasonably could conclude that the IRS was busy in 2015 addressing pending projects.

2016's Developments (So Far)

2016 started with the issuance of a Notice of Proposed Rulemaking on January 27, 2016, regarding the applicability of the normal retirement age regulations to governmental plans and the establishment of certain safe harbors by which the normal retirement age under a governmental plan would satisfy the requirements of Code § 401(a) (a project which had started with the IRS' issuance of final regulations defining normal retirement age in 2007).[4]

409A and 457 Proposed Regulations

One project which has been pending for several years, and for which developments were long awaited, is the proposed regulations related to Code §§ 409A and 457 regarding deferred compensation plans. On June 21, 2016, the IRS released proposed regulations regarding deferred compensation plans of state and local governmental and tax-exempt entities. For purposes of these proposed regulations, it is important to recall that Code § 457 allows state and local governments and tax-exempt organizations to offer eligible deferred compensation plans under which an employee may defer compensation on a pre-tax basis subject to specific limits (for 2016 the limit is $18,000 or 100% of the participant's includable compensation). As part of Code § 457, § 457(f) establishes the tax treatment of deferred compensation under plans or arrangements which are not "eligible" deferred compensation plans; plans/arrangements under Code § 457(f) are referred to as "ineligible" plans. Significant to whether an agreement or an arrangement constitutes a plan for purposes of Code § 457(f) is whether the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the future performance of substantial services by any individual. Certain employment retention plans are specifically identified in Code § 457(f). By contrast, Code § 409A establishes rules relating to constructive receipt of income and the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.

Within this context, the proposed regulations make certain changes to the final regulations under Code § 457 which were

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issued in 2003. In particular, the proposed regulations address developments arising from statutory changes under the Pension Protection Act of 2006 ("PPA"), the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART"), the Small Business Jobs Act of 2010 ("SBJA") and the American Taxpayer Relief Act of 2012. In essence, the proposed regulations reconcile developments from those acts with the current regulations under Code § 457. As importantly, the proposed regulations reconcile the interaction of the rules under Code § 457(f) and Code §409A regarding when compensation is subject to a substantial risk of forfeiture.

Significantly, the proposed regulations seek to:

- Make regulatory amendments to reflect statutory changes to Code § 457 with regard to a qualified Roth contribution program; to address Code § 402(l) and update the rules for the taxation of certain distributions from governmental plans for qualified accident and health insurance on behalf of eligible public safety officers; and to implement the requirements under the HEART Act and establish rules for 457 plans related to treating leave for certain military service as a severance from employment for purposes of the plan distribution requirements.
- Amend the definition of a plan for purposes of Code § 457 by revising and reorganizing the regulatory provisions which identify plans that are not subject to Code § 457 and plans that are treated as not providing for a deferral of compensation for purposes of Code § 457. In this regard, the proposed regulations provide additional guidance on the following issues which are treated as not providing for a deferral of compensation for purposes of Code § 457: bona fide sick or vacation leave, compensatory time, severance pay, disability pay, and death benefit plans, and plans paying solely length of service awards to bona fide volunteers or their beneficiaries. The proposed regulations also provide guidance on plans described in Code § 457(f)(2), which are exempt from the requirements under Code § 457(f)(1).
- Provide specific rules on the tax treatment of amounts deferred under Code § 457(f).
- Provide general rules for how to determine the present value of compensation deferred under an ineligible plan and specific rules for how to determine the present value of compensation deferred under ineligible plans that are account balance plans – such rules are similar to those in the proposed 409A regulations, and accordingly, include cross references to the proposed 409A regulations, including rules on how to determine present value under certain specific types of plans (e.g., reimbursement and in-kind benefit arrangements and split-dollar life insurance arrangements), and rules with regard to the treatment of payment restrictions and alternative times and forms of a future payment.
- Set forth rules for how to determine the present value of compensation deferred under ineligible plans that are not account balance plans, including reasonable actuarial assumptions, treatment of severance from employment, treatment of payments based on formula amounts, and unreasonable actuarial assumptions.
- Provide loss deductions rules – such rules are similar to those in the proposed 409A regulations.
- Provides a definition for deferral of compensation for the purpose to determine if Code § 457(f) applies to an arrangement because it provides for a deferral of compensation – specifically addressing short-term deferrals and recurring part-year compensation.
- Provide rules with regard to the conditions which constitute a substantial risk of forfeiture for purposes of Code § 457(f).

