Review of VRS Fiduciary Responsibility and Liability

Quick Summary and Contents

Definition and Performance of Board’s Fiduciary Responsibility .......................................................... Page 3
The VRS Board is the only named fiduciary, but other entities and individuals might have fiduciary responsibilities. To improve the Board’s capability to monitor the investment program, JLARC recommends that it consider appointing another trustee to each of its advisory committees, and that it receive the same performance report that is provided to the IAC. The General Assembly may wish to consider legislation to define fiduciary designations and responsibilities.

Risk of Potential Liability to VRS Trustees .................................................................................................. Page 9
The overall liability risk for VRS trustees appears minimal. A VRS consultant has identified potential environmental liability problems within the real estate investment program. JLARC recommends that VRS consider reviewing its environmental evaluation practices used in making real estate investments.

Sources of Liability Protection Available to VRS ......................................................................................... Page 12
VRS trustees receive a reasonable degree of protection from several sources, including statutory provisions, the State’s risk management plan, and liability insurance. Provision of legal representation during criminal proceedings is not available to the VRS Board. Given the unique nature of its role in State government, the General Assembly may wish to authorize VRS to retain special legal counsel for criminal proceedings in certain circumstances.

Profile: Virginia Retirement System Investments

Total Return on Investments
(Time Periods Ending 6/30/96)

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 years</td>
<td>10.5%</td>
</tr>
<tr>
<td>5 years</td>
<td>11.8%</td>
</tr>
<tr>
<td>3 years</td>
<td>12.1%</td>
</tr>
<tr>
<td>1 year</td>
<td>18.2%</td>
</tr>
</tbody>
</table>

Market Value of Assets: $22.09 billion
Number of External Managers: 70
Number of External Investment Accounts, Direct Investments, and Partnerships: 104
FY 1996 Investment Expenses: $54.7 Million
Number of VRS Investment Staff: 21 positions (3 vacancies)
Ratio of Active to Retired Members: 3.3
Ratio of VRS Revenues to Expenses: 3.2

Investment Policy Indicators (as of June 30, 1996)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Asset Allocation (% of Total Assets)</th>
<th>Where Invested (% of Asset Class)</th>
<th>Type of Management (% of Asset Class)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Target</td>
<td>Actual*</td>
<td>Domestic</td>
</tr>
<tr>
<td>Equity</td>
<td>70%</td>
<td>72.1%</td>
<td>81%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>21%</td>
<td>20.6%</td>
<td>98%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>9%</td>
<td>6.7%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Of total assets, 0.7% was cash.
Review of VRS Fiduciary Responsibility and Liability

INTRODUCTION

Since the appointment of the Virginia Retirement System Board of Trustees (the Board) in March 1994, the potential for personal liability resulting from decisions made in administering the investment program has been a concern within VRS. While precipitated by two specific factors, these concerns are related to two broader questions. First, what are the rules and standards by which the prudence of VRS investment decisions will be judged? Second, to what extent will the State support and defend, if necessary, investment decisions made by the VRS Board?

One specific factor which generated concern was a recently concluded criminal investigation by a federal grand jury regarding the acquisition of the RF&P Corporation by the prior VRS Board. During that investigation, two former trustees and a former director incurred substantial personal legal expenses, despite the fact that they were never charged with any wrongdoing. This situation created concerns among some current trustees regarding the adequacy of their potential legal representation.

Another specific factor which created liability concerns was the anticipation of a possible downward correction in the value of the public equity markets and a corresponding reduction in the value of the VRS portfolio. In the event of such a reduction in value, some individuals within VRS have expressed concerns that they could be held personally liable for the loss. VRS has a seventy percent allocation to equity investments. Among 51 state-sponsored public employee retirement systems surveyed by JLARC staff, VRS has the third highest percentage of fund assets allocated to equity investments.

There are several statutory provisions and administrative mechanisms currently in place in Virginia which provide a degree of protection to VRS trustees from the risk of potential personal liability. These include the statutory prudence standard, the statutory tort claims act, the State’s risk management plan, and the Board’s fiduciary liability insurance policy. In terms of the type and level of protection provided to the VRS Board, each of these have both strengths and weaknesses. Virginia is similar to many other states in the types of protections that it provides to its retirement system trustees. However, VRS is one of a relatively few state-sponsored public employee retirement systems with a fiduciary liability insurance policy. On the other hand, several other states do provide explicit statutory immunity from liability for their retirement system trustees provided that they act in good faith and do not knowingly, willfully, or maliciously engage in improper conduct. This is arguably an easier standard for a trustee to satisfy than the prudent expert standard required for VRS.

The potential personal liability of pension fund fiduciaries presents a delicate public policy issue. On one hand, the potential for personal liability needs to be real and significant enough to help ensure the board’s continued prudent, careful performance of its fiduciary responsibilities on behalf of the VRS members and beneficiaries. On the other hand, the potential liability should not be so excessive that the recruitment and retention of qualified, talented individuals for the VRS Board, its advisory committees, or staff is harmed. Given the nature of risk faced by VRS trustees, and the range of protections already in place, the potential for personal liability does not appear to be excessive, burdensome or oppressive. However, certain statutory changes could be considered in order to improve and clarify the legal framework regulating VRS fiduciary responsibility and liability.

Mandate and Approach for the Review

The Virginia Retirement System Oversight Act (Section 30-78 of the Code of Virginia) requires the preparation of a semi-annual report on the VRS investment program. The Oversight Act also authorizes JLARC to review and evaluate the structure and governance of the retirement system. In response to concerns regarding fiduciary responsibility and liability issues raised by VRS over the past two years, JLARC staff
proposed to the Commission at its May 1996 meeting that it examine these issues. The Commission directed JLARC staff to proceed with the review at that time.

Given the concerns expressed by VRS, the review was designed to evaluate the adequacy of the current statutory and administrative framework regulating VRS fiduciary responsibility and liability. Therefore, the review examined the following four issues:

- Are the Board’s fiduciary responsibilities clearly defined and understood?
- What is the nature of the potential personal liability risk faced by the VRS trustees?
- To what extent is the potential personal liability risk reasonably and effectively mitigated through current statutory provisions and administrative mechanisms?
- Should any additional protections against the risk of potential personal liability be provided?

Several research activities were performed to examine each of these issues. These included structured interviews with VRS trustees, advisory committee members and management. Interviews were also conducted with staff from the Attorney General’s (AG’s) office and the State Division of Risk Management (DRM) within the Department of General Services. Experts in the field of pension fund fiduciary responsibility were also interviewed. JLARC staff also surveyed other public employee retirement systems, reviewed retirement statutes for each of the 50 states, and performed other legal research and document reviews. JLARC staff also attended meetings of the VRS Board and its advisory committees.

**DEFINITION AND PERFORMANCE OF THE BOARD’S FIDUCIARY RESPONSIBILITY**

The terms “fiduciary” and “fiduciary responsibility” can be defined in a variety of ways. The range of definitions all tend to involve three concepts: (1) funds are held by one party (the fiduciary) for the ultimate benefit of another (the beneficiary); (2) trust, faith, and reliance that the beneficiary places in the fiduciary; and (3) loyalty that the fiduciary displays toward the beneficiary. As it pertains to the VRS Board, the definition of fiduciary responsibility within the *Code of Virginia* tends to be rather limited and vague.

In order to fulfill its fiduciary responsibility as trustee of the VRS funds, the VRS Board is the ultimate investment decisionmaker for the retirement system. In practice, within the context of its overall investment policy, the Board has delegated substantial decisionmaking responsibility to the VRS Chief Investment Officer (CIO). However, that delegation does not relieve the VRS Board of the ultimate responsibility for the outcomes of those decisions. Consequently, the need for the Board to effectively monitor and oversee the operations of the investment program is of the utmost importance.

**VRS Board Is the Only Named Fiduciary of the Retirement System**

Title 51.1 of the *Code of Virginia* contains a few provisions which make clear the fact that the VRS Board is the fiduciary of the pension fund:

To assist the Board of Trustees in fulfilling its fiduciary duty as trustee of the funds of the Virginia Retirement System, the Board shall employ a chief investment officer.... [Section 51.1-124.24]

To further assist the Board of Trustees in fulfilling its fiduciary duty as trustee of the funds of the Retirement System, the Board shall immediately elect an Investment Advisory Committee and a Real Estate Advisory Committee.... [Section 51.1-124.26]

The Board shall be the trustee of the funds of the Retirement System that it administers....[Section 51.1-124.30]

There is no further discussion in Title 51.1 of the *Code of Virginia* concerning who is or is not a VRS fiduciary, or who has or does not have fiduciary responsibilities.

