

# Introduction

by Cynthia L. Moore

**The National Council on Teacher Retirement<sup>1</sup> (NCTR)** is pleased to issue this fifth edition<sup>2</sup> of *Protecting Retirees' Money*, a survey of the 50 statewide retirement systems that include kindergarten through grade 12 teachers (“K–12 teachers”) and other public employees. These systems offer retirement security to roughly 17 million current and future retirees and hold around \$1.75 trillion in assets.

This publication explains the structure of the retirement systems that serve K–12 teachers and other public employees. It details the composition of the boards that oversee most of the systems. It describes whether a board administers the pension plan and invests its assets or whether some other entity carries out the investments.

A broad array of laws protects the assets of these retirement systems, as shown in the publication. These laws regulate the conduct of the fiduciaries who invest the assets. Because these fiduciaries are responsible for the money that will be paid to retirees, these fiduciaries are subject to the most stringent laws possible. They must adhere to prudence rules, conflicts of interest laws, and codes of ethics. As in the previous editions, the publication provides the citations to all the statutes, as well as relevant case law and regulations, so readers can obtain further information.

The publication shows the considerable extent of oversight and reporting that ensure accountability of the retirement systems. They are subject to legislative and executive oversight. They also prepare and widely disseminate a variety of reports that show their financial position and other critical data.

Finally, the publication summarizes the protection of plan participants’ right to their pensions. Some protections are in state constitutions or statutes. Others arise from court decisions. In many states, more than one type of protection exists.

This publication will assist federal policy makers in evaluating the extent of protection afforded to retirement systems that serve K-12 teachers and other public employees. It will also aid state legislators and other policy makers who wish to learn more about these retirement systems.

## Methodology

The information in this publication was gathered between February and May 2005. The administrators of the systems covered by this publication reviewed for accuracy the section relating to their system. Because state law changes from time to time, readers who need the most up-to-date data possible should refer to the statutes of the state in question, check with the relevant retirement system, or go to [www.nctr.org](http://www.nctr.org) and click onto Member Directory for information about any of the retirement systems in this publication.

## Overview

The retirement plans in this publication are principally defined benefit plans. Such plans are the primary retirement vehicle for most K–12 teachers and other public employees in the United States. A defined benefit plan provides a benefit based on a formula. The formula generally uses an individual’s years of service, multiplied by his/her final average salary, multiplied by some percentage (usually between 1.5 and 2%).

## Governance

Defined benefit plans offer a comprehensive package of guaranteed benefits to help ensure a high performance workforce. The legislatures of state and local governments (SLGs) create these packages of benefits through retirement programs. The relevant legislature establishes an entity, sometimes known as a system, within the government to operate the retirement program. The entity is generally overseen by a board of trustees and managed on a day-to-day basis by staff. The administrators and trustees of the

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<sup>1</sup> NCTR is a national association of 74 state, local, university, and territorial retirement systems. Some NCTR members cover teachers exclusively, whereas others serve additional state and local employee groups.

<sup>2</sup> NCTR published the previous editions in 1990, 1992, 1995, and 2000. This latest edition also incorporates and updates data from another NCTR publication, *Public Pension Plans: The State Regulatory Framework*.

systems make management decisions according to the state or local statute that governs them. Some systems also have the responsibility to invest the assets used to pay benefits. Trustees and administrators of SLG retirement systems must obey fiduciary, ethics, and other laws, the violation of which may result in fines and other punishment.

The relevant legislative body makes decisions about pension benefits. The legislative process allows the views of employers, employees, and taxpayers to be heard. In addition, meetings of retirement system boards are open under state sunshine laws. In these ways, pension decision making is an open and public process.

SLG retirement systems are subject to audits and actuarial valuations on a regular basis. They file financial reports with the Governor, legislature, or designated governmental bodies. Under state open records laws, decisions made by retirement systems are available to the public. In addition, retirement systems carry out extensive outreach to their membership through regular reports and notices.

### ***Funding and Return of Investment to Economy***

Funding for retirement benefits for SLG employees comes from three sources:

- Employer contributions, provided by taxpayers;
- Employee contributions, paid by the plan participants themselves; and
- Earnings from the contributions.

