Legislative Analysis

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PUBLIC EMPLOYEE RETIREMENT SYSTEMS: AUTHORIZED INVESTMENTS, ETC.

House Bill 5323 (Substitute H-3)
Sponsor: Rep. Richard Hammel
Committee: Banking and Financial Services

Complete to 2-17-10

A SUMMARY OF HOUSE BILL 5323 AS REPORTED FROM COMMITTEE

The Public Employee Retirement System Investment Act authorizes the investment of assets of public employee retirement systems in Michigan, and places limitations on the ways in which those funds can be invested. The act applies to all retirement systems operated by the state or by local units of government in Michigan.

The bill would amend the Public Employee Retirement System Investment Act (MCL 38.1133 et al.) to make the following changes:

<u>Investment fiduciaries</u>. Current law allows an investment fiduciary to use a portion of the income of the system for certain things, such as defraying the costs of investing, managing, and protecting the assets of the system. The bill would modify that provision by specifying that the costs of investing, managing, and protecting the assets would include providing training and education (i.e., for plan trustees).

An investment fiduciary is also currently allowed to use a portion of the system's income to retain investment services and all other services necessary for the conduct of the affairs of the system. The bill would add that these services would include investment advisors, consultants, custodians, auditors, attorneys, actuaries, administrators, and physicians.

The bill would also require all investment service providers to provide to the investment fiduciary of the system complete written disclosure of all fees or other compensation associated with their relationship with the system before services were provided. After services were provided, and on an annual basis, all investment service providers would have to provide written disclosure of all fees including, but not limited to, commissions, 12B-1 and related fees, compensation paid or to be paid to third parties, and any other compensation paid by the system to the investment fiduciary of the system. "Investment service provider" would mean any individual, third-party agent or consultant, or company which received direct or indirect compensation for consulting, managing, brokerage, or custody of the system’s assets. A retirement system would not be an investment service provider.

<u>Investment companies</u>. The act allows an investment fiduciary to invest in investment companies registered under the federal Investment Company Act, with some restrictions. The bill would add that an investment company could be established as a limited partnership, corporation, limited liability company, trust, or other organizational entity

for which the liability of an investor did not exceed the amount of the investment under the laws of the U.S. or the applicable laws of the jurisdiction under which the investment company had been established.

<u>Real estate investment trusts</u>. Current law allows investment in publicly or privately issued "real estate investment trusts" (REITs) or in certain other real or personal property. An investment cannot exceed 5 percent of a system's assets. The bill would increase the maximum investment to 10 percent.

Currently, in addition to the limit cited above, an investment fiduciary of a system with assets of more than $100 million can form or invest in one or more limited partnerships, corporations, limited liability companies, trusts, or other entities to hold title to, improve, lease, manage, develop, maintain, or operate real or personal property. The liability of the investor cannot exceed the amount of an investment under federal law or the laws of any U.S. state, district, or territory or of a foreign country. The limit on the aggregate of these kinds of investments currently cannot exceed 5 percent of assets; the bill would increase that to 10 percent.

Currently, if the investment fiduciary of a system is the State Treasurer then the investments described in the above paragraphs can exceed 5 percent of the assets of the system. The bill would allow investments by the State Treasurer to exceed the new limits of 10 percent of the assets of the system.

<u>Pooled funds</u>. Current law allows a financial institution, a trust company, or a management company retained as an investment fiduciary to invest the assets of a system in a collective investment fund, common trust fund, or pooled fund that is established and maintained for investment of those assets by the financial institution or management company. The bill would revise the provision to instead specify that an investment fiduciary could invest the assets of a system in any collective investment fund, common trust fund, or pooled fund established and maintained for investment of those assets under state or federal laws, rules, or regulations or an applicable foreign law.

The bill would add that the investment fiduciary of the collective investment fund, common trust fund, or pooled fund would have to be a financial institution, a trust company, a management company qualified under Section 13(10)(a) of the act (a registered investment advisor under the federal Investors Advisors Act or state Uniform Securities Act), or an affiliate of one of these entities. The pooled fund could be established as a limited partnership, corporation, limited liability company, trust, or other organizational entity for which liability of any investor did not exceed the amount of the investment under U.S. law or the laws of the state, district, territory, or foreign country that applied to the organization of the pooled fund. A pool in which the state treasurer had administrative or investment authority and the investment pools of the Municipal Employees Retirement System and retirement board created under that act <u>would not be pooled funds</u> for purposes of this provision.

