M E M O R A N D U M

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Procurement

DATE: November 6, 2018

In the upcoming months retirement boards will be seeking to procure various services in order to comply with the statutory limitations on contract length. As that process unfolds retirement board members must comply with their fiduciary duty. This memo outlines several reminders based on what the Commission has experienced since the adoption of Section 23B of Chapter 32.

The Inspector General ("IG") issues a regular Procurement Bulletin which is helpful to those about to engage in a competitive process. The Bulletin issued in April, 2017 provided the following advice in the article entitled:

> *Promote Robust Competition Among All Qualified Vendors by Addressing Any Inadvertent or Intentional Bid Tailoring*
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> When conducting a public procurement, the government acts as an agent for the taxpayers, and, therefore, procurement officials must comply with both the letter and the spirit of public procurement laws. All public procurement processes must be conducted in a fair and open manner that maximizes competition among all qualified vendors. Why is this a fundamental principle in public procurement? Because the goal of the public procurement process is twofold: (1) to ensure that taxpayers (and other stakeholders) get the best prices for the goods or services needed; and (2) to provide an equal opportunity to all qualified vendors interested in bidding.
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> Some procurement officials may not be aware of this duty while others simply neglect it. Neglect may be rooted in a desire to move the process along quickly or a mistaken belief that an open, competitive process will not result in the best deal. Some procurement officials may intentionally avoid a fair and open process because they want to ensure that a favored vendor wins the bid. In the worst cases, this conduct constitutes procurement fraud.

A common form of procurement neglect or fraud is bid tailoring. Bid tailoring happens when specifications, qualifications, or other bid or contract requirements favor one or more vendors and effectively exclude others. Sometimes this tailoring is intentional; other times it is inadvertent. For example, a procurement official mistakenly believes that a service provider requires professional licensure, and includes this requirement in the bid specifications. In fact, the type of service does not require the provider to be licensed, but only two of eight local vendors happen to be licensed. Adding this particular licensing qualification might have been a mistake based on misinformation or lack of research. As a result, the procurement official effectively limited the local bidder pool to only two vendors.

Consider the following examples of bidder requirements:

- A bidder must have a minimum of 40 years of experience in the trade
- Any firm submitting a bid must have an industry market share of more than 50%
- Vendors must have a facility within five miles of Town Hall
- Providers must be equipped with Acme products
- Vendors must own all equipment

After reviewing the examples above, you may see how such requirements might severely restrict competition while adding little to no benefit to the supply or service. If there is no legitimate business reason to include these requirements, then reconsider their inclusion in your bid specifications.

Even if there is a legitimate reason for the requirements, if they are detrimental to a fair, open and competitive process, you should re-examine whether these requirements are really necessary for a successful contract.

Procurement officials make mistakes like we all do, but what appears to be a mistake can also be procurement fraud. For example, a request for proposals ("RFP") for landscaping states that vendors must have a facility within five miles of Town Hall. The official who included the requirement claims that it is to ensure a quick response time from the vendor. However, response time is not a significant factor in the contract (in fact, the landscaping work will not be done at Town Hall). Further, while many potential vendors are located between six and ten miles of Town Hall, only one vendor, who also has personal ties to the official, is within five miles. In such a situation, what appears to be a poorly drafted RFP could actually be procurement fraud.

To help deter or detect procurement fraud based on bid tailoring, you may:

1) Question a requirement in the bid package that could limit competition. Make sure you know (1) what the reason is for including it; (2) whether the reason is logical; and (3) if the requirement is necessary.

2) Listen to vendor complaints. Most vendors want to increase their business by submitting bids. Vendors therefore often pinpoint the specification requirement that deters or limits competition.

3) If you receive only one bid or a very small number of bids, review your bid specifications. The same is true if you receive bids from the same vendor(s) all the time. If you are using a fair and open competitive process, then you should generate robust competition. If you are not, then check your requirements for anything that might be deterring competition. If the bidder pool is severely limited, that may be a red flag indicating some sort of bid tailoring.

4) Compare your requirements to those of other jurisdictions purchasing the same goods or services. Compare their competitive pool of vendors to yours.

5) If vendors are not bidding, then ask them why they are not.

Elaborating on the examples set forth, PERAC's Compliance Unit has seen many RFP's that reject a submission if the service provider does not meet a minimum number of Massachusetts public pension fund clients, fails to manage a minimum level of assets, in general or in a particular asset class or similar requirements. Mandating such requirements prevents otherwise eligible firms from even submitting responses. It is not an open process if the minimum criteria discourage RFP responses. The proper approach is to assess the substance of each RFP response and award points based on meeting the criteria (for example a firm with no Massachusetts pension fund clients could be awarded 0 points; a firm with 1-5 clients could be awarded x points and a firm with 5-10 clients could be awarded y points). A mandatory requirement requiring rejection of the RFP submission due to failing to have a certain level or type of client or lack of a certain number of years in business is particularly pernicious because it assures that only incumbents will respond.

An additional issue has arisen, as some retirement boards and consultants have enunciated a reluctance to conduct in-person interviews as part of the assessment of service providers.

The failure to conduct such interviews does not expose the fiduciary to personal liability until something goes wrong. In that situation, the fact that interviews were conducted as part of the search process has been a key aspect of a ruling in favor of the fiduciary.