According to the Public Fund Survey (PFS) and the U.S. Census Bureau, the bulk of funding for benefits derives from earnings. For the 20-year period ending in 2002, earnings paid 62% of benefits. Employer contributions made up 26%. Unlike in the private sector, employees must contribute to their plans. Their share amounted to 12%.

As a group, SLG plans have nearly 90% of the funds required for each dollar they owe in future benefits. Professional investment managers invest the assets, subject to the strict structure of fiduciary laws. For the 5- and 10-year periods ended 12/31/04, SLG pension funds earned 4.1% and 10.2%, compared to corporate pension plans' returns of 3.9% and 10.8%, according to PFS data.

The assets held by SLG plans are an important source of liquidity and stability for financial markets. Most of the assets are in stocks and bonds, but a significant segment goes to other investments, such as real estate and venture capital.

Not only do the assets contribute to financial markets, they also strengthen local economies. SLG pension plans annually distribute benefits to six million recipients. The average annual benefit is \$18,500. Benefit recipients, who usually reside in the same area where they worked, fuel local economies with these funds.

### ***Portability***

Although many people think that pension portability is achieved only through defined contribution plans, such as 401(k)'s, SLG defined benefit plans provide broad portability through purchases of service credit. Such purchases allow teachers and other public employees to recover service credit for work with previous employers for which they will not earn such credit. Previous employers may include other state or local governments, the federal government, or for-profit and non-profit organizations. The law of each state sets out rules for such purchases, which are also known as "buy backs of prior service." The purchases allow an individual to combine years of service so that his/her final pension benefit will represent, as closely as possible, all of his/her years of work for which he/she earned service credit.

### ***Narrow Federal Government Role***

Although the retirement systems in this publication are creatures of the state that established them, the systems are subject to a narrow range of federal regulation. These regulations govern the tax treatment of the current and future benefits of the participants in SLG retirement systems. The federal regulation appears in various sections of the Internal Revenue Code.

Over the years, a well-established line between SLG and federal government regulation of the retirement systems has developed. The line defines which entity, SLGs or the federal government, has responsibility for some aspect of regulation. The regulation of company retirement plans is markedly different. Such plans are wholly subject to federal regulation through the Employee Retirement Income Security Act (ERISA). SLG retirement systems, by contrast, are exempt from this broad federal regulation, except for that described above. Regulation comparable to that under ERISA is carried out at the SLG level.

## Retirement Boards, Plan Administration, and Asset Investment

As noted above, retirement programs for SLG employees, including K–12 teachers, are usually overseen by a board with the daily administration generally carried out by a retirement system. Forty-seven out of the 50 retirement systems in this publication have boards. State officials, plan participants, retirees, and members of the public commonly sit on the boards. As noted on Table 1, plan participants are well represented. Out of 476 positions in the 47 retirement systems, 216 are for plan participants. By contrast, private sector pension plan boards (with the exception of multi-employer plans) are usually composed of employer representatives only.

In 31 states, the retirement board oversees the plan administration and the asset investment. In the remainder, the functions are split between two entities. Table 2 shows the break down. The investment function is carried out by a board separate from the retirement board or by a single state official.

## Fiduciary and Other Laws

The duty of a fiduciary is to manage someone else's money. In the context of SLG pension systems, board members and system administrators act as fiduciaries because they handle the assets that will be paid to plan participants as benefits. According to a 19th century case, a fiduciary "shall conduct himself faithfully and exercise sound discretion." *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1830). These two duties—conducting oneself faithfully and exercising sound discretion—form the principles underlying the prudence standards that govern the SLG pension systems in this publication.

Prudence laws are not the only standards applicable to SLG retirement plan fiduciaries. A majority of states require fiduciaries to adhere to conflicts of interest laws and in all states, codes of ethics apply. Prudence standards are discussed in this section. The conflicts of interest and ethics laws are treated later in this section.