Comments were due by September 20, 2016. Anyone interested in these proposed regulations should watch for future developments.

Potential Future Developments

Based upon the 2016-2017 Priority Guidance Plan (released on August 15, 2016) for Treasury and the IRS, governmental plans should watch for developments involving the following identified projects:

- Possible regulations on exceptions to the early distribution tax penalty under Code § 72(t).
- Final regulations on the application of the normal retirement age regulations to governmental plans.
- Additional guidance on the determination letter program.
- Regulations under Code § 401(a)(9) on the use of lump sum payments to replace lifetime income being received by retirees under defined benefit pension plans (also known as "de-risking").

The Changing Landscape for Governmental Plans – Recent Developments From the IRS *(continued)*

- Regulations on the definition of governmental plan under Code § 414(d), including regulations on the status of Indian tribal government plans as governmental plans.
- Regulations on qualified excess benefit arrangements under Code § 415(m).
- A revenue procedure modifying the employee plans compliance resolution system ("EPCRS") under Rev. Proc. 2003-12 to provide guidance with regard to certain corrections (the IRS released updates to EPCRS as this article was going to press; see Rev. Proc. 2016-51).
- Final regulations under Code § 409A and Code § 457(f).

Conclusion

Given all of the recent and anticipated regulatory developments which are affecting governmental plans, plan executive officers and general counsel should make sure they are staying abreast of the landscape as it continues to shift.

Given all of the recent and anticipated regulatory developments which are affecting governmental plans, plan executive officers and general counsel should make sure they are staying abreast of the landscape as it continues to shift.

ENDNOTES

[1] The authors would like to thank one of our paralegals, Greg Wolf, for his assistance with this article and for helping us to keep track of regulatory developments throughout the year.

[2] For a detailed discussion of this development, *see* Treasury-IRS Regulatory Project Definition of Governmental Plan by Anthony J. Roda, *The NAPPA Report*, Vol. 29, No. 1 (April 2015).

[3] *See, e.g.*, PLR 201540014, PLR 201532036 and PLR 201529009.

[4] For a detailed discussion of this development, *see* Proposed Regulations on Normal Retirement Age by Anthony J. Roda, *The NAPPA Report*, Vol. 30, No. 1 (April 2016).

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Investing in Private Equity, Perception Versus Reality

By: Jennifer J. Yamane and Brian J. Bartow

Private equity is an important and increasingly controversial component of institutional investing. From the institutional investor perspective, the private equity market is desirable not only because of historically high rates of return, but also because of its role in portfolio diversity and as part of a strategy to address the risk of market volatility. In general, it makes sense for institutional investors to utilize private equity investments. The long-term investment horizon structure can be properly aligned with the long-term nature of institutional investor's (such as pension funds) liabilities, notwithstanding the potential need for liquidity, which requires diversity in other asset classes.

From the institutional investor perspective, the private equity market is desirable not only because of historically high rates of return, but also because of its role in portfolio diversity and as part of a strategy to address the risk of market volatility.

However, despite the relatively high-yield and diversification factors, there is still a strong negative connotation associated with investing in private equity. Over the past few years, there have been repeated regulatory actions against general partners and a steady stream of negative media coverage concerning the general partner compensation structures and overall opaqueness of the private equity industry. In addition, media reports often accuse or imply that institutional investors are not sophisticated enough for private equity investments, or criticize the institutional investors for agreeing to excessive fee compensation and of being unaware of other questionable general partner practices. Institutional investors who may have made prudent investments as limited partners can, and do, get caught in the media's crosshair for failing to seek greater public transparency of the private equity industry in general.

In the face of this criticism of institutional investors in private equity investments, it nevertheless appears that many of the issues raised are inherent in the industry, and not specific to institutional investors, who by and large, are sophisticated professional investors. Such issues include the perception of excessive compensation in both management and incentive fees (the "2 and 20" model), lack of transparency especially in contrast to the public markets, misuse of fund assets, failure to have proper oversight of employees and fund assets, and failure to properly disclose fees (either inadequate disclosure or resulting from potentially ambiguous provisions in the limited partnership agreements), among other topics. Of course, risk is a factor common to any investment strategy, but the relative lack of transparency magnifies those risks and unfortunately, private equity remains fraught with certain perils that continue to cause concern to investors and members of the public.

