

MEMORANDUM #27, 2012

Commonwealth of Massachusetts | Public Employee Retirement Administration Commission

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MEMORANDUM

TO: All Retirement Boards

FROM: Joseph E. Connarton, Executive Director

RE: Investment Under Chapter 176 of the Acts of 2011

DATE: March 8, 2012

INTRODUCTION

As you know, the Public Employee Retirement Administration Commission (PERAC) has disseminated several memoranda regarding the statutory changes made by Chapter 176 of the Acts of 2011. The subject of this memo is investment of retirement system assets.

The reform law simplified the regulatory requirements for retirement boards to follow in investing system assets. This approach is in keeping with the general thrust of the governance sections of the new law and recognized the experience gained over the last 26 years by retirement board members in investing assets.

This Memo should be read in conjunction with the following PERAC Memos:

PERAC Memo #22/2012 “Collusion/Fraud Provisions of Chapter 176;

PERAC Memo #15/2012 “Procurement Under Chapter 176 of the Acts of 2011”;

PERAC Memo #7/2012 “Placement Agent Policy Implementation”;

PERAC Memo #35/2011 “Chapter 176 of the Acts of 2011: An Act Providing for Pension Reform and Benefit Modernization (Governance Provisions)”;

and, PERAC Memo #34/2011 “Placement Agent Policy”

PRE-CHAPTER 176 PROCESS

Under the previous process managers and retirement boards were required to submit a series of documents to PERAC for review. The most extensive of these items was submitted by the investment manager with detailed information about the manager and the particular product or investment vehicle to be used in investing system assets (“Applications For Exemption From Investment Restriction For: Alternative Investments, Real Estate, and International/Global Investments”; see Hedge Fund discussion below as to Hedge Fund Forms). That form is no longer required as a result of the passage of Chapter 176 of the Acts of 2011. Furthermore, PERAC will no longer be providing retirement boards with an “exemption” or “waiver” but will be providing an “acknowledgement of receipt” of various documents. Again, this is consistent with a focus on procurement practices and disclosure.

POST CHAPTER 176 PROCESS

The documents which must be received and acknowledged by PERAC prior to investment of funds with a manager include:

- (1) a certification, signed by the Board Chairman, that, in making the selection, the board has complied with the procurement process established in section 23B (Retirement Board Procurement Compliance Certification);
- (2) a copy of the vendor certification as required under section 23B that its submission was made in good faith and without fraud or collusion (Vendor Certification);
- (3) copies of disclosure forms submitted by the selected vendor (Placement Agent Disclosure Statement, Disclosure of Conflict of Interest Form, Annual Disclosure of Compensation Received Form and Annual Disclosure of Compensation Paid Form);
- (4) a certification that the investment is not a prohibited investment as set forth in regulations of the Commission (Retirement Board Prohibited Investment Compliance Form) (see below);
- (5) if the board has retained a consultant, a copy of the consultant reports pertaining to the investment and the selected vendor (Retirement Board Certification of Consultant's Reports); and,
- (6) a copy of a board member form signed by each board member certifying that, to his/her knowledge and belief, the proposal of the vendor selected has been made in good faith and without fraud or collusion (Retirement Board Member Certification Form)

The Commission may withhold the acknowledgement if it determines that it is in the best interest of the retirement system.

The documents which must be received and acknowledged by PERAC prior to retention of a consultant are similar and include:

- (1) a certification, signed by the Board Chairman, that, in making the selection, the board has complied with the process established in section 23B (Retirement Board Procurement Compliance Certification);
- (2) a copy of the vendor certification required under section 23B that its submission was made in good faith and without fraud or collusion (Vendor Certification);
- (3) copies of disclosure forms submitted by the selected consultant (Disclosure of Conflict of Interest Form, Annual Disclosure of Compensation Received Form and Annual Disclosure of Compensation Paid Form; and,
- (4) a copy of a board member form signed by each board member certifying that, to his/her knowledge and belief, the proposal of the vendor selected has been made in good faith and without fraud or collusion (Retirement Board Member Certification Form)

Under separate cover we have disseminated PERAC Memo #15/2012 addressing Procurement Under Chapter 176 of the Acts of 2011. That Memo details several aspects of the procurement process that must be followed when seeking investment services.

In that context it should be emphasized that, although an investment consultant may be responsible for the initial evaluation of proposals "the retirement board or its consultant ...shall prepare initial evaluations **based solely on the criteria set forth in the request for proposals.**" (Emphasis added).

Furthermore the statute states:

"If the initial evaluation is conducted by a consultant retained under this chapter the consultant shall review **all** initial evaluations with the retirement board and provide to **each** member of the retirement board the initial evaluation of each proposal." (Emphasis added).

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 the Commission's duties regarding the initiation of investment activity of the retirement boards.

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.

Consequently, subject to statute and regulation, retirement boards may invest assets in PRIT or 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 on the retirement board’s investment of assets. These include restrictions on investment in companies that generate earnings through the sale of tobacco products 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 under the Fiduciary Standard, 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.

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. The Commission is presently conducting a review of this issue and hopes to provide guidance in the near future regarding the status of existing regulations not addressed below or, if necessary, promulgate an emergency regulation to repeal those regulations that are no longer consistent with the statute.

Pursuant to Chapter 30A, Section 8, PERAC makes this advisory ruling with respect to the applicability of the regulations listed below.