## Prudence Standards

All systems in this publication except one<sup>3</sup> use a prudence rule. The rule is usually in statute. In the few instances where it is not statutory, it may be in regulation, interpreted through case law, or adopted by system administrators as a matter of policy. The majority of systems in this publication use either the prudent investor or the prudent person rule. The remainder use some variation. Readers will find a summary of the prudence standards in Table 3.

(1) **Prudent Investor Standard.** The most common standard is that based on the Employee Retirement Income Security Act of 1974 (ERISA), ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1). It is commonly called the "prudent investor" standard. The following example applies to trustees of the Teachers' Retirement System of the State of Illinois.

A trustee must discharge his or her duties with respect to the retirement system solely in the interest of the participants and beneficiaries; and for the exclusive purpose of providing benefits to participants and their beneficiaries; and defraying reasonable expenses of administering the retirement system or pension fund; with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man<sup>4</sup> acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims; by diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. 40 ILCS 5/1-109.

Thirty-four systems in this publication use some variation of this standard. They are: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, New Hampshire, New Jersey, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

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<sup>3</sup> The assets of North Carolina's retirement system are invested according to a standard in which the investment objective is to transact in the best interest of beneficial owners.

<sup>4</sup> Some states use "man" while others use "person" or "investor."

(2) **Prudent Person Standard.** Eight systems in this publication use a slightly different rule, which is commonly called the “prudent person” standard. The following statute, which governs investments of the Iowa Public Employees’ Retirement System, is typical.

In establishing the investment policy of the retirement fund and providing for the investment of the retirement fund, the system and board shall . . . exercise the judgment and care, under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for the purpose of speculation, but with regard to the permanent disposition of funds, considering the probable income, as well as the probable safety, of their capital. Iowa Code Ann. § 97B.7(1)(a).

The systems in this publication that use a form of this standard are: Connecticut, Delaware, Iowa, Minnesota, Nevada, Pennsylvania, South Dakota, and Texas. In Connecticut, the prudence standard is not defined in the statute, but a court applied the same definition as that given above for Iowa. While the Delaware Public Employees’ Retirement System is not subject to a statutory prudence standard, it has adopted the prudent person standard as a matter of policy.

(3) **Other Formulations of Prudence Rules.**

Other systems in this publication use variations of the prudence rule. For example, the North Dakota State Investment Board, the entity that invests the funds of the Teachers’ Fund for Retirement, is subject to the following rule.

In making investments, the fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation but in regard to the permanent disposition of funds, considering the probable safety of capital as well as probable income. N.D. Century Code § 21-10-07.

Other systems that use variations are Hawaii, Nebraska, New Mexico, New York, Utah, and Vermont. In New York, the prudence standard for the State Teachers’ Retirement System is located in regulation.

### **Legal Lists**

In addition to the prudence rule, 19 systems in this publication are also subject to legal lists. These lists set limits on the types of investments in which retirement system trustees and administrators may invest (e.g., no more than 50% of plan assets may be invested in stock). The lists also prohibit in some cases any investment of system assets in certain types of investments.

States having legal lists are: Arizona, Colorado, Connecticut, Florida, Georgia, Kansas, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, New York, North Carolina, Oregon, Tennessee, Washington, West Virginia, and Wisconsin. Table 3 shows which states have legal lists.

### **Other Authority**

In some states, retirement systems are given statutory authority to make economically targeted investments (ETIs). ETIs are generally defined as investments that are selected for the economic benefits they create in addition to their investment return to the pension plan. Even though the investment provides a collateral economic benefit, it must still satisfy the applicable prudence standard. Accordingly, the language of ETI authority is generally hortatory, not mandatory.

Twenty-one systems in this publication have ETI statutory language. They are: Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Illinois, Iowa, Kansas, Kentucky, Massachusetts, Michigan, Minnesota, Montana, Ohio, Pennsylvania, Rhode Island, Tennessee, Texas, and West Virginia. Statutory language is not always needed for ETI investment. Some systems without explicit statutory language do so because such investments are considered prudent under their general investment authority.

