PERAC

PERAC Memo # 49/2012

COMMONWEALTH OF MASSACHUSETTS | PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

M E M O R A N D U M

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Investment Under Chapter 176 of the Acts of 2011 - #2

DATE: October 11, 2012

INTRODUCTION

The Public Employee Retirement Administration Commission (PERAC) issued PERAC Memo #27/2012, "Investment Under Chapter 176 of the Acts of 2011" earlier this year. At that time it was noted that the Commission was continuing the review of regulations and guidelines that were not addressed in Memo #27/2012. This Memo sets forth the results of that further review.

The Commission continues to assess the issue of system investment in Hedge Funds and hopes to provide guidance relative to that issue and Chapter 176 (particularly as it relates to Indemnification) in the near future.

Attached is a summary of the impact of Chapter 176 on PERAC Regulations and Guidelines reviewed in this Memo and Memo #27/2012.

PERAC'S ROLE UNDER CHAPTER 176

The general statutory language setting forth the manner in which retirement boards are to invest assets is found in the revised Chapter 32, Section 23(2)(b). This represents a dramatic change in the role of PERAC and encompasses the statutory limits on that role regarding the initiation of investment activity by the retirement boards. The specific result of these changes on the pre-Chapter 176 regulatory environment is outlined below. The new statute reads as follows:

> The board of each system shall invest and reinvest the funds of the system in the PRIT Fund under subdivision (8) of section 22, in the PRIT Fund by purchasing shares of the fund, as provided for in the trust agreement adopted by the PRIM board under subdivision (2A), or under the standards in subdivision (3), provided that: (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 revenue 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.

A further restriction in law is set forth in Chapter 32, Section 23(2)(h). This provision retains the existing prohibition on investment directly in mortgages or in collateral loans as well as the limitations on investment in certain companies doing business in South Africa or Northern Ireland.

As always, in addition to statutory and regulatory requirements, retirement boards must invest in accordance with the Fiduciary Duty established in Chapter 32, Section 23(3). That duty is set forth as follows:

> (3) Fiduciary Standards. — A fiduciary as defined in section one shall discharge his duties for the exclusive purpose of providing benefits to members and their beneficiaries 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 by diversifying the investments of the system so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

As cited above, the new law, while retaining the South Africa and Northern Ireland limitations, includes three other statutory directives regarding the retirement board's investment of assets. These include restrictions on investment in companies that generate earnings through the sale of tobacco products (see PERAC Memo #37/1997 and PERAC Memo #48/1997) and prohibitions on investing directly in mortgages or in collateral loans. Perhaps, most significantly, in order to avail itself of the option to invest outside of PRIT a retirement board must employ an investment manager(s) to invest the assets of the system.

These changes result in PERAC no longer providing exemptions from the extensive restrictions previously contained in Subdivision (2)(b). Under the new law the Commission will be reviewing the forms filed under Section 23(2)(c) and, if appropriate, providing retirement boards with an acknowledgement of receipt of those forms.

The regulatory emphasis of the Commission will focus on the retirement board's compliance with its fiduciary duty, the retirement board meeting the requirements of Chapter 176, particularly the procurement process of Chapter 32, Section 23B and the various disclosures mandated by the statute and the Commission's Placement Agent Policy.

The Commission is, however, authorized to "...withhold acknowledgement if it determines it is in the best interest of the retirement system". Such a circumstance clearly arises when the board has not complied with Section 23B, including those provisions pertaining to mandatory contractual terms.

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MANDATORY CONTRACTUAL TERMS

In the context of investing assets it should also be noted that Section 23B requires that each contract with an "investment service provider" include certain mandatory terms and conditions. These provisions must be incorporated into the RFP and agreed to by the contractor as part of that process. The phrase "investment service provider(s)" includes, but is not limited to, managers, partnerships, trusts, custodians, consultants, as well as those providing proxy services, securities litigation services and services related to the financial information (cash books, pooled fund statements, Annual Statements) retirement boards must file with PERAC.

The relevant terms of the statute are:

> (k) (1) In the event of a competitive process to select an investment service provider the request for proposals shall include mandatory contractual terms and conditions to be incorporated into the contract including provisions:
>
> (a) stating that the contractor is a fiduciary with respect to the funds which the contractor invests on behalf of the retirement board;
>
> (b) stating that the contractor shall not be indemnified by 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 contactor's ability to render unbiased and objective services to the retirement board. Other mandatory contractual terms and conditions shall address investment objectives, brokerage practices, proxy voting and tender offer exercise procedures, terms of employment and termination provisions.

As noted above failure to include such terms in the agreement between the retirement board and the investment service provider will result in the Commission withholding "…acknowledgement … in the best interest of the retirement system". It has been asserted that PERAC's role in this regard is limited to an audit review after the investment has been made. Such an interpretation

would lead to the ludicrous result whereby PERAC was foreclosed from preventing a violation of the law before it takes place, but empowered to enforce the law after such a violation.