**Other Fiduciaries Within VRS.** According to the VRS director and the CIO, other entities within VRS have fiduciary responsibilities. These include the VRS director, CIO, IAC members, REAC members, external investment managers, and some internal VRS investment staff by virtue of their responsibilities and authority. This opinion is entirely reasonable, given the delegation of responsibilities within VRS, and given the realities — including the prevalence of team and group-based decisionmaking — of administering a $22 billion pension fund. However, the imposition of fiduciary responsibility principles in light of these group dynamics is unclear. For example, none of these individuals are recognized as fiduciaries, nor given any fiduciary responsibilities, by statute. Moreover, the extent to which any of these individuals have explicitly acknowledged, in writing, a fiduciary responsibility to VRS is uncertain. Nevertheless, given the lack of specificity in Title 51.1 of the *Code of Virginia*, a court of law could possibly find, relying on precedent from the common law of trusts and the federal Employee Retirement Income Security Act (ERISA), that such individuals and entities have fiduciary responsibilities to VRS.
Uniform Management of Public Employees Pension Fund Act. As part of its continuing effort to discourage federal preemption of state laws, the National Conference of Commissioners on Uniform State Laws (NCCUSL) is drafting model legislation for the management of public pension funds (the Uniform Act). NCCUSL notes that public funds are regulated by laws in each state, which vary considerably across states and have often failed to keep pace with modern investment practices. NCCUSL hopes that its model act, which is still in draft form, will modernize, clarify and make uniform the rules governing the management of public retirement systems. This effort began in 1991. The NCCUSL expects to approve a final version of the Uniform Act in the summer of 1997.

Among the Uniform Act’s many provisions are definitions of “fiduciary” and “trustee.” The Uniform Act defines a fiduciary in the same way as does ERISA:

[A] person who exercises any discretionary authority to manage the operation and administration of a retirement system or any authority to invest or manage assets of the system, or who renders investment advice for a fee or other compensation, direct or indirect, with respect to the assets of the system, or has any authority or responsibility to do so.

The Uniform Act defines trustee as “one or more individuals who have the ultimate authority to manage the operation and administration of a retirement system or to invest or manage assets of the system.” Under this definition, trustees are a subset of a larger group of fiduciaries.

There should not be any vagueness or uncertainty concerning VRS fiduciary designations — they should be clear and unambiguous. A lack of clarity and ambiguity in naming fiduciaries and defining their responsibilities could promote uncertainty and harm accountability within the system’s governing structure. If it is the General Assembly’s intent to recognize and define certain fiduciary responsibilities residing somewhere other than on the Board, it may wish to provide for this in statute. This above-mentioned provision of the Uniform Act could be used as a model. However, statutory language expanding the designation of fiduciary status and responsibility beyond the Board — as a number of other states have done — would likely have liability and accountability implications for the system’s governing structure.

Recommendation (1): The General Assembly may wish to closely monitor the work of the National Conference of Commissioners on Uniform State Laws in drafting the Uniform Management of Public Pension Funds Act. Based on further review of the Uniform Act, the General Assembly may wish to consider the development of legislation which would affirmatively state and define fiduciary designations within the Virginia Retirement System.

Prudent Expert Standard of Care Governs VRS Fiduciary Conduct

Virtually every state retirement system uses a prudence rule as its standard for governing the investment of assets by trustees and other fiduciaries. Over the past several years, states have been revising the prudence rules that govern the management of their public employee retirement systems. Typically, these changes have consisted of replacing the prudent person language with the more stringent prudent expert language contained in ERISA.

Virginia’s Statutory Prudence Standard. Section 51.1-124.30 of the Code of Virginia identifies what is the Board’s single greatest responsibility. According to the statute, the Board shall:

discharge its duties with respect to the Retirement System solely in the interest of the beneficiaries thereof and shall invest the assets of the Retirement System with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a like character and with like aims.

This prudence standard is referred to as the prudent expert (or prudent investor) standard. This version of the prudence standard, which is also found in ERISA, serves as a guide to VRS trustees, advisory committee members, and staff concerning expectations for the management and administration of the system. This standard also serves as a legal basis for accountability and potential liability for the system’s fiduciaries.

Use of Prudent Expert Standard Recommended by Bear Stearns. The applicability of the prudent expert standard to VRS is a result of a 1993 review of the VRS investment program conducted by JLARC and its investment consultant, Bear Stearns Fiduciary Services, Inc. (Bear Stearns.) Based on its review, Bear Stearns recommended that the prudent expert standard replace the less stringent prudent person standard. Bear Stearns stated that the prudent expert standard would provide VRS with “the flexibility needed to accommodate modern portfolio theory and new investment instruments, but only so far as prudent.”

Prudent Expert Standard Widely Used by Other States. Virtually every state employee retirement system uses some form of the prudence standard, usually as a statutory requirement. The prudent expert standard is the single most frequently employed version of the standard, used by 23 of the 50 states. Moreover, the prudent expert standard is being adopted by states with...
increasing frequency. Since 1990 11 states, including Virginia, have adopted the prudent expert standard.

**Statutory Guidance for Interpreting the Prudence Standard.** The public employee retirement statutes of most states, including Virginia, provide little if any guidance to interpreting the practical meaning or intent of the prudence standard. In contrast, the Uniform Act specifies general fiduciary duties, investment and asset management fiduciary duties, establishes a test of compliance with those duties, and poses a standard for determining personal fiduciary liability. Table 1 summarizes key provisions of the Uniform Act pertaining to prudent expert standard of care.

A few states, particularly Minnesota, Missouri, and Utah, provide rather extensive statutory guidance to their prudence standards. The provisions of these three states closely resemble, in several ways, the provisions of the Uniform Act. For example, the Utah statute states that a trustee shall manage trust fund assets “as a prudent investor,” and then proceeds to define what that means.

In its 1993 report, Bear Stearns stated that the General Assembly could choose to provide statutory guidance for interpreting the prudent investor standard:

> Assuming the Virginia Legislature adopted standards comparable to ERISA, it is impossible in the abstract to predict whether or to what extent the state courts would actually refer to such case law; but if any legislation is adopted, the Legislature could choose to provide direction in this regard.

All of the VRS trustees stated to JLARC staff that they believe they have an adequate understanding of what the prudent expert standard of care requires in practice. One trustee, while stating that he personally has an adequate understanding of the standard, does have some doubts about the Board’s overall understanding of the standard:

> I doubt anyone on the Board fully understands all of the technicalities that are involved. It would be in the best interests of each of the trustees if they had a better legal understanding of prudence standard requirements.

Additional statutory guidance could promote a better sense of awareness among the VRS trustees concerning the General Assembly’s intent and expectations concerning application of the prudent expert standard.

**Recommendation (2).** The General Assembly may wish to closely monitor the work of the National Conference of Commissioners on Uniform State Laws in drafting the Uniform Management of Public Pension Funds Act. Based on further review of the Uniform Act, the General Assembly may wish to consider the development of legislation to provide guidance to the statutory prudent expert standard by affirmatively defining fiduciary responsibilities.

**VRS Board Has Delegated Substantial Investment Responsibilities to CIO**

From the time of its appointment in March 1994, the VRS Board has favored an macro-level approach to overseeing and directing the investment program. The Board does not want to micro-manage the investment program. Under this type of approach, broad policy issues, such as the fund’s asset allocation, are determined by the Board. Virtually all other investment decisions — particularly the hiring and firing of external investment managers — are delegated to the CIO. Delegation of various investment responsibilities within a $22 billion fund is entirely appropriate. However, as the only named fiduciary of the retirement system, the Board can not delegate its ultimate responsibility for the results of decisions made by others.

**CIO’s Delegated Investment Decisionmaking Authority.** According to IAC policy guidelines, the following decisions are made by the CIO, based on recommendation of the IAC and subject to review and oversight by the Board:

- determination of target allocation within ranges,
- approval of proposed program structure — including active, passive, internal and external investment management approaches,
- hiring and firing external managers, and
- hiring and firing consultants.

According to REAC guidelines, the following decisions are made by the CIO, with the concurrence of the REAC, and subject to review by the Board:

- determination of target allocation within ranges,
- purchase of a 100 percent interest in a real estate property,
- hiring and firing managers, and
- hiring and firing consultants.

