

PERAC

COMMONWEALTH OF MASSACHUSETTS | PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

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MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Fund of Funds/Manager of Managers

DATE: May 20, 2014

In the wake of passage of Chapter 176 and the insertion of Section 23B into Chapter 32 questions have arisen as to the impact the investment provisions of that legislation on the use of a “fund of funds” or “manager of managers” (FOF/MOM) vehicle by retirement boards. The evolution of the marketplace has seen an increase in the strategies that use this structure as well as in the entities that offer such products.

There has also been an evolution in the marketing of investment managers or partnerships. A recent invitation from the Opal Financial Group (Opal) has relevance to the discussion of disclosure by sub-advisors (investment managers). Opal is sponsoring an event that promises investment managers (in the context of a FOF sub-advisor) one on one meetings with “...institutional investors”. Public and corporate pension funds are granted complimentary registration. The pertinent statement is:

“Fund of Fund Managers are invited free only if the person attending from the firm is part of the investment team. Marketing and Business Development associates do not qualify for complimentary passes. **All other Managers and service providers are required to sponsor the event.**” (Emphasis added).

In this respect Opal is acting as a placement agent and the FOF Managers are a draw for investment managers to attend and gain unfettered access to those FOF managers as well as pension fund investors. These investment managers (potential sub-advisors in the FOF scenario) pay Opal, the placement agent, in order to obtain this access. The invitation states:

“Asset Gatherers and Allocators have the opportunity to request specific one on one meetings through the Opal Exchange scheduling tool. While at the event, Asset Gatherers will have a private Meeting Suite in which they will host up to 24 intimate meetings with potential allocators. Each exchange will last 25 minutes...”

In the absence of a policy such as that set forth herein, the payment by the investment manager (sub-advisor) to the placement agent (Opal) for access to the FOF manager would not be reported to the retirement board and the Commission. This is one example, however, the same would be true of



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any payments made by the investment manager (sub-advisor) to others in connection with seeking to be a manager or fund to whom the FOF or MOM allocates retirement system assets.

This Memorandum is designed to provide a framework that enables a retirement board to employ this option when investing retirement system assets.

Statutory Analysis

The Commission has long recognized the fact that these instruments are used with respect to alternative and hedge fund investment. In fact, the Commission Hedge Fund Guideline called for investing in this manner. More recently products have been developed that provide for much, if not all, of a pension fund's assets to be managed through a "fund of funds" or by a "manager of managers".

It is therefore the position of the Commission that the phrase in Chapter 32, Section 23(b) requiring that a retirement board "(ii) in investing funds...shall employ an investment manager who shall invest the funds of the systems;" does not preclude the use of a "fund of funds". In fact at the time of passage of the statute the use of fund of funds managers by the retirement systems was not uncommon, particularly regarding alternative and hedge fund investing. That history supports the view that the Legislature did not intend to preclude the use of the fund of funds structure through adoption of Chapter 176.

However, in the absence of meeting the general intent of the statute in terms of process, transparency/disclosure, indemnification and fiduciary duty the FOF/MOM structure would provide the Commission with no alternative other than to conclude that investing through such a structure is not "...in the best interests of the retirement system..." and preclude the Commission from issuing an Acknowledgement Letter.

Retirement boards in selecting a FOF/MOM manager or Discretionary Manager (DM) must comply with the provisions of Chapter 32, Section 23(b), Section 23B and other relevant provisions of law and regulation, as well as meet the fiduciary duty set forth in Section 23(3) of that Chapter.

Compliance with Statute

However, there are a number of other provisions of Chapter 32, Section 23(b) and Section 23B that must be met in order for such an investment structure to ensure compliance with the law. Conceptually the "fund of funds" manager is acting as an investment consultant with broader authority. As noted, the retirement board must comply with all of the statutory provisions in selecting and retaining the FOF/MOM/DM manager. Similarly, in selecting an investing manager the FOF/MOM manager must satisfy the intent of the provisions of Chapter 32, Section 23(b), Section 23B and other relevant provisions of law and regulation as well as meet the fiduciary duty set forth in Section 23(3) of that Chapter.

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Investment Restrictions

Massachusetts law contains several prohibitions that bar the investment of retirement system assets in certain instruments and companies. All of the parties (retirement board, FOF/MOM manager and Selected or Investing Managers) are restricted in their investment activities by these prohibitions. The statute sets those restrictions forth as follows:

- (i) no investment of funds shall be made in stocks, securities or other obligations of a company which derives more than 15 per cent of its revenues from the sale of tobacco products; (ii) in investing funds the board shall employ an investment manager or investment managers who shall invest the funds of the system; and (iii) no funds shall be invested directly in mortgages or collateral loans.