Erik Daley, CFA Managing Principal of the MULTNOMAH Group, states the following in "Conducting a Vendor Search: Benefits and Best Practices":

> Once proposals are reviewed and compared, the plan sponsor typically selects three to four finalists from among the candidate pool. The finalists represent the proposals that best address the plan's unique objectives and overall circumstances. Finalists are typically given another opportunity to present the highlights of their offering in-person at the plan sponsor's location. The analysis phase concludes with the selection of the plan's vendor.

He goes on to observe that:

> Although there is no "uniform checklist" for procedural prudence, Tatum, 761 F.3d at 358, it must be the case that prudence requires more than blindly to defer to the decisions of someone else, no matter how qualified. Brotherson v. Putnam Invs., LLC.

In a convoluted but seminal case with numerous appeals, Unisys mounted a successful defense to a claim of a violation of fiduciary duty in selecting an insurance company GIC product for employees to choose as part of a 402(k) type plan. The Appeals Court in reviewing the findings of the District Court stated:

> Unisys delegated the responsibility of investing for the Fund to Davis White and Leon Level. White and Level have educational and practical backgrounds in financial matters. At the direction of White and Level, Unisys purchased three Executive Life GIC's as investments for the Fund through bidding processes in June 1987, December 1987 … and January 1988. Of the many GICs purchased for the Fund, only three were Executive Life GICs, constituting between 15 and 20 per cent of the Fund's assets. Unisys, through White and Level, considered many firms through a process of competitive bidding, and Unisys heard in-person presentations from the insurance companies.

In this case Unisys (1) delegated/assigned responsibility to employees with a financial background (thus avoiding allegations that individuals who were not up to the job were selected); (2) engaged in a competitive bidding process; and (3) "heard in-person presentations from the insurance companies."

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Commentators have made it clear that in-person interviews provide a shield against charges of a violation of fiduciary duty in the selection of service providers. For example the Schiff Hardin Law Firm citing Unisys notes:

> Having a prudent process for selecting a service provider can be a critical step in defending against a breach of fiduciary duty claim. The case of In re Unisys Savings Plan Litigation [22 EBC 2945 (3d Cir. 1999)] demonstrates this point. Unisys included a guaranteed insurance contract (GIC) as an investment choice that participants could select in their directed accounts. At some point, the insurance company was placed into receivership and participants who had invested in the GIC stood to lose the guaranteed return promised in the GIC. Participants who invested in the GIC sued Unisys, alleging that it had imprudently selected the insurance company. The court, however, concluded that Unisys had engaged in a prudent selection process. The court noted that Unisys had retained the services of two highly qualified consultants to help it select the insurance company that it had engaged in a competitive bidding process, **that it had <u>in-person presentations</u> from the insurance companies under consideration,** and that it had reviewed the ratings of the insurance companies before making the selection. Under the circumstances, the court held that Unisys had discharged its duties to the plan prudently, and therefore was not liable for the losses to the plan.

This issue comes up only after losses have been incurred and recovery is sought from the fiduciary. A hypothetical might assist in understanding the importance of interviews:

Investment consultant X, following a review of RFP responses, recommended to retirement board Y, that $100 million be allocated to a fund managed by Bernie Madoff. The investment consultant said that no interview is needed and Mr. Madoff is somewhat of a recluse and does not participate in such interviews. Retirement board Y voted to allocate $100 million to the Bernie Madoff Fund. Several months later it is discovered that the valuations of the Fund were fraudulent and the $100 million is lost. Securities litigation firms, having seen their fees for that kind of lawsuit diminish, have branched out and are now representing retirement system members suing trustees for breaches of fiduciary duty. Such a lawsuit has been filed against you due to the Madoff loss. The plaintiff's attorney asks you "Did you ever meet Mr. Madoff?" You respond "No". He says "Do you mean to tell the members of this jury that as a fiduciary you gave Bernie Madoff $100 million to invest without reviewing other firms?" "Yes." "Do you mean to tell the members of this jury that you gave Bernie Madoff $100 million that he has lost without even interviewing him?" "Yes." "Your honor, I rest my case!"

In addition to issues pertaining to searches for investment service providers, some have expressed reservations about conducting interviews as part of the search for legal services.

In the advisory entitled "How to Choose a Lawyer in Five Easy Steps" the first step is:

"Conduct Candidate Interviews"

One of the best ways to assess a lawyer's legal ability is by interviewing the lawyer. Most attorneys will provide an initial consultation (usually an hour or less) at no charge. A few important questions to ask during this meeting are:

- What experience does the lawyer have in your type of legal matter?
- How long has he been in practice?
- What is his track record of success?
- What percentage of his caseload is dedicated to handling your type of legal problem?
- Does he have any special skills or certifications?
- What are his fees and how are they structured?
- Does he carry malpractice insurance? If so, how much?
- Who else would be working on your case and what are their rates?
- Does he outsource any key legal tasks for functions?
- What additional costs may be involved in addition to lawyer fees (postage, filing fees, copy fees, etc.)?
- How often will you be billed?
- Can he provide references from other clients?
- Does he have a written fee agreement or representation agreement?
- How will he inform you of developments in your case?

The Commission understands that this period of increased procurement activity is a challenging one for board members. Please contact PERAC Compliance Officer, Tom O'Donnell, if you need assistance or have questions regarding the procurement process.