**Prior VRS Delegation of Investment Decisionmaking Authority.** A previous policy decision of the VRS Board to delegate substantial investment decisionmaking authority to the IAC was rescinded in December 1995 in response to two legislative concerns. First, the General Assembly intended for the IAC and REAC to be purely advisory in nature. The Code of Virginia does not authorize either advisory committee to make investment decisions on behalf of VRS. Second, IAC and REAC members are required only to comply with the financial disclosure provisions of the State and Local Government Conflict of Interest Act (Section 2.1-639 et seq. of the Code of Virginia.) Advisory committee members are not required to comply with the contract and transaction prohibition provi-
### Table 1: Uniform Management of Public Employee Pension Funds Act (Draft)

<table>
<thead>
<tr>
<th>General Provision</th>
<th>Detail</th>
</tr>
</thead>
</table>
| Definition of Fiduciary | 1) A person who exercises any discretionary authority to manage the operation and administration of a retirement system  
2) A person who exercises any discretionary authority to invest or manage assets of a retirement system  
3) A person who renders investment advice for a fee or other direct or indirect compensation with respect to assets of a retirement system, or who has any authority or responsibility to do so; |
| Specifies General Fiduciary Duties | A fiduciary shall discharge his or her duties with respect to a pension plan:  
1) solely in the interests of the participants and beneficiaries;  
2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;  
3) with the skill, care, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an activity of like character and purpose;  
4) impartially, taking into account any differing interests of participants and beneficiaries; and  
5) in accordance with the instruments governing the plan. |
| Specifies Investment and Asset-Management Fiduciary Duties | Among the circumstances that a trustee shall consider are the following:  
1) general economic conditions,  
2) possible effect of inflation or deflation,  
3) role that each investment or course of action plays within the overall portfolio,  
4) expected total return from income and the appreciation of capital,  
5) needs for liquidity, regularity of income, and preservation or appreciation of capital, and  
6) adequacy of funding for the plan.  
A trustee shall diversify the investments of the plan unless, because of special circumstances, it is clearly prudent not to do so.  
A trustee shall make a reasonable effort to verify facts relevant to the investment and management of assets. |
| Test of Compliance with Fiduciary Duties | Compliance must be determined in light of the facts and circumstances existing at the time of the decision or action.  
Decisions must be evaluated not in isolation but in the context of the portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the program. |
| Standard for Determining Personal Fiduciary Liability | A trustee or other fiduciary who breaches a duty imposed by this Act is personally liable to a retirement system for any losses resulting from the breach and any profits made by the trustee or other fiduciary through use of assets of the system |

Source: JLARC staff analysis of the September 1996 draft of the Uniform Management of Public Pension Funds Act prepared by the National Conference of Commissioners on Uniform State Laws.
sions of the statute. If the IAC were no longer considered advisory, it would raise the issue of whether the limited application of the Conflict of Interest Act is still appropriate. This issue concerning the Conflict of Interest Act was a primary reason for REAC’s refusal — unlike the IAC — to have any investment decisionmaking authority delegated to it by the Board.

Current Focus of Board Is on Fine-Tuning the Investment Program

Since the establishment of the VRS asset allocation policy, the Board’s role in overseeing the investment program has been to ensure that the investment program is “fine-tuned” when and where necessary. This is consistent with the broad investment policy and review role the Board has established for itself. In order to be effective in this role, the Board needs to ensure that it receives information concerning the investment program that is both timely and sufficiently detailed. The Board also needs to ensure that an issue raised within VRS concerning the power of the CIO position is resolved to its satisfaction.

Power of the CIO Position. Following the revisions to the VRS investment policy statement, in order to comply with legislative intent concerning the advisory committees, some individuals within VRS raised the issue that the amount of power and influence now vested in the CIO position was excessive, unwise, and possibly prone to fraud and abuse. Individuals who advocated this position noted that they had no concerns with the current CIO, but rather their concerns reflected uncertainty about future CIO’s. These individuals stated that the current investment decisionmaking structure was working well despite the structure, not because of it. As described to JLARC staff, a future CIO might act in response to personal ambition and perceived financial incentives, contrary to the Board’s established investment policy and procedures. In such a case, the Board might not detect any improper behavior until it was too late.

The CIO is supposed to be a powerful position within VRS. The intent of Section 51.1-124.24 of the Code of Virginia is that the CIO should be a supervisor and a decisionmaker, albeit one who is subservient to the Board. This statute was enacted, as in the case of the advisory committees, because a CIO was seen as a necessity to the VRS investment program. Prior to the 1993 study by JLARC and Bear Stearns, the CIO position had been vacant for a considerable period of time.

Advocates of the proposition that the CIO position is too powerful contend that the Board’s prior investment policy, wherein the IAC was delegated investment decisionmaking authority, contained greater checks and balances than currently exist. As one individual stated, it is far easier to visualize a “rogue” individual staff member than it is to visualize a “rogue” committee. However, that same individual acknowledged that in the investment arena it is always better to designate an individual as the decisionmaker and then hold that individual accountable.

VRS trustees express divergent opinions concerning whether or not the CIO position currently has too much power and influence. In personal interviews with JLARC staff, four trustees stated that the position did contain too much power and influence, four stated that the position did not contain too much power and influence, and one trustee was not sure.

• Two of the trustees who stated the opinion that the CIO has too much power and influence attributed their concerns to policy decisions of the Board and not to the wording or interpretation of the statute, and they also stated that the Board has delegated too much of its investment decision making responsibility.

• The other two trustees who stated the opinion that the CIO has too much power and influence attributed their concerns to the legislative interpretation of the statute.

If the VRS Board genuinely believes that there is a potential problem with the CIO position, particularly in terms of disproportionate or inappropriate power and influence, it is the responsibility of the Board to take steps to address the issue as the fiduciary of the system. Given the amount of investment expertise on the Board and the range of resources available to it, this issue is within the ability of the Board to effectively address within the bounds of existing statutory provisions concerning the CIO and the advisory committees.

Board’s Approach to Monitoring the Investment Program. The Board does not currently spend an inordinate amount of time during its monthly meeting reviewing and discussing the investment program. This is understandable, given the Board’s macro-level approach to overseeing VRS investment policy and practices, and given the fact that the asset allocation policy decision was made two years ago. All of the trustees reported being comfortable with the Board’s ability to oversee the investment program as a fiduciary. Six of the nine trustees told JLARC staff that the Board is spending about the right amount of time and effort monitoring and overseeing the investment program.

Three of the trustees indicated to JLARC that the Board should be spending additional time monitoring the investment program:

The Board is not spending enough time working to understand the investment process and monitoring results against established standards. The Board ought to hear more about the investment
program than it does. During Board meetings investment staff — not the IAC chair — ought to be the focal point in discussing the investment program.

The Board needs to be a little more involved. All the Board gets is a total of a half-hour or an hour report per month from the two advisory committees. As a trustee, I would like to receive more extensive reports on the investment program than we now receive.

I guess we should spend a little more time making sure we are all up to speed on the categories of investments and risks. I would have liked to have had more of a discussion at the Board level concerning the fact that the allocation to domestic equity was at the maximum end of the range that we had established.

A great deal of information concerning the operation and administration of the investment program is available for trustees who make it a point to obtain it. For example, every member of the VRS Board is welcome to attend meetings of the IAC and REAC. Attendance at these meetings can be an effective but time consuming way for trustees to obtain detailed information concerning the management of the investment program.

JLARC staff analyzed the minutes of IAC and REAC meetings from June 1994 through August 1996. Over that period of time, most VRS trustees attended very few, if any, advisory committee meetings. The VRS Board chairman and another trustee were notable exceptions, with each attending most meetings during that period. In addition, one trustee is a member of the IAC and another is a member of REAC. Both of these trustees regularly attend their respective advisory committee meetings.

It is important to note that not all of the VRS trustees necessarily feel that it should be their responsibility to attend advisory committee meetings in order to receive a greater amount of information concerning the investment program. As one trustee told JLARC staff, “I don’t want to attend a meeting just for the sake of attending a meeting.” This trustee also told JLARC staff that “I would feel a little more comfortable as a trustee if I knew more about what was going on in the investment program. I want more detailed information on the reasons for investment decisions.”

Three trustees told JLARC staff that they would like the Board to appoint another trustee to both the IAC and REAC. According to one of the trustees, this would provide him with an additional individual to rely on during Board meetings for information concerning the investment program. Currently, there is one trustee on the IAC and another on the REAC. The Code of Virginia permits a maximum of two trustees on the IAC and REAC. While this issue does not appear to be a concern with a majority of the trustees, the Board may wish to explore the merits of this idea further.

Recommendation (3). The Virginia Retirement System Board of Trustees may wish to consider increasing the number of trustees on the Investment Advisory Committee and the Real Estate Advisory Committee from one to two, as permitted by law.

Investment Performance Reporting to the Board

The current chairman of the IAC intends to modify the approach to providing the Board with information concerning the investment program. The chairman’s plan is to brief the Board on key investment policy issues, on how and why investment decisions were made, and on the risks that VRS has assumed in order to generate the investment returns that are reported to the Board. The CIO will be reporting to the Board on the performance of specific external managers. This approach contrasts with the approach under the prior IAC chairman, wherein the IAC report to Board consisted largely of a presentation of the proceedings of the IAC meeting.