Retirement Board Process

Chapter 32, Section 23(b) requires the following be submitted to PERAC as part of the initiation of an investment:

- (c) No investment of funds shall take place until the board has received from the commission an acknowledgement of receipt of the following: (i) certification that, in making the selection, the board has complied with the process established in section 23B; (ii) a copy of the vendor certification required under section 23B; (iii) copies of disclosure forms submitted by the selected vendor; (iv) a certification that the investment is not a prohibited investment as set forth in regulations of the commission; (v) if the board has retained a consultant, a copy of the consultant reports pertaining to the investment and the selected vendor; (vii) a copy of the board certification required under section 23B.

In the case of a FOF/MOM or DM a copy of the due diligence process followed by the FOF/MOM in selecting, retaining and monitoring an investing manager must also be submitted to the Commission.

The Commission may withhold the acknowledgement if it determines that it is in the best interest of the retirement system. If the Commission determines that the due diligence process followed by the FOF/MOM/DM in selecting, retaining and monitoring investing managers does not meet the parameters of Section 23B it shall not issue an Acknowledgment Letter.

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FOF/MOM/DM Selection of Investing Managers

For purposes of the selection and retention of an investing manager by a FOF/MOM manager or DM the Commission requires the following to be filed with the Commission with respect to each such selection:

No investment of funds by a FOF/MOM or DM manager shall take place until the board and the FOF/MOM/DM manager has received from the Commission an acknowledgement of receipt of the following: (i) certification that, in making the selection, FOF/MOM/DM manager has complied with a process reviewed by the Commission as set forth herein; (ii) a copy of the vendor certification required under section 23B for the selected or investing vendor; (iii) copies of disclosure forms submitted by the selected or investing vendor; (iv) a certification that the investment is not a prohibited investment as set forth in regulations of the commission; (v) a copy of detailed reports and evaluations of the FOF/MOM/DM manager pertaining to the investment and the selected or investing vendor; (vi) a copy of the board certification required under section 23B; (vii) a copy of the placement agent statement completed by the selected or investing manager and (viii) a copy of the selected or investing managers registration with the SEC or, if applicable, the Massachusetts Office of the Secretary of State.

Similarly the FOF/MOM manager or DM must follow a process in selecting funds that parallels that set forth for retirement boards in Section 23B. The goal of that statute is to assure that an open, fair and competitive process is used in selecting vendors that will invest the assets of retirement systems. The Commission recognizes that in the FOF/MOM/DM setting the detailed process set forth in Section 23B is impractical. As a result the retirement board as part of the RFP process for the selection of a FOF/MOM manager or DM shall require that the prospective manager submit a detailed review of the due diligence process it follows in selecting, retaining and monitoring investing managers. The retirement board shall assess each prospective manager's due diligence process and incorporate that assessment into the evaluation criteria used to select an FOF/MOM manager or DM. Such a process is as follows:

- (1) The FOF/MOM/DM process must be open in that new managers/funds can gain entry to the platform;
- (2) The evaluation criteria used by the FOF/MOM/DM manager as part of the selection, retention and monitoring process must be independent and objective;
- (3) The evaluation criteria that will be utilized in those circumstances by the FOF/MOM/DM must be clear and available to prospective investing managers; and,

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(4) Evaluation of investing managers shall be based solely on those criteria.

In addition, Section 23B establishes mandatory contractual terms to be incorporated into agreements governing the investment of retirement system assets. Modifying the statutory language in light of the FOF/MOM/DM structure the Commission requires the following be set forth as part of the terms of a contract:

- (a) The selected or investing manager must agree that it is a fiduciary with respect to the funds which are invested on behalf of the retirement board;
- (b) The selected or investing manager must agree that it shall not be indemnified by the retirement board;
- (c) The selected or investing manager must 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 selected fund manager's services relating to the retirement board or any other client;
- (d) The selected or investing manager must 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 connection to the fund manager's services relating to the retirement board or any other client; and
- (e) The selected or investing manager must annually disclose to the Commission and the retirement board in writing any conflict of interest the selected fund manager may have that could reasonably be expected to impair the selected fund manager's ability to render unbiased and objective services relating to the retirement board.

Placement Agent

In addition to the filings and contractual provisions noted above, the prospective investing managers must also comply with the PERC Placement Agent Policy (PERAC Memo #34/2011). As a result these firms must submit a completed placement agent form to the retirement board and the Commission.

Debarment

In the event that a fund or a manager that has been selected by a FOF/MOM manager has been debarred or suspended by the Commission pursuant to Section 21A of Chapter 32 the FOF/MOM manager shall not allocate assets of a Massachusetts retirement system to said fund or manager.

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Registration

In the event that a fund or manager that has been selected by a FOF/MOM manager is not registered with the Securities and Exchange Commission or, if applicable, the Massachusetts Office of the Secretary of State, the FOF/MOM manager shall not allocate assets of a Massachusetts retirement system to said fund or manager.

Failure to Agree to Terms/Disclose

In the event that a fund or a manager that has been selected by a FOF/MOM manager has failed to agree to the mandatory contractual terms in Section 23B in a manner that meets the provisions of this policy or fails to file the disclosures required by said Section in a manner that meets the provisions of this policy, the FOF/MOM manager shall not allocate assets of a Massachusetts retirement system to said fund or manager, provided, however that the FOF/MOM may allocate said assets to funds or managers that have so agreed and disclosed.

