

## MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Chapter 32, Section 23B Contract Terms, Indemnification, Disclosure, and Fiduciary Duty

DATE: October 18, 2012

Chapter 176 of the Acts of 2011 inserted Section 23B into Chapter 32 of the General Laws. That section delineates a specific procurement process to be followed by retirement boards when seeking certain services. It also mandates that contractual terms relative to fiduciary status, indemnification, and disclosure be incorporated into contracts for “investment service providers”.

In order to provide guidance to retirement boards, attorneys, investment consultants and managers (particularly general partners in the context of partnership or trust agreements) the Commission sets forth the following as to the provisions of Section 23B relating to fiduciary status, indemnification and disclosure.

Chapter 32, Section 23B requires that contracts entered into by retirement boards include and/or exclude certain terms and conditions. Specifically these include terms:

“(a) stating that the contractor is a fiduciary with respect to the funds which the contractor invests on behalf of the retirement board; ... (c) requiring the contractor to annually inform the commission and the board of any arrangements in oral or in writing, for compensation or other benefit received or expected to be received by the contractor or a related person from others in connection with the contractors services to the retirement board or any other client; (d) requiring the contractor to annually disclose to the commission and the retirement board compensation, in whatever form, paid or expected to be paid, directly or indirectly, by the contractor or a related person to others in relation to the contractors services to the retirement board or any other client; and (e) requiring the contractor to annually disclose to the commission and the retirement board in writing any conflict of interest the contractor may have that could reasonably be expected to impair the contractor’s ability to render unbiased and objective services to the retirement board.”



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Indemnification

The statute also requires that the contract include terms "... (b) stating that the contractor shall not be indemnified by the retirement board ...". Thus the applicability of any such indemnification clause to a retirement board is prohibited.

It is important in this context to review relevant terms as defined in Section 23B.

The prohibition states that the "contractor shall not be indemnified" by the board. The definition of contractor is "a person having a contract with a retirement board."

As a result the prohibition on indemnification runs to the person providing the services to the retirement board. Section 23B defines a "person" as "a natural person, business, partnership, corporation, union, committee, club or other organization, entity or group of individuals."

A contract is defined in Section 23B as "an agreement for the procurement of services, regardless of what the parties may call the agreement."

The statute does not define "indemnification".

Applying this to the investment management context requires an assessment as to how this law is given effect under the legal structure governing the relationship between the retirement board and "contractor".

In the separate account context the inclusion of this term and others required by Section 23B is straightforward. The investment manager is the contractor, the investment management agreement is the contract, and that contract must contain the terms required by Section 23B.

In the context of limited partnerships and similar legal entities the retirement board or system becomes a limited partner or other similar party and, through that vehicle, another party (often the general partner or an affiliate) contracts to manage assets of the limited partners including those of the retirement board or system.

In the limited partnership, trust and mutual fund context the application of the statutory terms is required but the manner in which that is accomplished is different. In the absence of the necessary terms being in the partnership or trust agreement the normal method of establishing unique terms for one investor is through a legally binding contractual agreement referred to as a "side letter". In the event that the partnership agreement does not comply with the statute, the 23B mandatory terms relating to fiduciary status, indemnification and disclosure must be set forth in such an agreement between the retirement board and the contractor.

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It is particularly important to note that the indemnification exclusion relates to the contractor or general partner in the limited partnership situation because it is the general partner that is providing services to the retirement board and not the limited partnership itself. Thus, although the law prohibits the retirement board from indemnifying the "contractor", in this case the general partner, it does not prohibit the retirement board in its capacity as a limited partner from indemnifying the limited partnership.

Recently the Commission addressed this issue with a Board and its attorneys and the following language in the side letter was deemed to comply with the statute:

"Section 3(a) of the Investment Manager and Subscription Agreement of \_\_\_\_\_ (the "Subscription Agreement") is deleted in its entirety and the Manager hereby waives all right to indemnity by \_\_\_\_\_ that it would otherwise be entitled to under the terms of the LLC Agreement, Confidential Placement Memorandum, and/or Subscription Agreement."