Each month, the CIO presents investment performance reports to both the Board and the IAC. The reports present investment return data for the total fund, each investment program, and each external and internal investment manager. The reports constitute an important aspect of the oversight and monitoring functions performed by the Board and the IAC.

While similar in many respects, there is a key difference between the report presented to the Board and the report presented to the IAC. The report presented to the IAC shows all investment return data calculated as of the most recent available date. For example, the report presented to the IAC at its August, 1996 meeting showed investment return data for one, three, and five year time periods as of June 30, 1996. In contrast, the report presented to the Board at its August, 1996 meeting showed investment return data for one and five year periods ending December 1995. Both reports did show year-to-date return data for the calendar and fiscal years.

The report that is presented to the IAC is, overall, a more comprehensive and up-to-date portrayal of VRS investment performance than that which is presented to the Board. According to the CIO, the report that is presented to the Board is easier for the trustees to understand than would be the report that is prepared for the IAC. However, given the amount of investment expertise on the Board, it is reasonable to expect that the expanded report can be understood by the trustees.
Furthermore, it would be a more efficient use of VRS staff time to prepare one monthly report instead of two.

**Recommendation (4).** The Virginia Retirement System Board of Trustees may wish to require the Chief Investment Officer to provide it with the same investment performance report that is presented to the Investment Advisory Committee.

**RISK OF POTENTIAL FIDUCIARY LIABILITY TO VRS TRUSTEES**

The position of a VRS trustee is fairly unique in Virginia State government by virtue of the fact that, in addition to being the member of a citizen governing board, the trustee is also a fiduciary. This legal distinction carries with it significant responsibilities which, if not performed prudently, can potentially result in financial liability. Given the vast size and complexity of the investment program, there are several types of hypothetical situations within which liability could potentially arise against VRS collectively or personally against certain individuals within VRS:

- alleged breach of fiduciary responsibility due to financial losses within the investment program,
- environmental pollution associated with real estate wholly-owned by VRS, and
- attorneys fees incurred by VRS trustees defending their interests in situations in which the Attorney General’s office is unable to provide representation.

It is important to recognize that while situations such as these may create the potential for liability, they do not necessarily pose a reasonable likelihood of liability.

**Litigation Alleging Breach of Fiduciary Responsibility Is Rare**

Lawsuits against public employee retirement systems which allege a breach of fiduciary responsibility are very rare. Among the 51 respondents to JLARC’s survey of other public employee retirement systems, only seven reported that they had been the target of such a suit within the past ten years. VRS itself has never been sued for an alleged breach of fiduciary responsibility involving the investment program.

JLARC’s finding is consistent with similar research performed by the National Council on Teacher Retirement (NCTR). According to NCTR, the rarity of lawsuits against public employee retirement system fiduciaries is attributable to three broad factors:

- The plans operate in a public setting, subject to open meetings laws, open records laws, legislative oversight, and close monitoring of the plan’s performance by its members.
- Trustees exercise procedural prudence in their decisions through formal investment policies and practices.
- The potential for liability in connection with the actions and decisions of fiduciaries promotes prudent performance.

**Applicability of ERISA in Determining Potential Liability**

Governmental pension plans are not bound by ERISA. Therefore, the extent to which ERISA case law (as opposed to various aspects of State trust and fiduciary law, and common law) can serve as a guide to public pension plan fiduciaries is not completely certain. Nevertheless, the Attorney General’s Office has concluded that one can look to ERISA decisions for guidance concerning non-ERISA governed trustees’ obligations. This is because “the principles that govern a trustee’s duties are derived in large measure from the common law of trusts.” ERISA decisions can also provide guidance for questions that are not otherwise answered by State statutes or common trust law principles.

**ERISA Decisions Interpreting Prudent Expert Rule.** Over the past 20 years, an extensive body of case law has developed to interpret numerous aspects of the ERISA prudent expert standard. Table 2 (page 10) provides examples of some of the leading ERISA decisions concerning the diversification and investment of plan assets. Assuming that ERISA case law can be used as an accurate guide and a valid source of legal precedence for VRS, other leading cases indicate that fiduciary liability tends to occur only in the event of truly egregious investment decisions.

- A proposed loan of almost 36 percent of a plan’s total assets to finance construction of a hotel and gambling casino violated the prudence requirement, since the risk of business failure was quite high whether or not the construction was ultimately completed. [Marshall v. Teamsters Local 282 Pension Trust Fund, 1978, ED NY]

- A plan that proposed to loan 25 percent of its assets to a single borrower to develop a time-share project would violate diversification requirements because the loan represents a significant amount of plan assets that would be committed to a single, speculative project. [Marshall vs. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 1980, DC HI]

- Plan trustees who invested up to 89 percent of fund assets in certificates of deposit breached their fiduciary duty by failing to diversify fund assets so as to minimize the risk of large losses. [Whitfield v. Tomasso, 1988, ED NY]
Table 2: Examples of Leading ERISA Decisions
Interpreting the Prudent Expert Standard

<table>
<thead>
<tr>
<th>Aspect of the Standard</th>
<th>Explanation</th>
<th>Name of Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversification</td>
<td>Action alleging failure to diversify investments was without merit against some trustees in light of fact that failure to diversify was a prudent course of action. The larger the amount of assets, the greater is the degree of diversification that is possible and thus the greater the degree of diversification of investments to be expected of the trustees.</td>
<td>Davidson v. Cook (1983, ED VA), affirmed (1984, U.S. 4th Circuit)  Fine v. Semet (1983, U.S. 11th Circuit)</td>
</tr>
<tr>
<td>Investment of Plan Assets</td>
<td>Compliance with standard should be based not on effect of investment now, but what trustee knew was reasonable under prevailing circumstances at plan’s inception. Fiduciaries are not imprudent simply because the plan loses money as long as they took all prudent steps in making and monitoring the plan’s investments in the first place. A fiduciary’s actions do not have to cause the plan to suffer a financial loss for the fiduciary to have breached the prudent person rule.</td>
<td>Brock v. Walton (1985 SD FL), affirmed (1986, U.S. 11th Circuit)  DeBruyne v. Equitable Life Assurance Society of the United States (1989, ND IL), affirmed (1990, U.S. 7th Circuit)  Brock v. Robbins</td>
</tr>
<tr>
<td>Duty to Investigate</td>
<td>A fiduciary’s independent investigation of the merits of a particular investment is Òat the heartÓ of the prudent investor standard. Failure of trustee to independently investigate and evaluate potential plan investment was a breach of fiduciary obligations which could give rise to liability of trustee, if investigation would have revealed investment as objectively imprudent.</td>
<td>Fink v. National Sav. and Trust Co. (1985, D.C. Circuit)  Whitfield v. Cohen (1988, SD NY)</td>
</tr>
</tbody>
</table>

Source:  JLARC staff analysis of Pension and Profit Sharing 2nd (Commerce Clearing House), and Office of the Attorney General internal staff memo from John M. McCarthy to Michael K. Jackson dated 9/19/95. JLARC staff interviews with staff of the Attorney General’s Office and with the legal counsel for the National Council on Teacher Retirement.

Nature of the VRS Defined Benefit Mitigates Potential Liability

Since VRS is a defined benefit pension plan, as opposed to a defined contribution plan, the value of a member’s retirement benefit is not linked in any way to the performance of the VRS investment program. This fact raises the question of who could or would be in a position to validly claim and successfully prove damages as a result of poor VRS investment performance. It appears that it would be extremely difficult for an active or retired member of VRS to prove such a claim. There is a link between VRS investment performance and the ability of employers to fund the cost of pension benefits over the long term. The better the investment program performs over the long term, the more affordable it is for employers to pay the continuing cost of VRS benefits. Whether individual employers, such as a political subdivision, could or would sue VRS due to poor investment performance is uncertain.

Insurance Consultant Sees Liability Potential Within Real Estate Program

According to an insurance consultant’s report recently prepared for VRS, there are other sources of potential liability for VRS which would not necessarily involve the issue of whether or not the VRS Board had complied with the statutory prudence standard. Many of these sources of potential liability arise in connection with the VRS real estate investment program. In particular, the insurance consultant (Sedgwick James) raised the issue of potential liability resulting from the federal Comprehensive Environmental Response, Li-
ability, and Compensation Act (CERCLA.) According to Sedgwick,

The VRS Board may face new areas of exposure not contemplated under the traditional concepts of ERISA fiduciary activities by virtue of VRS’ direct involvement in the search, acquisition, management, and eventual sale or disposal of miscellaneous real estate assets. These exposures are usual and expected among other similar corporate ventures, but fall outside of the protection of conventional Fiduciary Liability Insurances.