Yet, despite all the media coverage focused on negative issues associated with the industry, there has been little to nothing addressing what general partners are doing correctly, much less the steps institutional investors have taken and the progress made to obtain more favorable terms for limited partners and increased transparency into general partner fees, expenses and other accounting information. Many institutional investors seek to address the risks and concerns prevalent in the industry by negotiating side letters to ensure more detailed reporting and/or clarify certain terms in the limited partnership agreements. However, rather than providing precision and efficiency, it appears that the complexity of side letters, particularly when combined with most favored nation provisions, creates additional encumbrances for investors and general partners alike, and ultimately results in additional opaqueness.

Sophisticated investors acknowledge there are no readily available solutions to these matters that can be generally applied to the limited partner investment community as a whole (although continuing efforts are ongoing through organizations such as the Institutional Limited Partners Association). Therefore, it is important to oversee and enforce those matters that are within the institutional investor's ability and control. This includes continuous monitoring of not only the performance of the private equity funds, but also the general partners' compliance with the fund documents. To the extent that the fund documents provide some protection and disclosure to limited partners that may counteract the potential risks discussed above, it is worthwhile for investors to review the partnerships for internal compliance, which was the focus of a recent CalSTRS project, discussed in greater detail below.

Internal compliance, for purposes of this article, refers to monitoring general partners for compliance with the terms contained in fund documents, such as limited partnership

Investing in Private Equity, Perception Versus Reality *(continued)*

agreements and side letters. Important matters are addressed in these documents that can, and do, provide some amount of disclosure, protection and assurance to limited partners. This includes holding the general partners accountable for properly reporting compensation structures, fund expenses, and fund returns. It is also worth remembering that private equity investments are long-term partnerships, so continuous monitoring and review of partnerships is warranted.

Internal compliance, for purposes of this article, refers to monitoring general partners for compliance with the terms contained in fund documents, such as limited partnership agreements and side letters.

CalSTRS took the initiative to review several of its existing private equity partnerships for the purpose of determining internal compliance with fund documents, as well as obtaining a more detailed understanding of the general partners' policies and procedures. Given the complicated and confidential nature of the documents to be reviewed, CalSTRS retained the law firm, Jackson Walker. CalSTRS and Jackson Walker worked with a specialized consulting firm, to assist in conducting the review project. The total review project took approximately five months to complete, and included a multi-step review process involving questionnaires to the general partners, on-site office visits to review documents identified in the questionnaire, and detailed follow-up conversations to clarify and explain relevant documents, policies and procedures.

The scope of the questionnaire and review was designed to delve into the general partners' compliance with crucial clauses in the limited partnership agreements and side letters, including management fee calculations, portfolio company transactions, distributions, financial reporting process, partnership expenses, and advisory committee matters. Questions concerning SEC examinations, valuation processes, and cross-fund investments were also included, but the primary focus was compliance with the limited partnership agreements and side letters. To be clear, this review was not an audit, nor was it intended to confirm that the general partners were in compliance with federal securities laws and/or SEC rules and regulations. Ultimately, the endeavor provided evidence that those general partners reviewed were substantially compliant with the limited partnership agreements and side letters, and that the general partners' internal control and compliance policies and practices did not appear to have any material weaknesses.

Although the review project undertaken by CalSTRS did not fully settle the common concerns arising from the private equity industry, it did provide some level of assurance that certain general partners are complying with the terms and conditions agreed upon with limited partners. CalSTRS, having found some value and reassurance from the endeavor, will likely continue this type of internal compliance review in the future with other private equity partnerships. CalSTRS is also considering expanding this type of internal compliance review with partnerships in other asset classes, such as real estate and infrastructure.

It is important to note that since the inception of its private equity program, CalSTRS earned an average return of 13.11%. Given the positive historical performance and return on investment enjoyed by CalSTRS and other institutional investors, private equity will likely continue to be an overall worthwhile investment strategy. Thus, it is consistent with the long-term view of institutional investors to continue efforts to improve the quality of information provided to limited partners, while preserving the competitive advantage of the business model.

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Brian Bartow *is General Counsel for the California State Teachers' Retirement System.*

CALSTRS

CalSTRS took the initiative to review several of its existing private equity partnerships for the purpose of determining internal compliance with fund documents, as well as obtaining a more detailed understanding of the general partners' policies and procedures.

If Bankers Were Better, Could We Have Better Banks?