With respect to Northern Ireland, the legislatures’ concern relates to discrimination in employment based on one’s religion. Frequently, the statutes permit the retirement systems to invest only when the relevant company in Northern Ireland adheres to the MacBride principles. The principles cover practices designed to avoid religious discrimination. Two systems in this publication are subject to restrictions: Connecticut and Massachusetts. Minnesota encourages affirmative action in Northern Ireland. Laws in Michigan, Nebraska, and Rhode Island advocate shareholder resolutions that support the MacBride principles.

Other restrictions are also included in this publication. Connecticut has a limitation on investment in Iran. The officials responsible for investment of the Florida Retirement System's assets may not invest in Cuba. California retirement systems may not make any new or additional investment in companies that comply with the Arab League's boycott of Israel.

Five states have laws that encourage retirement systems to use minority investment managers. These individuals are sometimes referred to as "Emerging Investment Managers." The following states have such statutes: Illinois, Missouri, Ohio, Tennessee, and Wisconsin.

### ***Conflicts of Interest Rules***

Trustees, administrators, and others in 38 systems are subject to conflicts of interest rules. An example follows that governs the conduct of trustees of the North Carolina Teachers' and State Employees' Retirement System.

Trustees may have no direct interest in gain or profits of the plan investments, nor be an endorser, surety, or obligor on loans to or from the system. N.C. Gen. Stat. § 135-7(e).

The other states having this type of law, in addition to North Carolina, are: Alabama, Arizona, Arkansas, California, Colorado, Georgia, Hawaii, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts (in regulations), Minnesota, Mississippi, Missouri, Montana, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, West Virginia, Wisconsin, and Wyoming.

### ***Codes of Ethics***

In addition to the conflicts of interest rules, all states have codes of ethics. These codes govern the conduct of public officials and employees and impose various civil and criminal penalties for violations, as well as sanctions such as removal from office. The relevant provisions of the codes applicable to board members, officers, and employees of the retirement systems are included in this publication.

## **Oversight and Reporting**

All retirement systems in this publication are subject to extensive oversight of their operations. The systems are required by law to have an annual audit performed by either a state auditor or an independent auditor or by both. All of the retirement systems have actuarial valuations performed by certified actuaries. Most have them annually. Most also commission periodic valuations of the mortality, service, and compensation experience of members and beneficiaries. These reports, which are usually prepared by major national firms with pension fund expertise, are distributed to key officers of a state's executive and legislative branches.

In addition to these outside assessments, all retirement systems in this publication are required to file detailed financial reports with the Governor or some other members of the executive branch and the legislature, usually on an annual basis. These reports, although differing in form from state to state, provide comprehensive information on the financial performance of the system.

As this publication demonstrates, many states have special legislative retirement commissions charged with ongoing review of the performance of SLG pension systems and with making recommendations for needed legislative reforms. States without formal oversight commissions have designated permanent and interim committees of the legislature to oversee pension fund performance. These developments have resulted in a core group of state legislators and staff with special expertise on the complicated issues affecting SLG pension plan administration.

Finally, many states prepare a fiscal or actuarial note for pension legislation. The note provides an estimated cost and other information associated with the proposed change. As with the other means of oversight and reporting, these notes help ensure a full and formal discussion of any proposed changes to the retirement law.

## **Guarantee of Pension Rights**

As a general proposition, participants in the pension systems in this publication are afforded the right to receive retirement benefits at a defined point in the future. SLG employees—like their private sector counterparts—regard their pension benefits as an integral part of the employment

contract, with the expectation that benefit levels cannot be reduced without the agreement of both the employer and the employee. This perception, and the political pressure exercised to make it a reality, have resulted in the gradual transformation of the law defining benefit rights from one that treats a pension as a gratuity that can be amended by the legislature at will, to one that views a vested pension as a contractual right that can only be modified for good reason, if at all.

Legislators clearly recognize the existence of these rights. The National Conference of State Legislatures (NCSL) warned that “legislators should be mindful that any revisions of pensions occur within a framework of guarantees, and that they have only a limited power to affect past decisions.” *Public Pensions: A Legislator’s Guide*, NCSL, 1995.