Sedgwick’s report to VRS bases much — if not most — of its potential liability concern on the federal Comprehensive Environmental Response, Liability, and Compensation Act (CERCLA.) Commonly known as the federal “Superfund” law, CERCLA authorizes the U.S. Environmental Protection Agency (EPA) to take direct response actions, including short term removal actions and long term remedial actions with money from the Superfund. EPA may then file suit to recover these response costs from the responsible parties. CERCLA also authorizes lawsuits by private parties. Although there is no record of any CERCLA case having been brought against a public pension fund, Sedgwick believes that “a hazardous waste site connected with the pension fund would be a prominent and attractive vehicle to test the limits of CERCLA liability and limited immunity.”

Overview of CERCLA Provisions. Sedgwick’s report describes CERCLA as a potential significant source of liability exposure with respect to real estate in which VRS has a 100 percent ownership interest. Sedgwick also has concerns about the effectiveness of wholly-owned, single-purpose corporations which VRS uses to protect the pension fund from any liability that might arise in connection with its 100 percent ownership of real estate. The following are excerpts from Sedgwick’s report:

CERCLA liability may be imposed on the owners and operators of any facility where hazardous substances are located.

CERCLA is a strict liability statute, requiring only a showing that the substance involved is hazardous and that the defendant was sufficiently involved with it to satisfy the statute. Liability under the statute is joint and several, so that even the most minor responsible party may be required to bear huge cleanup costs.

Defenses to CERCLA liability are extremely limited, as might be expected from its overwhelmingly remedial nature.

In recent years several courts have held that a parent company can be held liable for a subsidiary’s acts.

Sedgwick noted that in determining whether to hold a company liable, the standard focuses on the parent company’s control over the subsidiary. According to Sedgwick, four factors are commonly reviewed to determine the degree of interrelationship between two entities:

- interrelation of operations,
- centralized control of labor relations,
- common management, and
- common ownership or financial control.

According to Sedgwick, the last item should be of the most concern to VRS.

VRS Direct Equity Real Estate Program Seeks to Avoid CERCLA Liability

VRS purchases 100 percent interests in real estate properties through its direct equity real estate program. Under the program, VRS invests in specific properties through single-purpose corporations designed to protect the VRS pension trust fund from liability. External real estate investment management firms are hired by VRS to identify potential investments. Once the VRS Board decides to invest in a particular property, key personnel from the external investment management firm are elected by the VRS Board to serve as the officers and directors of the single purpose corporation.

VRS real estate investment policy delegates all decision-making authority with respect to operating the property, including the decision to ultimately sell the property, to the single-purpose corporation. As of June 30, 1996, five external real estate investment firms managed 16 different properties. VRS investments in this program totaled $421 million as of June 30, 1996.

Review of CERCLA Liability Issues Prior to Establishing Program. The direct equity program was established following more than a year of research concerning its feasibility, including legal research by the law firm of Mays & Valentine. During the course of that research many, if not all, of the issues raised by Sedgwick pertaining to CERCLA were examined. In 1992, Mays & Valentine advised VRS that CERCLA posed a potential source of liability.

CERCLA has created potential liability of parent companies for the conduct of their subsidiaries as to hazardous waste sites. While the federal courts of appeal are split on how this potential liability is to be applied, the majority view is that a parent corporation (in the position of VRS) may be held liable as an operator of a subsidiary corporation (such as one of VRS’ single purpose corporations). This liability, however, must be based on the parent’s active involvement in the activities of
the subsidiary, rather than on the parent’s mere ownership of the subsidiary and the parent’s ability to control that follows such ownership. The line between active involvement and mere passive ownership is not easy to draw.

“Innocent Landowner” Defense Under CERCLA. Under this statutory defense, property owners who at the time of acquisition do not know, and have no reason to know, that hazardous substances had been placed on the property are relieved of liability. In order to establish that it had no reason to know, a property owner must show that it undertook all appropriate inquiry into the previous ownership and uses consistent with good commercial or customary practice. Consequently, potential landowners have the dilemma of performing a costly environmental investigation of the property or conducting a lesser investigation and risk losing the use of this defense.

Sedgwick’s report to VRS did not discuss this statutory defense to CERCLA. In order to assess the likelihood of CERCLA liability being imposed on VRS, the adequacy of investment policies and procedures within the direct equity program must be taken into account. In other words, how likely is it that VRS would qualify as an innocent landowner of a property later found to be contaminated? Sedgwick did not undertake such an examination as part of its study, as such was outside the scope of its review.

Environmental Evaluation Prior to Property Acquisition. Based on the research and advice provided by Mays & Valentine, VRS established the direct equity program fully cognizant of the potential risks — including CERCLA liability — that existed. According to the VRS managing director for real estate, VRS made certain business decisions “to avoid as much as humanly possible” potential exposure under CERCLA.

VRS utilizes four environmental investment criteria. According to these criteria, VRS intends to invest only in properties that are without environmental problems or conditions which would:
- cause the property to be in violation of any current or anticipated environmental law or regulation,
- create liability for cleanup, other response costs, or damages,
- restrict in any way the currently existing or proposed uses of the property, and
- restrict in any way anticipated future uses, including expansions of existing uses, on the property.

VRS real estate investment procedures require that, prior to acquisition within the direct equity program, the external investment manager perform an environmental investigation. The investigation must be sufficient to:
- satisfy the environmental investment criteria,
- satisfy the requirements of the “innocent landowner defense” under CERCLA and its supplemental and successor laws, and
- create the highest level of confidence reasonably attainable in the accuracy of the results of the investigation.

VRS requires that the external investment manager arrange for the evaluation by a qualified environmental consulting firm of 15 different matters as part of the environmental site assessment. These include:
- presence of asbestos-containing material,
- presence of lead in drinking water,
- subsurface soil conditions with respect to the presence of any hazardous substances or other contaminants, and
- environmental risks associated with current tenants or users of the property.

According to the VRS managing director for real estate, VRS goes far beyond what other pension funds do in terms of environmental evaluations prior to making real estate acquisitions.

Recommendation (5). The Virginia Retirement System Board of Trustees may wish to review the adequacy and effectiveness of the environmental evaluation procedures and practices within its real estate investment program, taking into account the potential liability concerns described in the report prepared by Sedgwick James.

SOURCES OF LIABILITY PROTECTION AVAILABLE TO VRS

The Code of Virginia states that no officer, director, or member of the VRS Board or of any advisory committee, whose actions are within the prudent expert standard of care, shall be held personally liable for investment losses suffered by the retirement system on authorized investments. This statutory provision clearly provides the VRS trustees and advisory committee members with substantial legal protection from liability.

There are a number of other sources of protection which are intended to provide VRS trustees with a degree of protection from personal liability. In addition to the previously mentioned investment policies and practices, these include the legal doctrine of sovereign immunity, the State’s risk management plan, and a fiduciary liability insurance policy. While each of these sources of protection have strengths, each also has certain deficiencies, exclusions, or gaps in coverage which tend to weaken their overall effectiveness in protecting the pension fund and the VRS Board. Furthermore, one area for which there is little protection is liability for legal fees resulting from criminal investigation or prosecution.
Sovereign Immunity Provides an Initial Layer of Liability Protection

State immunity from suit is part of the common law of Virginia. This legal doctrine, rooted in ancient common law, was originally based on the belief that “the king can do no wrong.” Today it is often described as a means of protecting the State from burdensome interference with its governmental functions. According to this view, public service might be hindered if the State’s authority could be subjected to suit at the instance of every citizen.

The doctrine of sovereign immunity has been repeatedly upheld as a valid legal defense by the Virginia Supreme Court. According to the doctrine, as interpreted by State courts, the State cannot be sued without its permission. Moreover, the privilege to sue must be provided by statute. Virginia courts have extended the State’s immunity from suit to the officers and agents of the State if the action is, in effect, against the State itself.

A recent Virginia Supreme Court decision which upheld this doctrine is Lohr v. Larsen. This decision illustrates a number of important points pertaining to sovereign immunity:

• A function that is essential to a governmental objective, and one in which the government has a great interest and involvement, weighs heavily in favor of a claim of immunity.
• Broad discretion vested in a government employee performing a function complained of weighs heavily in favor of a claim of immunity.
• A high level of governmental control and direction of its employee weighs heavily in favor of a claim of immunity.
• When a governmental employee is specially trained to make discretionary decisions, the government’s control must necessarily be limited in order to make maximum use of the employee’s special training and experience.