By: Catherine E. LaMarr

The vast majority of public pension funds have exposure to the financial sector through passive investments in index products and strategies. As such these investors own, directly or indirectly, shares of multinational financial institutions. Despite the reforms arising from Dodd-Frank and foreign regulatory efforts, irresponsible (if not fraudulent) acts from banks continue to plague the pages of our newspapers and websites.

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University of Minnesota Law School professors Claire A. Hill and Richard W. Painter present an enlightened approach to incentivizing responsible banker behavior in *Better Bankers, Better Banks*.[1] In their book, Professors Hill and Painter discuss the development of a culture of bad behavior with bankers engaged in increasing, if not excessive, risk taking, leading to the global financial meltdown. With strong personal incentives for highly compensated bankers to pursue profits substantially greater than any penalties imposed and indemnification or other protection against personal liability, little or nothing causes bankers to pause and weigh potential peril arising from their actions. When penalties, fines, settlements or legal expenses occur, they are paid from shareholder value.

Bankers, especially those at large, well-capitalized institutions, know that the resources of the bank are available to avoid personal liability. Professors Hill and Painter seek to require all highly compensated bankers to take personal responsibility for that which occurs on their watch. Covenant Banking – by contract or set forth in bank bylaws – would require all highly compensated bankers to contribute toward restitution, regulatory fines, civil judgments or settlements, penalties and legal expenses involving fraud. The thinking here is simple, if a banker must contribute to the costs of fraud occurring on his or her watch, he might actually be watching.

In *Better Bankers, Better Banks*, Professors Hill and Painter describe the economic, political, sociological and technical developments leading to the evolution of the banking industry. Professors Hill and Painter lead the reader from changes to the business model of investment banking, scaled up securities markets and limiting liability to the altered business goals of bankers, thus fundamentally changing bankers' relationship with customers and clients. Financial institutions became too big to fail and bankers lost sight of customer interests in favor of incentives for personal gain.

In an interview with Professors Hill and Painter, the two eminent legal scholars talk about how they developed their thoughts on responsibility as a means to change behavior in banks.

Professor Painter: "We're both securities lawyers, having done a lot of work for banks as lawyers. The 2008 crises really put the spotlight on the problem. We were both unconvinced that Dodd-Frank could solve all the problems. [The federal regulation is the] right direction but we didn't see enough emphasis on the individuals. There was no aggressive clawback as described in the book."

Question: Why is the emphasis on individuals so important?

Professor Hill: "The discussion in terms of what one does about [fraud in banks is viewed in] two tangible strains among people who are trying to deal with these issues more constructively. One of them is 'let's have more supervision, let's watch more carefully.' The other is to change their financial incentives. Both concepts are perfectly fine, but my problem with both approaches is the kinds of behavior we've seen recently reflect a pathological culture that is antithetical to responsibility. This made me think that the answer is responsibility, not just liability. This isn't just about tweaking incentives while conceding that what people want is money, power, etc. I wanted to write about responsibility as the reason you have to pay because 'it is on your watch.' What we need is a focus on Responsibility, capital "R," where monetary responsibility is part of the discussion."

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If Bankers Were Better, Could We Have Better Banks? *(continued)*

Question: Many NAPPA members have investments outside of the United States. *Better Bankers, Better Banks* doesn't seem too keen on foreign regulation, such as the new bonus clawback rules introduced by the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA).

Professor Painter: "To date, there hasn't been a great deal of success with clawbacks. Don't see a lot of fraud cases in Britain. Loser pays is a pretty good deterrent to this type of litigation."

Professor Hill: "In Ireland, the regulators didn't feel that they needed this type of constraint. In Ireland, the Central Bank signs off on banker character for the senior people. But it is not looking for the kind of character that might change bank culture."

The higher ups set up the pay structure and they know the risks that come along with the sales structure, but they didn't set up the necessary constraints or protections.

Question: Do you think Brexit will have any effect upon European securities regulation, as Britain seems to have the most robust regulatory scheme?"

Professor Painter: "Just cannot tell at this point. Britain has been important even before there was an EU. Hope that there isn't a race to the bottom on regulation to attract/keep investors and companies in Britain."

Question: If regulation, whether U.S. or foreign, isn't having the desired effect, how can the concept of responsible banking or covenant banking be implemented?