Constitutional provisions, statutes, and case law protect the pensions of SLG employees. Of the 50 states covered by this publication, most have at least one major form of pension protection and many have multiple forms. The major forms break down into the following groupings:

- Nine have constitutional provisions guaranteeing pension rights;<sup>5</sup>
- 20 have explicit guarantees in their statutes;<sup>6</sup>
- 18 have common law pension rights developed by courts (described below);<sup>7</sup> and
- Three approach the issue in other ways.<sup>8</sup>

The number of states with express guarantees has increased since the last edition of this publication. New Jersey in 1997 and Connecticut in 2003 added protections to their statutes.

Courts have developed a body of common law pension rights defining exactly what these rights are in the absence of constitutional and statutory provisions. Most state courts have adopted a common law rule defining the pension right as a contractual one. All of these preclude any modification of the pension rights of retirees;

however, some permit a modification of the entitlements of employees who have vested but not yet retired, but only if some standard is met. In many states, any resulting disadvantage to participants must be offset by a comparable new advantage.

The law in some states offers the participant in an SLG pension plan considerably greater protection than is provided in the private sector. Internal Revenue Code Section 411, applicable to private plans only, prevents cutbacks in benefits that have already accrued, but does not protect the plan participant’s right to future benefit accruals. The pension rights of some SLG employees preclude changing the benefit formula, even with respect to future accruals (e.g., *PEF v. Cuomo*, 62 N.Y.2d 450 (1984)). Thus, an employee’s pension benefits are fixed on date of hire; no changes can be made thereafter, except improvement of benefits. If the plan sponsor wishes to decrease pension benefits, it can only do so for employees hired after a certain date in the future.

## Conclusion

The retirement systems in this publication are public entities that are created by the legislature and funded through tax revenues, employee contributions, and investment income. The plans serve K–12 teachers and many other public employees. These plans are subject to an extraordinary level of oversight through the legislative and the executive branches of the states.

The regulatory frameworks governing these retirement systems are well conceived and generally well enforced. They are reviewed periodically and systematically by the state legislatures. The necessary laws are on the books to protect plan participants and beneficiaries. It’s up to state government officials, retirement system administrators, system participants, and the concerned public to make certain that they are effectively implemented.

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<sup>5</sup> Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, New Mexico, New York, and South Carolina. The South Carolina provision relates more to funding than to specific contractual rights.

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<sup>6</sup> Connecticut, Florida, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Montana, Nevada, New Jersey, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Virginia, and Wisconsin.

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<sup>7</sup> Alabama, Arkansas, California, Colorado (based on the state’s constitutional contract clause), Delaware, Georgia, Idaho, Indiana, Missouri, Nebraska, New Hampshire, North Carolina, Oklahoma, Oregon, Texas, Utah, Washington, and West Virginia.

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<sup>8</sup> Minnesota embraces a theory of promissory estoppel to protect the public employee from unreasonable changes in his/her pension expectations. The author found no statutes or cases directly on point in either Vermont or Wyoming.

Cynthia L. Moore is an attorney who specializes in issues affecting state and local government retirement systems. As part of her practice, she serves the National Council on Teacher Retirement (NCTR) as its Washington Counsel. She provides comprehensive oversight of federal legislative and regulatory issues that affect NCTR members. She also works with individual retirement systems and other clients on various issues. Ms. Moore has conducted many surveys on state laws affecting state and local government retirement systems, including those that serve teachers. Surveys include cost of living adjustments for retired teachers, fiduciary and other protections in state law for public retirement plans and their participants, portability of defined benefit plans through purchase of service credit, and yearly surveys on state legislative developments in teacher retirement. Ms. Moore speaks around the country on pension issues and other retirement issues, such as Social Security reform. Before entering law practice, Ms. Moore served as a member of former Congressman Dan Glickman's legislative staff for five years. Ms. Moore graduated from Case Western Reserve Law School in Cleveland, Ohio. She was elected Notes Editor of the Law Review. She is a member of the bar of the Commonwealth of Virginia, the District of Columbia, and the United States Supreme Court.