Virginia Tort Claims Act. In 1981, the General Assembly enacted the Virginia Tort Claims Act (Section 8.01-195.1 et seq. of the Code of Virginia). This statute waives the State’s sovereign immunity from suit in all but certain specific types of situations. None of the specified situations pertain to VRS. The statute also limits the amount recoverable from the State by any claimant to $75,000, or the maximum limits of any liability policy maintained to insure against negligence or other tort. However, the statute clearly states that the immunity of individual public officers, employees, and agents is preserved.

Possible Limitations to Sovereign Immunity Protection for VRS. Courts of one state are not bound to recognize the sovereign immunity claims of another state. Most of the real estate investments held by VRS are located outside Virginia. In the event of any lawsuit brought in the court of the state where such a property is located, a claim of sovereign immunity may not be effective. While courts sometimes do recognize the sovereign immunity claims of other states, out-of-State real estate investments do constitute a potential weakness in the applicability of sovereign immunity for VRS.

Risk Management Plan Provides an Additional Layer of Protection

This plan, established pursuant to Section 2.1-526.8 of the Code of Virginia, is a means by which the State attempts to protect itself and its officers and employees from liability resulting from performance of its authorized governmental duties. The risk management plan includes VRS trustees, advisory committee members and employees within the scope of its coverage. According to the written plan document, the plan will pay, subject to specific exclusions, all sums:

which the Commonwealth, its agencies, board, officers, agents or employees shall become obligated to pay by reason of liability imposed by law for damages resulting from any claim arising out of any facts or omissions of any nature while acting in an authorized governmental or proprietary capacity and in that course and scope of employment or authorization.

Coverage, Exclusions and Limitations Under the Plan. Under the plan, the amount recoverable by any claimant on a cause of action established by Virginia law is $100,000. For causes of action other than those established by Virginia law, the amount recoverable shall not exceed $2 million per claim. Each State agency is responsible for making an actuarially-determined contribution to DRM in order to pay for this coverage. For FY 1997, the required contribution from VRS for tort liability coverage is $2,876.

According to the plan document, the risk management plan shall not be liable for any amount which is collectable under commercial insurance, such as the fiduciary liability insurance policy held by the VRS Board. In that situation, the risk management plan is intended to provide excess coverage above that provided by the fiduciary liability policy.

The risk management plan does not apply to liability for punitive damages. The plan also does not apply to liability incurred by reason of acts of fraud or dishonesty, or acts of intentional, malicious or willful and wanton misconduct. According to Sedgwick, liability arising from acts that are outside the scope of one’s employment and authorization also might be excluded under the plan. However, the plan may provide coverage for such acts or punitive damages if the Governor and the Attorney General determine that such coverage is in the public interest.
Administration of Claims Under the Plan. The risk management plan is administered by the Division of Risk Management. However, the Attorney General’s Office serves as the ultimate arbiter of claims. The importance of the AG’s role in the overall claims administration and settlement process is due to his statutory authority, pursuant to Section 2.1-127 of the Code of Virginia, to compromise and settle disputes involving the interests of the State. Moreover, settlement of claims over $50,000 must be approved by the Governor.

According to DRM, coverage under the risk management plan is limited to liability arising from tort claims — as defined in the Virginia Tort Claims Act — that are filed against the State. A tort claim is defined as a claim for money:

on account of damage to or loss of property or personal injury or death caused by the negligent or wrongful act or omission of any employee while acting within the scope of his employment....

Non-Tort Claims. The risk management plan is not intended to cover liability arising from non-tort, or pecuniary claims. Therefore, DRM has no involvement in the settlement of pecuniary claims. However, pecuniary claims are subject to the AG’s overall authority to settle and discharge claims involving the interests of the Commonwealth.

Pecuniary claims are required to be presented to the head of the specific agency responsible for the alleged act or omission. The agency head then forwards the claim to the Comptroller along with appropriate supporting papers and recommendations. Upon receipt, the Comptroller “shall promptly allow so much on account thereof as may appear to be due.”

Fiduciary Liability Insurance Policy Provides Further Liability Protection

One of the statutory powers and duties of the VRS Board is that of “purchasing insurance to insure against losses suffered by the Retirement System if any member of the Board or of any advisory committee breaches” the prudent expert standard of care. Pursuant to this statutory provision, VRS has had a $10 million fiduciary liability insurance policy since 1984. VRS is the owner of the policy and pays 100 percent of the premiums. VRS is one of relatively few state-sponsored public employee retirement systems to have this type of insurance policy. Only 18 of 51 other retirement systems surveyed by JLARC staff reported having a fiduciary liability insurance policy.

The policy provides coverage against liability resulting from a breach of fiduciary duty, defined as “the violation of any of the responsibilities, obligations, or duties imposed upon fiduciaries by Virginia statutory or common law, or amendments thereto or any regulations as are promulgated thereunder.” The policy provides coverage to essentially everyone involved with VRS. Coverage is extended to any past, present, future, or replacement director, officer or trustee, any member of the Medical Board or IAC or REAC, or any VRS employee “while acting in a fiduciary capacity solely with respect to management or administration of the plan.

Coverage Exclusions. Several specific coverage exclusions are contained in the policy provisions. These include “any dishonest, fraudulent, criminal or malicious act, libel, slander, discrimination, or humiliation.” Other exclusions are for:

• fines, penalties, taxes or punitive or exemplary damages,
• any claim arising from the gaining of any personal profit or advantage to which the insured was not legally entitled, and
• any claim based on the failure to comply with disability benefits law.

In its report to VRS, Sedgwick concluded that the claims arising from violations of U.S. Securities Exchange Commission (SEC) rules and regulations were also excluded under the policy. There is not a specific exclusion for SEC violations stated anywhere in the policy. However, according to Sedgwick, the insurance carrier would interpret the policy provisions so that coverage for such a claim would be excluded.

One of the policy endorsements states as follows:

It is agreed that the validity, performance and all matters relating to the interpretation and effect of the policy shall be governed by the laws of the Commonwealth of Virginia. It is also agreed that the Attorney General of Virginia is responsible for settling and discharging claims involving the interests of the Commonwealth subject to the provisions of Section 2.1-127 of the Code of Virginia.

According to the VRS Assistant Director for Finance, who serves as the primary liaison to the insurance carrier, the intent of this policy provision is that neither the VRS Board nor the insurance carrier can settle a claim on the policy, regardless of whether or not litigation is involved, without the Attorney General’s intervention and approval. While the insurance carrier and its attorneys may play a role in settling any claim made on the policy by VRS, the Attorney General is the ultimate authority.

The policy provisions do not explicitly state that the AG’s office has a role in determining whether or not the policy provides coverage for a potential claim that might be filed sometime in the future. According to the Assistant Director for Finance, the previously mentioned policy provision is not intended to provide the AG’s office with a role in determining coverage. It is the understanding of the Assistant Director for Finance
that the insurance carrier retains that authority. However, it appears that the AG’s office is playing a significant role in determining whether there is coverage under the VRS policy.

In February 1996, the VRS Board received written demand on behalf of two former trustees and a former director for reimbursement of legal expenses. VRS sent the demand to the AG’s office for review and advice. In May 1996, the VRS director wrote to the AG for guidance concerning the mechanism for resolving the issue and coordinating the efforts of DRM, the AG and the liability insurance carrier. In August 1996, the AG notified the VRS director that it did not interpret the policy as providing coverage for a claim such as may be asserted by the former officials. No claim has been filed.

Over the past several years, this liability insurance coverage has become increasingly expensive for VRS. In 1992, the policy premium was $74,250 with a zero deductible amount. By 1996, the policy premium had increased to $175,000 with a $100,000 deductible amount. This is despite the fact that VRS has never filed a claim on the policy. According to the VRS Director, the most recent increase in the premium was due to the insurer’s uncertainty concerning the prospect of having to pay legal fees for two former trustees and the former director. The VRS Director also told JLARC staff that he was verbally informed by the insurance carrier that, if no such claim were filed, the amount of the premium increase would be rebated to VRS. This appears to indicate that the insurance carrier expected a claim for legal fees to be submitted.

Coordination with Risk Management Plan. It is not clear how the settlement of any potential claim filed against VRS would be coordinated given the fact that the liability insurance policy and the State’s risk management plan represent two potential sources for payment. According to the Director of DRM, the State’s plan and the VRS policy are operating side by side, but they don’t necessarily fit together well. For example, it is difficult to determine which would be used to provide primary coverage, and which would provide secondary or excess coverage. Both the insurance policy and the risk management plan contain provisions by which they attempt to define themselves as secondary carriers.

According to the fiduciary liability insurance policy:

There shall be no liability hereunder with respect to any claim for which the Insured is entitled to recover under any other policy or bond whether such insurance is stated to be primary, excess, or contingent upon the existence of other insurance unless such other insurance specifically applies as excess insurance over the limits of liability provided in this policy.