The following regulations are superseded by the noted provisions of Chapter 176 and will no longer be enforced as of February 16, 2012:

1. 840 CMR 16.01 - Definitions

2. 840 CMR 16.02 - Employment of a Qualified Investment Manager
3. 840 CMR 16.03 – Authority of Investment Manager to Invest Funds
4. 840 CMR 16.06 – Petitions for Additions to the Legal List
5. 840 CMR 16.08 – Procurement of Investment Related Services
6. 840 CMR 16.10 – Investment of Funds by Exempt Boards
7. 840 CMR 19.01(1), (2), (3), (5), (9), (11)
8. 840 CMR 19.02 – Complete Exemption by Commission
9. 840 CMR 19.03 – Revocation of Exemption
10. 840 CMR 19.04 – Determination of Qualifications of Investment Manager; Review of Application
11. 840 CMR 19.05 – Rating of Investment Performance and Qualifications
12. 840 CMR 26.01 – Application for Approval by the Public Employee Retirement Administration Commission
13. 840 CMR 26.02 – Determination of Consultant Qualifications
14. 840 CMR 26.03 – Rating of Qualifications of Consultant
15. 840 CMR 26.04 – Approval by Commission
16. 840 CMR 26.05 – Change of Consultant
17. 840 CMR 26.06 – Revocation of Approval by the Commission

As noted, the Commission is continuing its review of regulations as well as investment guidelines and expects to issue further advisory rulings in the near future.

PERAC INVESTMENT GUIDELINES

The same provisions of the new law impact the status of PERAC Investment Guidelines.

INVESTMENT GUIDELINE 99-2

PERAC Investment Guideline 99-2 allows retirement boards to make modest modifications or adjustments to the mandate with an existing manager without following a competitive process. This Guideline remains in effect as it addresses circumstances that may arise in the context of Section 23B.

INVESTMENT GUIDELINE 99-3

Section 23B of Chapter 32 provides that all procurements for investment services meet the requirements of that Section. Consequently, PERAC Investment Guideline 99-3, which allowed for retirement boards to commit funds to new partnerships offered by alternative investment managers with whom they have already invested without an RFP and a competitive process contradicts the statute and is no longer in effect.

The Commission is reviewing the status of INVESTMENT GUIDELINE 99-1 dealing with interest rate financial futures and options, and PERAC GUIDELINES FOR HEDGE FUND INVESTMENT and will provide the results of that review in the near future.

MANDATORY CONTRACTUAL TERMS

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 term, “investment service provider(s)”, includes, but is not limited to, managers, partnerships, trusts, custodians, consultants, as well as those providing proxy services, services related to the financial information (cash books, pooled fund statements, Annual Statements) retirement boards must file with PERAC, securities litigation services and other services which are investment related.

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 contractor'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."

In addition, the Commission's Placement Agent Policy requires investment managers to agree to the following:

CONTRACT TERMS

Each contract and amendment to an existing contract as of January 1, 2012 shall secure the agreement of the manager in the final written agreement between the board and the manager to provide the board with the following remedies in the event the manager knew or should have known of any material inaccuracy or omission in the placement agent information disclosure or any other violation of this policy:

- a. whichever is greater, the reimbursement of any management or advisory fees paid by the board for the prior two years or an amount equal to the amounts paid or promised to be paid to the placement agent as a result of the board investment;
- b. the authority to immediately terminate the investment management contract or other agreement with the manager without penalty, to withdraw without penalty from a limited partnership, limited liability company or other investment vehicle, or to cease making further capital contributions (and paying any fees on these recalled commitments) to the limited partnership, limited liability company or other investment vehicle without penalty; and,
- c. provisions requiring the manager to annually inform PERAC and the board of any arrangements in oral or in writing, for compensation or other benefit received or expected to be received by the manager or a related person from others in connection with the managers' services to the board or any other client, provisions requiring the manager to annually disclose to PERAC and the retirement board any compensation, in whatever form, paid or expected to be paid, directly or indirectly, by the manager or a related person to others in relation to the managers' services to the board or any other client, and provisions requiring the manager to annually disclose to PERAC and the board in writing any conflict of interest the manager may have that could reasonably be expected to impair the manager's ability to render unbiased and objective services to the board."

As you can see the language of item "c" of the cited language is similar to the statutory language set forth above.

Each contract and amendment to an existing contract as of January 1, 2012 shall secure the agreement of the manager in the final written agreement between the board and the manager that the manager shall be solely responsible for, and the board shall not pay (directly or indirectly), any fees, compensation or expenses for any placement agent used by the manager.

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. As noted, the Commission hopes to address the status of its regulations in the near future. However, regardless of the outcome of that process, supplemental regulations adopted by the retirement boards will 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.

FORMS

Attached please find the following forms that relate to investment procurement:

1. Retirement Board Procurement Compliance Certification Form;
2. Retirement Board Member Certification Form;
3. Retirement Board Certification of Consultant's Reports Form;
4. Vendor Certification of Good Faith Proposal;
5. Vendor Annual Disclosure of Compensation Received Form;
6. Vendor Annual Disclosure of Compensation Paid Form;
7. Vendor Disclosure of Conflict of Interest Form;
8. Retirement Board Certification of Prohibited Investment Compliance Form; and,
9. Placement Agent Statement

CONCLUSION

The Commission understands that the implementation of the new statute presents a challenge for the retirement boards and others 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.

Attachments