Mandatory Contract Terms

As noted the FOF/MOM approach presents several challenges for the Commission as it attempts to accommodate the offering of this option to retirement boards with the need to meet the disclosure, fiduciary duty, indemnification and selection process mandates of Chapter 32, Section 23B. The relationship created by the FOF/MOM structure is Retirement Board –FOF/MOM manager – Selected or Investing Managers. It is agreed that a retirement board must follow all of the dictates of Section 23B in choosing a FOF/MOM manager or DM. The outstanding matters pertain to the impact of Section 23B on the FOF/MOM managers or DM process of selecting Selected or Investing Managers as well as the obligation of Selected/Investing Managers to meet the transparency/disclosure, indemnification and fiduciary requirements of Section 23B. In the absence of those Selected/Investing Managers doing so the provisions of Section 23B would be rendered moot and the protections offered to retirement boards by that statute would be voided.

There are several possible approaches to resolving these issues that have been noted by practitioners in the context of FOF/MOM/DM investing:

- (1) The first approach that has been suggested is straightforward and presents little difficulty – The Retirement Board (RB) in a Section 23B compliant search selects the Discretionary Manager (DM) – in the contract between the RB and DM, the DM agrees that it is a Chapter 32 fiduciary, that it will not be indemnified by the RB and that it will file the Annual Disclosures as mandated – The DM selects managers to invest assets of the RB – in direct contracts between the RB and those Selected Managers (SM), the SM's agree that they are Chapter 32 fiduciaries, that no indemnification of the SM by the RB will take place, and the SM will make the

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Annual Disclosures as mandated – in short the RB is merely delegating the final selection decision to the DM;

- (2) The second approach that has been suggested is more complicated – The RB in a section 23B compliant search selects a FOF/MOM manager – in the contract between the RB and the FOF/MOM manager, the FOF/MOM manager agrees that it is a Chapter 32 fiduciary, that it will not be indemnified by the RB and that it will file the Annual Disclosures as mandated – the FOF/MOM manager selects managers to invest assets of the RB - in direct contracts between the FOF/MOM manager and those Selected Managers (SM) the SM's agree that they are Chapter 32 fiduciaries owing a duty to the RB, that no indemnification of the SM by the RB will take place and the SM will make the Annual Disclosures as mandated;

A third approach is also possible-

- (3) The RB in a section 23B compliant search selects a FOF/MOM manager – in the contract between the RB and FOF/MOM manager the FOF/MOM manager agrees that it is a Chapter 32 fiduciary, that it will not be indemnified by the RB and that it will file the Annual Disclosures as mandated – The FOF/MOM manager selects managers to invest assets of the RB – also in the contract between the RB and the FOF/MOM manager or DM the FOF/MOM manager agrees that it will be liable to the RB for any losses due to a failure of a SM to meet the Chapter 32 fiduciary standard, that the FOF/MOM manager will assume any indemnification obligation that may be owed by the RB to the SM and in direct contracts between the FOF/MOM manager and those SM's, the SM's agree to make the Annual Disclosures as mandated.

The Commission will accept any of these three arrangements as meeting the provisions of Section 23B relative to the mandatory contractual terms regarding disclosure, indemnification and fiduciary status. Other structures will be assessed on a case by case basis to determine if these provisions are met.

Fiduciary Representation

One of the mandatory statutory elements set forth in Section 23B is the requirement that the manager agree to status as a fiduciary to the retirement board. PERAC believes that this requirement can be met in the context of FOF/MOM by the following side letter language:

The Manager (FOF/MOM) hereby represents and warrants to, and agrees with (Retirement Board) that the Manager, and any investment manager employed in connection with the Fund, is a fiduciary with respect to the Fund, which includes the assets invested by (Retirement Board), and will discharge its duties to the Fund,

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including assets invested by (Retirement Board), with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims and investment policies.

In the case of an alternative investment MOM the language referring to “any investment manager” would be amended to read “any General Partner”.

Indemnification

Another mandatory statutory element set forth in Section 23B is the requirement that the Manager agree that it will not be indemnified by the Retirement Board. Concerns have been raised relative to this issue and the following side letter language should be considered:

The FOF/MOM will not cause the (Retirement Board) to be contractually obligated to indemnify any investment manager, portfolio fund or portfolio fund manager. In the event that the FOF/MOM fails to comply with this agreement the FOF/MOM agrees to assume any indemnification obligation owed by the (Retirement Board) to the (Selected Manager, Limited Partnership or other investing entity).

We recognize that this is a difficult area in which the statute provides limited direct guidance. However, in issuing this Memo the Commission is seeking to ensure that the dictates of the law are met without the foreclosing of the opportunity for retirement boards to employ the FOF/MOM/DM structure in investing assets.