According to the risk management plan:

If at any time of loss, claim, suit, action or other proceeding there is commercial insurance or a self-insurance plan available to any individual or organization covered by this plan, or which would have covered such loss, claim, suit, action or other proceeding except for the existence of this plan, this plan shall not be liable for any amount which is collectable under such other commercial insurance or self-insurance plan.

Additional Liability Insurance Coverage Purchased by VRS. Sedgwick recommended that VRS expand the scope of its fiduciary liability insurance coverage to include protection for directors’ and officers’ liability, along with pollution and employment practices liability extensions. As described by Sedgwick, which is currently the broker for the fiduciary liability policy, directors’ and officers’ (D&O) liability insurance policy can be thought of as a management errors and omissions policy. It would be intended to protect directors and officers against liability which could arise from “a broad range of management decisions made while acting in their capacity as directors and officers.” Sedgwick advised VRS that:

Every day decisions may result in lawsuits alleging misrepresentation, misleading statements, or neglect/breach of duty. In effect any decision made by a director or officer could conceivably result in a lawsuit against directors and officers.

In response to this recommendation, VRS recently restructured and expanded its liability insurance to include $10 million in primary coverage for D&O liability. This additional D&O coverage is linked to the existing fiduciary liability coverage such that a maximum of $10 million may be paid in aggregate from the two policies. In addition, VRS has purchased $10 million in excess coverage for both the fiduciary liability and D&O policies. Under this arrangement, an additional $10 million can be paid for D&O liability, and an additional $10 million can be paid for fiduciary liability. The total annual deductible for the fiduciary liability coverage and the D&O coverage is $150,000 over the two policies. VRS has decided not to purchase any pollution liability insurance coverage.

The D&O policy provides coverage against liability arising from a “wrongful act.” The policy defines a wrongful act as

Any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Directors and Officers in the discharge of their duties, individually or collectively, or any matter claimed against them solely by reason of their being Directors or Officers....
The total annual premium for the fiduciary liability and the D&O coverage is $340,000. The annual premium for the excess liability coverage is $275,000. VRS has submitted a budget addendum request for an additional $750,000 in FY 1997 and FY 1998 in order to pay for this additional coverage. The $750,000 represents a mid-range estimate of the additional cost.

An additional aspect of the expanded insurance coverage for VRS is the fact that it will prepay $150,000 of next year’s anticipated premium amount to the insurance carrier. This amount will be retained by the carrier and, in the event of a claim on the policy, can be drawn down by VRS to cover the amount of its deductible. In that event, VRS will be responsible for replenishing the $150,000.

Expansion of Liability Protection for VRS Trustees

Over the course of the past year, VRS has discussed the possibility and desirability of statutory amendments that would expand the amount of liability protection for VRS trustees. In the Fall of 1995, outside legal counsel for VRS prepared draft legislation — which was not introduced during the 1996 Session — that rewrote the statutory provision concerning trustee and advisory committee member liability for actions not in accordance with the prudent expert standard of care. The proposed provision would have retained the prudent expert standard but, notwithstanding that provision, would have barred personal liability “so long as such person acted in good faith and in a manner that he believed to be in the best interest of the retirement system.” One of the factors that precipitated the drafting of this legislation was the threatened resignation by a member of the IAC if potential liability issues were not resolved to his satisfaction. That individual did not resign, and is still a member of the IAC.

Code of Virginia Provisions Limiting Liability for Directors and Officers. As part of its review of fiduciary liability protections, VRS has considered the possibility of providing its trustees personal liability limitations similar to those of tax exempt organizations and non-profit corporations. Sedgwick recently recommended to VRS that it consider examining these statutory limitations on liability. According to Sedgwick, this should be done “with an eye towards changes to the Virginia Code to offer the maximum possible protection to trustees, and consistent with the public service orientation of the agency.”

The Code of Virginia contains provisions which limit the personal liability of officers, trustees, and directors of certain such organizations to the amount of compensation received from the organization during the twelve months. Section 8.01-220.1:1 pertains to certain tax-exempt organizations:

In any proceeding against a director, trustee, or officer of an organization exempt from taxation under Section 501(c) or Section 528 of the Internal Revenue Code who receives compensation, the damages assessed for acts taken in his capacity as an officer, trustee, or director and arising out of a single transaction, occurrence or course of conduct shall not exceed the amount of compensation received by the officer, trustee, or director during the twelve months immediately proceeding the act for which liability was imposed.

The liability...shall not be limited as...if the officer, trustee or director engaged in willful misconduct or a knowing violation of a criminal law.

Section 13.1-870.2 of the Code of Virginia contains an almost identical provision pertaining to directors of non-stock corporations:

In any proceeding against an officer or director who receives compensation from a corporation exempt from income taxation under Section 501(c) of the Internal Revenue Code for his services as such, the damages assessed arising out of a single transaction, occurrence or course of conduct shall not exceed the amount of compensation received by the officer or director from the corporation during the twelve months immediately proceeding the act for which liability was imposed.

The liability...shall not be limited as...if the officer, trustee or director engaged in willful misconduct or a knowing violation of a criminal law.

VRS is a qualified pension plan, and therefore exempt from federal income taxes, under Section 401(a) of the U.S. Internal Revenue Code. Consequently, neither of these Code of Virginia sections apply to VRS.

Compensation of VRS Trustees. VRS trustees, with the exception of three trustees who are actively employed by governmental entities, receive a stipend of $3,000 per quarter, or $12,000 per year. The VRS Board chairman receives an additional stipend of $1,500 per quarter, or $6,000 per year. Each trustee also receives a per diem payment of $300 per meeting, with the VRS Board typically meeting eight times a year. This compensation structure makes the VRS trustees a significant exception to the vast majority of state-sponsored public employee retirement systems, whose trustees typically receive little if anything in the way of compensation. However, this amount of compensation also represents an extremely low ceiling on potential fiduciary liability for trustees of a $22 billion pension fund.

The General Assembly intended for this compensation structure to help recruit qualified individuals to serve on the Board, given the fact that service as a VRS
trustee can be demanding and time consuming. In addition, while not specifically intended for this purpose, the compensation could potentially be used by trustees to purchase their own individual liability insurance policy to provide supplemental protection in connection with their service on the VRS Board.

**Fiduciary Liability Protection Mechanisms of Other States.** The vast majority of other states, like Virginia, have some type of mechanism for providing their pension fund fiduciaries with a measure of protection from personal liability. Table 3 provides a summary of the type and prevalence of various types of fiduciary liability protection mechanisms among state-sponsored public employee retirement systems. Some states have provided a more extensive range of protections than others. Overall, the protections afforded to VRS trustees compare favorably with those provided by other states. As previously mentioned, Virginia is one of a relatively few states whose pension fund trustees are covered by a fiduciary liability insurance policy.

**Statutory Indemnification Provisions of Other States.** As shown by Table 3, 12 states have trusteed indemnification provisions within their retirement or fiduciary statutes which permit indemnification in the event that the trustees’ actions and decisions are made in good faith, and without wanton or malicious misconduct. The retirement systems in most — but not all — of these 12 states do not have fiduciary liability insurance policies. In Virginia, unlike these 12 states, the statutory prudence standard governing pension fund investments is also the standard for determining fiduciary liability. These 12 states have, in effect, different statutory standards for investment decisionmaking and fiduciary liability.

Virginia’s fiduciary liability standard, compared to these 12 states, appears stricter. The following are the statutory provisions from three such states:

The state shall indemnify every person who is made, or is threatened to be made, a party to any action, suit or proceeding, including administrative and investigative proceedings by reason of his service in a fiduciary capacity with the Employees’ Retirement System.... [Maryland]

Any action taken as a trustee, or any failure to take action as a trustee, shall not be the basis for monetary damages or injunctive relief unless:

1. The trustee has breached or failed to perform the duties of the trustee’s office in compliance with this section; and
2. In the case of an action for monetary damages, the breach or failure to perform constitutes willful misconduct or wanton and reckless disregard for human rights and property. [Kentucky]

The State shall indemnify a Board member to sit on a committee of the Board who was or is threatened to be made a party to any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative, or investigatory by any reason of the fact that he or she is or was a Board member against expenses (including attorney’s fees if the Attorney General determines that he may not provide representation), judgments, fines and amounts paid in settlement actually and reasonably incurred...if he or she acted in good faith and with respect to any criminal action or proceeding had no reasonable cause to believe his or her conduct was unlawful. [Delaware].