Professor Hill: "Imagine that Judge ________ says 'well, it's either $100 million from the company or $60 million if comes from the company management.' Imagine company executives trying to deal with this."

Professor Painter: "Yes, there could be an opportunity to settle for lower sums if it comes from the right pockets. This may be a challenge with class actions, but perhaps doable by regulators. But, can one argue that the lead plaintiff has an obligation to protect investors against future action?"

Question: Does the recent news about Wells Fargo present any opportunities for promoting covenant banking? The bank has a clawback provision[2] but the banker responsible for the unit subject to federal fines appears to be retiring with $124 million, including a mix of shares, options and restricted stock. According to reports, $17 million represents unvested stock awards. The bank's board has yet to take any action to clawback any portion of this compensation. If not now, when? Isn't Wells Fargo the poster child for a need for responsible bankers and covenant banking?[3]

Professor Hill: "Right now, it seems we just have to do something. Need to shove some sense into these people. The lower level people and those who objected to the plan were fired from the bank. What a bombshell!"

Professor Painter: "The higher ups set up the pay structure and they know the risks that come along with the sales structure, but they didn't set up the necessary constraints or protections. Without the [necessary] balancing, fraud is inevitable. A substantial part of the fine should come out of the compensation of the top people and if [fraud] happens again, even more should come out of the pockets of those people.

Those with the greatest benefit should have the highest personal responsibility.

Even if, ideally, a company pays less if the settlement comes out of the pockets of executives, perhaps other types of concessions may be included. If covenant banking is incorporated, perhaps we could see further reductions."

If Bankers Were Better, Could We Have Better Banks? *(continued)*

Question: What else are people doing or what can we do to promote the concept of covenant banking?

Professor Painter: "Some smaller [State and regional] banks may be quicker to adopt this policy as a competitive advantage. A lot of people are getting tired of dealing with big banks. The push back on our proposal is that bankers at the big banks are reluctant to take on liability for things that happen in a remote office. We can get this started more easily in the smaller banks."

Professor Hill: "I was just at an academic conference that had a lot of local banks in Alabama. They prided themselves on the fact that they could drive to every location where the bank had made a mortgage. Customers need to ask 'Do your bankers stand behind your bank?' This may force more and more people to consider this. This is the trajectory that we hope for in the book."

Bankers are in the best position to know what they should and should not do. Put them in a position and give them the incentive to make the change.

Professor Painter: "Additionally, as you are considering where your money is invested in the first place and want to avoid getting involved in class litigation, it is better to do business with the better bankers. Pension funds have influence on the front end. Use it.

Also consider proxy fights, by placing the question on the ballot and let shareholders vote. That should be given some serious consideration. Institutional investors should be getting pretty sick and tired of paying settlements and fines that come straight out of shareholder value. Finally, shareholders should consider offering to settle litigation for less money, if it comes from the right pockets. Not only does this reduce paying settlements out of shareholder value but, in the long term, the increased risk for highly compensated bankers could also change behavior."

Professor Hill: "So much of the message with bankers is the need to sell more, craft something ingenious to make more money. All of these incentives contribute toward pushing people (it's called the hot house effect) in a negative direction. We need to move people to a different approach. Yes with financial liability, but to have the bankers act responsibly. Bankers are in the best position to know what they should and should not do. Put them in a position and give them the incentive to make the change."

Professors Hill and Painter conclude that "it is time for a new approach." Focusing on individual bankers may require a long-range plan of implementation, but as long-term investors, isn't it in our interest to have sustainable, ethical financial institutions with strong connections to clients, shareholders and communities?

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ENDNOTES

[1] Claire A. Hill and Richard W. Painter, *Better Bankers, Better Banks: Promoting Good Business through Contractual Commitment* (University of Chicago Press, 2015).

[2] Wells Fargo & Co. bylaws include the following: Board or [Human Resources Committee] HRC determines to clawback or recoup compensation following a determination that a senior executive has engaged in misconduct, including in a supervisory capacity, that results in significant financial or reputational harm to the Company or in a material financial restatement, the Board or HRC will determine whether and to what extent public disclosure of information regarding such clawback or recoupment, including the amount of compensation and the executive(s) impacted, is appropriate, subject to applicable legal and contractual restrictions, including privacy laws.

[3] NOTE: The Wells Fargo scandal is a fluid matter. At the time of the interview, the bank's board had yet to clawback compensation. We may anticipate further developments.