<u>Basket clause</u>. The act allows an investment fiduciary to invest a percentage of the system's assets in investments not specifically authorized by the act. The bill would change the asset classes and investment percentages as follows:

- A system with less than $250 million currently is allowed to invest up to 5 percent of its assets. Under the bill, a system with less than $250 million would be allowed to invest not more than 15 percent of its assets.
- A system having assets of $250 million or more currently is allowed to invest up to 10 percent of those assets. Under the bill, a system having $250 million or more but less than $1 billion in assets would be allowed to invest not more than 20 percent.
- A system having more than $1 billion in assets could, under the bill, invest up to 25 percent of its assets – increased from the current 15 percent.
- The "basket clause" limit for the state treasurer would be increased to 30 percent from 20 percent.

Foreign Securities. The bill would increase from 20 percent to 30 percent the limitation on assets invested by an investment fiduciary in foreign securities.

FISCAL IMPACT:

House Bill 5323 would have an indeterminate, but likely negligible, fiscal impact on the Department of Treasury and local pension boards administratively. Any fiscal impact to the State or locals would derive from a change in an investment fiduciary's investment portfolio breakdown. This bill would allow pension plans to diversify their investments in an effort to protect them in certain financial markets. A change in the investment portfolio will likely result in a change in the portfolio's return on investments, which is dependent upon the market performance of each asset held by the pension plan.

BACKGROUND INFORMATION:

The bill would once again update the Public Employee Retirement System Investment Act to reflect the rapid pace of change in the financial marketplace.

Arguments for the bill include the following:

- The bill would clarify that interest earnings from investments could be used for training and education of plan trustees, along with other necessary services. Many plans are already using the interest earnings for such things but would like to see the practice specifically authorized in statute.
- The bill would require fees and commissions for a range of services investment service providers to be disclosed both upfront and on an annual basis.
- The bill would allow smaller funds to pool with other funds in a venture similar to that allowed for real estate investments. Though sometimes done now, the bill would clarify that the practice was allowed.
- The bill would raise the caps on several types of investments. This would provide fund managers with more flexibility and would allow funds to rebalance their investments to match what is happening in the market. Due to recent fluctuations in the market, many funds have segments that exceed current caps, meaning that to be in compliance, investment fiduciaries must sell off investments, even if that means doing so at a lower price. For example, if domestic stocks suddenly fall, the fund’s investments in foreign securities may just as suddenly represent a

larger share of the fund's total investments, even though no new investments in those foreign stocks had been made. Increasing the caps will therefore accommodate market fluctuations and not force investment fiduciaries to sell off securities when prices are down.

- Many U.S. companies are now experiencing growth in foreign countries, and many non-U.S. domiciled companies employ lots of U.S. citizens. Thus, investing in a foreign security can actually affect the employment and wealth of U.S. citizens. Therefore, increasing the cap on foreign investments could benefit U.S. companies or U.S. citizens working for foreign companies.
- Supporters of the bill believe the changes will allow investment fiduciaries to fulfill their statutory mandate – meaning to maximize investment returns while remaining prudent. Some believe that by removing restrictions on diversification, the bill will allow investment fiduciaries to defer some of the risks of investing.

Arguments against the bill include the following:

- The primary argument against the bill is that because the bill regulates the investments of public pension funds, the investments should be more conservative. For example, the bill would increase the percentage of the total investments that can be placed in foreign securities. Yet, there is little policing of foreign investments because few emerging markets have security exchanges. A security exchange requires that if a company is going to sell stock, the company must prove that the business is really there and is capitalized. This protects against what is known as "blue sky investments," a term associated with investment products for which there is no real "business" behind it. If the share price of a "blue sky" stock begins to drop, which it inevitably does, the holder cannot sell its shares because the company issuing the original stock is found not to exist. Even if the investment is legitimate, investments in emerging markets are high risk, with severe crashes often wiping out any gains. Thus, the restrictions in current law are there to protect the retirement funds of workers dependant upon their pensions to provide for themselves and their families in later life. As such, any changes in investment practices or increasing caps on restricted investments should be carefully scrutinized.

POSITIONS:

A representative of the Department of Treasury testified in support of the bill. (2-4-10)

A representative of the Municipal Employee's Retirement System testified in support of the bill as substituted. (2-4-10)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.