PERAC REGULATIONS

The deletion of clause (f) of Section 7 of Chapter 7 of the General Laws in Section 2 of Chapter 176 of the Acts of 2011, the changes in Chapter 32, Section 23 (2)(b) in Section 40 of that Chapter and the addition of Section 23B to Chapter 32 in Section 42 of that Chapter impact the status of many of the PERAC Regulations in 840 CMR. PERAC Memo #27/2012 outlined the impact of the new law on a number of these regulations.

In addition, the following regulations are superseded by the noted provisions of Chapter 176 and will no longer be in effect:

(1) 840 CMR 19.01(4), (6), (7), (8), (10) – These matters deal with transitional issues related to the previous regulation revision (1); limits on a retirement board's asset allocation to real estate (4); limits on the nature of a retirement board's allocation to real estate investment vehicles (6); the process for selecting alternative investment managers (7); limits on the retirement board's asset allocation to alternative investment (8) and limits on the nature of a retirement board's allocation to alternative investment (10).

In each instance the substance of the regulation is embodied in the fiduciary duty of the retirement board members, that is the actions (or lack of actions) of the retirement board members in regards to these matters will be assessed in light of how a "prudent expert" would act. For example, rather than explicit allocation limits in regulation limiting the assets that may be dedicated to a particular class of investments the wisdom of the allocation that a retirement board may make will be assessed in light of the "prudent expert" standard.

840 CMR 21.01 – PROHIBITED INVESTMENTS

840 CMR 21.01(1), (2), (3), (4), (5), (6), (7),(8), (9) and (10) preclude retirement boards from engaging in certain investments. Although a number of Supplemental Regulations have been granted to enable such investments, in the absence of Chapter 176, these restrictions would remain in place. As a result of the reform of the investment process, particularly as it relates to PERAC's role embodied in the new Chapter 32, Section 23(2)(b), the law now supersedes the limits set forth in 840 CMR 21.01(1), (2), (3), (4), (5), (6).

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Specifically these are:

(1) Purchases of securities by partial payment of their cost (purchases on margin).
(2) Sale of securities not owned by the system at the time of sale (short sales).
(3) Future contracts other than as follows:
(a) Forward currency contracts may be written against securities in the international portfolio by an investment advisor registered under the Investment Advisors Act of 1940 and who has been the subject of an exemption for international investment.
(b) Forward currency contracts may be written against securities in an international portfolio to a maximum 25% of the international portfolio non-dollar holdings at market value. Speculative currency positions unrelated to underlying portfolio holdings are strictly prohibited.
(4) Call options written against securities in the portfolio other than as follows:
(a) Call options may be written against equity securities (excluding international equities) in the portfolio by a qualified investment adviser registered under the Investment Advisers Act of 1940.
(b) Call options may be written against equity securities (excluding international equities) in the portfolio to a maximum of 25% of the market value of the equity portfolio (excluding international equities).
(c) Only options listed on a U.S. registered exchange may be written.
(5) Purchases of options other than as required to close out options positions.
(6) Lettered or restricted stock (with the exception of those investments that are venture capital investments).

The cited language does <u>retain</u> several restrictions and thus some provisions of 840 CMR 21.01 restricting investment will remain intact. These include prohibitions regarding:

(7) Direct investment in mortgages.
(8) Collateral loans (with the exception of those investments that are leveraged buyout investments), provided, however that boards may participate in so-called "securities lending" programs through a custodian and provided, further, that the lending of securities is limited to brokers, dealers, and financial institutions and that the loan is collateralized by cash or United States Government securities according to applicable regulatory requirements.
(9) Loans to employees or individuals.
(10) Direct purchase or lease of real estate.

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INVESTMENT GUIDELINE 99-1

This Guideline relates to the use of interest rate financial futures and options for the purpose of managing duration in fixed income portfolios. Although such use would otherwise be prohibited by 840 CMR 21.01 Prohibited Investments, Section 40 of Chapter 176 amended Chapter 32, Section 23(2)(b) to streamline the filings needed for a retirement board to proceed with an investment. The provisions of 840 CMR 21.01 that would otherwise preclude the investments outlined in PERAC Investment Guideline 99-1 contradict the statute and are no longer in effect. As a result this Guideline is no longer needed.

EXISTING SUPPLEMENTAL REGULATIONS

Over the years many boards have sought and received supplemental regulations that addressed issues related to PERAC Regulations. Often those supplemental regulations authorized a deviation from the provisions of the PERAC Regulations now superseded as noted above. However, those supplemental regulations remain in effect as they are board specific. In the event that a retirement board believes that a supplemental regulation(s) is no longer necessary in light of the passage of Chapter 176 it should adopt a motion rescinding the supplemental regulation and notify PERAC. The Commission will expedite a response and the supplemental regulation will no longer be in effect.

CONCLUSION

The Commission understands that the implementation of the new statute presents a challenge for the retirement boards and other in the public pension community. We thank you for your assistance in assuring an orderly transition and hope to work with you to resolve any difficulties as we proceed.

Attachment