A second issue that arises in the context of these investment vehicles and indemnification is how to address liabilities that result from the misfeasance or malfeasance of a limited partner when that limited partner is a retirement board. In making these investments retirement boards provide various assurances to the other limited partners as well as the general partners relative to the status of the retirement board, its legal ability to make the investment and other issues. Responsibility for liability to the partnership or general partner arising from the retirement board making inaccurate or misleading assertions as to these matters or a failure of the retirement board to meet its obligations under the agreement is not the type of "indemnification" that the statute prohibits.

Again we recently addressed this issue and the following language was deemed satisfactory:

"(a) Section 3(b) of the Subscription Agreement is deleted in its entirety and replaced with the following:

Notwithstanding anything to the contrary in the LLC Documents, the client hereby agrees to indemnify, to the fullest extent permitted by law, the LLC, within the meaning of Section 15 of the Securities Act of 1933, as amended (the "Securities Act"), against any and all losses, claims, damages expenses and liabilities, including, but not limited to, any reasonable investigation, or reasonable legal or other reasonable expenses incurred in connection with (i) any false representation or warranty made by the Client, or breach or failure by the Client to comply with any covenant or agreement made by the Client, in the LLC documents or in any other document furnished by the client to any of the foregoing in connection with this transaction or (ii) any action for securities law violations instituted by the Client which is finally resolved by judgment against the Client. The Client also agrees to indemnify the LLC, to the fullest extent permitted by law for any and all costs, fees, and expenses resulting from the Client's assertion of

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lack of proper authorization to enter into this Agreement or perform the obligations hereof because such Client is acting as agent, representative or nominee for a subscriber.”

Disclosure

As cited above Section 23B also mandates that contractors provide annual disclosures to the retirement board and PERAC. Under separate cover guidance will be provided in that regard. In this memo we are addressing the meaning of that requirement in the context of contract agreements, particularly the arrangements outlined above.

The disclosure requirement required by statute states “(d) requiring the contractor to annually disclose to the commission and the retirement board compensation, in whatever form, paid or expected to be paid, directly or indirectly, by the contractor or a related person to others in relation to the contractors services to the retirement board or any other client;” (similar language appears in (c)).

The primary concern in this regard is the meaning of the term “...any other client”. PERAC believes that the statute did not intend that every possible arrangement relating to all public, private, and individual clients of a contractor be disclosed. It is the position of the Commission that the statutory requirement to disclose the noted compensation “...in relation to the contractors services to ... any other client” can be met by disclosing such compensation in connection with the investment being made by the other clients in the same product or for the same service in which the retirement board is investing. For example, if the retirement board is investing in Venture Capital Limited Partnership V, compensation paid in relation to the retirement boards’ investment and the investment of others in that partnership must be disclosed.

The identity of the other client need not be disclosed.

In addition the statute uses the term “related person”. The Commission interprets that phrase in a manner that is generally consistent with the definitions included in the SEC ADV Glossary of Terms. Applying that here results in a “related person” being any affiliate or any person that is under common control with the contractor. Section 23B defines a “person” as “a natural person, business, partnership, corporation, union, committee, club or other organization, entity or group of individuals.”. “Control” means the power, directly or indirectly, to direct the management or policies of a person whether through ownership of securities, by contract or otherwise.

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Fiduciary Duty

Finally the Commission has addressed the issue of the Fiduciary Representation in the context of these arrangements by finding that the following is deemed satisfactory in a side letter:

“The Manager hereby represents and warrants to, and agrees with \_\_\_\_\_, that the Manager, and any investment advisor employed in connection with this Fund, is a fiduciary with respect to the Fund, which includes the assets invested by \_\_\_\_\_, and will discharge its duties to the Fund, including the assets invested by \_\_\_\_\_, with the 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 an enterprise of a like character and with like aims and investment policies.”

Retirement boards should carefully review partnership agreements, trust agreements and other similar investment vehicles to discern if the terms of such agreements run afoul of Section 23B. In such instances the retirement board may wish to explore the possibility of negotiating a side letter with the general partners or other similar entities that bring the contract between the retirement board and the contractor into compliance with the law.