**Fiduciary Liability Provisions Contained in Uniform Act.** The current version of the uniform act contains the following provision based closely on ERISA:

A trustee or other fiduciary who breaches a duty imposed by this [Act] is personally liable to a retirement system for any losses resulting from the breach and any profits made by the trustee or other fiduciary through use of assets of the system by the trustee or fiduciary. The trustee or other fiduciary is subject to other equitable or remedial relief as the court considers appropriate, including removal.

The extent to which public pension fund trustees should be held personally liable in the event of a breach of fiduciary duty has been vigorously debated by the NCCUSL. The debate centers on whether the liability standard will make it too difficult for public funds to recruit and retain trustees. Some of the members of the NCCUSL committee that is drafting the uniform act believe that, since the proceedings of public plans are subject to open meetings rules as well as other measures designed to ensure disclosure, another liability standard would be more appropriate. For example, an earlier draft of the uniform act conditioned trustee liability on “knowingly and willfully” breaching his fiduciary responsibility. However, according to a member of the drafting committee, that phrase was deleted in response to concerns that the fiduciary responsibility standards would be weakened if violations could occur without sanctions. The goal is to protect the pension fund, and to focus the attention of the fund’s fiduciaries on their responsibilities. Nevertheless, this provision remains subject to change prior to approval of the final draft.

At this point in time, as reflected by the current draft of the Uniform Act, the direction of the national debate of public pension fund fiduciary liability standards appears headed toward the application of a relatively strict standard. This standard, based closely on the provisions of ERISA, is currently the standard applicable to private sector pension fund fiduciaries.
<table>
<thead>
<tr>
<th>System</th>
<th>Indemnification in Retirement Statute</th>
<th>Indemnification if Actions Made in Good Faith and Without Willful Misconduct</th>
<th>Fiduciary Liability Insurance Policy</th>
<th>Tort Claims Act/Risk Management Plan</th>
<th>Statutory Definition of Fiduciary and/or Fiduciary Responsibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alaska Teachers</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arizona</td>
<td>•</td>
<td>•</td>
<td></td>
<td>•</td>
<td></td>
</tr>
<tr>
<td>Arkansas</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arizona Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>California</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>California Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colorado</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Connecticut Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delaware</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Florida</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Georgia Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hawaii</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Idaho</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Illinois Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indiana Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kansas</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Louisiana</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Louisiana Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maine</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minnesota Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mississippi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Missouri</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Missouri Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Montana Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nebraska</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nevada</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Hampshire</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Jersey</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Mexico Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Mexico</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New York Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North Carolina</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North Dakota</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ohio</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ohio Teachers</td>
<td>•</td>
<td>•</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 3: Fiduciary Liability Protections of Public Employee Retirement Systemes
Table 3 (continued)

<table>
<thead>
<tr>
<th>System</th>
<th>Indemnification in Retirement Statute</th>
<th>Indemnification if Actions Made in Good Faith and Without Willful Misconduct</th>
<th>Fiduciary Liability Insurance Policy</th>
<th>Tort Claims Act/ Risk Management Plan</th>
<th>Statutory Definition of Fiduciary and/or Fiduciary Responsibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oklahoma</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oklahoma Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pennsylvania Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Carolina</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Dakota</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tennessee</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Texas Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utah</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vermont Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Virginia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Washington</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>West Virginia Teachers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wisconsin</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wyoming</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>23</td>
<td>12</td>
<td>19</td>
<td>27</td>
<td>26</td>
</tr>
</tbody>
</table>

Source: JLARC staff survey, review of other state retirement statutes, and NCTR study.

As previously mentioned, the General Assembly has already chosen to require such a standard for VRS.

It is certainly true that VRS operates, as do all public pension funds, in an environment characterized by public meetings, information disclosure and reporting requirements, and legislative oversight. Nevertheless, that does not mean that a breach of fiduciary responsibility could not occur at some point, under a given set of circumstances, or under the oversight of a different VRS Board. To that end, the current statutory prudent expert standard promotes a healthy source of tension within the governing structure of VRS. This tension promotes a sense of fiduciary responsibility and accountability, which is important to help protect the interests of VRS members and beneficiaries. Consequently, changes to the standard do not appear to be appropriate. Furthermore, given the actual nature of the liability risk and the range of existing protections, changes to the standard do not appear to be necessary.

Legal Services Provided by the Attorney General’s Office

As is the case for all State agencies, the Attorney General provides legal services in all civil matters, including civil litigation, involving VRS. This representation is required by Section 2.1-121 of the Code of Virginia. Another statutory section, 2.1-122, provides for the hiring of special counsel by State agencies in specific circumstances with the approval of the Attorney General. VRS currently retains three outside law firms: one to provide advice concerning financial investments, another for real estate investments, and a third to provide advice concerning benefit administration. Each of these law firms was hired with the approval and involvement of the Attorney General. None of these law firms are authorized to represent VRS in court.

Appropriations Act Language Concerning Employment of Attorneys. Item 4-5.04 of the 1996-98 Appropriations Act contains the following language:

All attorneys authorized by this act to be employed by any state agency, and all attorneys compensated out of any monies appropriated in this session of the General Assembly shall be appointed by the Attorney General... This section does not apply to attorneys employed by state agencies in the Legislative Department, Judicial Department or Independent Agencies.

The VRS director interprets this language broadly as authorizing VRS, as an independent State agency, to hire outside legal counsel without the involvement or approval of the Attorney General. The Attorney General disagrees with that interpretation. According to the Attorney General, special legislation would be required.
specifically authorizing any State agency, independent or otherwise, to hire outside legal counsel without the Attorney General’s approval. The VRS director has not sought to hire outside legal counsel without the Attorney General’s approval. The General Assembly may wish to examine the language of Item 4-5.04 of the Appropriations Act to determine whether any modification is necessary in order to clarify legislative intent.

**Representation in Criminal Proceedings.** The Attorney General is prohibited by Section 2.1-124 of the *Code of Virginia* from providing legal representation to State agencies or employees involved in criminal proceedings or investigations. However, the *Code of Virginia* provides several State agencies with exceptions to this ban on legal representation during criminal proceedings. These agencies are generally authorized to retain or reimburse the cost of special legal counsel, approved by the Attorney General, in order to represent and defend the interests of certain employees who are involved in, or the target of, criminal proceedings arising out of their official acts. The following employees, who primarily have law enforcement responsibilities, have this type of protection:

- forest wardens appointed by the State Forester,
- employees of the Department of Corrections,
- members, agents, or employees of the Alcoholic Beverage Control Board,
- employees of the Marine Resource Commission,
- game wardens appointed by the Department of Game and Inland Fisheries,
- employees of the Commonwealth Transportation Board,
- law enforcement officers appointed by the Commissioner of the Department of Motor Vehicles,
- sheriffs and deputy sheriffs,
- employees of the Department of Mental Health, Mental Retardation, and Substance Abuse Services,
- State Police officers, and
- employees of local public welfare or social service departments.

The statutory provision for the State Police provides for legal representation under a broad range of potential situations:

If any police officer appointed by the Superintendent of State Police shall be brought before any regulatory body, summoned before any grand jury, investigated by any other law-enforcement agency, or arrested or indicted or otherwise prosecuted on any charge arising out of any act committed in the discharge of his official duties, the Superintendent may employ special counsel approved by the Attorney General to defend such officer. Upon a finding that (i) the officer did not violate a law or regulation resulting from the act which was the subject of the investigation and (ii) the officer will not be terminated from employment as the result of such act, the Superintendent shall pay for the special counsel employed. The compensation for the special counsel employed...shall, subject to the approval of the Attorney General, be paid out of the funds appropriated for the administration of the Department of State Police.

As previously mentioned, a recently concluded criminal investigation by a federal grand jury concerning the acquisition of the RF&P Corporation by the prior VRS Board created concerns among some current trustees concerning the adequacy of their potential legal representation, particularly in the event of criminal investigation of possible violations of federal or State securities statute. During the RF&P investigation, two former trustees and a former director incurred substantial personal legal expenses, despite the fact that they were never charged with any individual wrongdoing.

Due to the types of investment decisions that the VRS Board is required to make, and due to the fact that investments are governed and regulated by complex federal securities statutes, the possibility of an inadvertent violation during the performance of the Board’s official duties cannot be ruled out. Such a possibility, and the criminal proceedings and consequences that could result, create a potential situation for the VRS Board that is unique within State government.

Given the statutory exceptions that already exist for certain State employees and officials, and given the unique nature of a VRS trustee’s responsibilities, it may be appropriate to authorize VRS to represent VRS trustees, officers and employees in criminal investigations and other proceedings related to securities laws.

**Recommendation (6).** The General Assembly may wish to consider legislation amending the *Code of Virginia* to provide the Virginia Retirement System with the right to hire special legal counsel, approved by the Attorney General, to provide representation during criminal investigations and prosecutions related to federal and State securities laws.