

BILL NUMBER: AB 1052 (Cooley) as amended August 17, 2015

SUMMARY

Consistent with existing authority set forth in the California State Constitution, AB 1052 authorizes the boards of the California State Teachers' Retirement System (CalSTRS) and the California Public Employees' Retirement System (CalPERS) to contract for specified investment-related services under the boards' terms and conditions and, except under specified circumstances, utilizing competitive processes, in lieu of state contracting requirements.

BOARD POSITION

Sponsor. Authorizing the CalSTRS and CalPERS boards to set the terms and conditions to contract for specified investment-related services utilizing competitive processes preserves the assets and minimizes the liabilities of the funds and gives more flexibility to the boards in their administration.

REASON FOR THE BILL

As global markets increase in complexity and the assets of California's state retirement systems grow in size, the CalSTRS and CalPERS boards are increasingly constrained by the traditional state procurement requirements when contracting for investment expertise. This bill seeks to allow the CalSTRS board to set the terms and conditions for procuring investment management services, thus eliminating the opportunity costs that result from a diminished universe of potential investment manager firms and from delays in the timely funding of asset allocation strategies. The bill would provide similar authority for CalPERS board when contracting for custodian and trade order management services. Such authorization would enhance the boards' ability to secure the best value for members and beneficiaries and successfully fulfill their fiduciary obligations.

SUMMARY OF AMENDMENTS

The August 17, 2015, amendments delete the sections of the bill that address CalPERS ability to invest the assets of the retirement fund without compliance with any other law pertaining to state contracting.

ANALYSIS:

Existing Law:

Most of California's state agencies, including CalSTRS and CalPERS, must abide by state contracting requirements. In recognition of the unique nature of the services required of certain government agencies, often out of the need for expediency, the Legislature has granted specific exemptions from state competitive bidding requirements. For example, the California Housing Finance Agency and the California Health Benefit Exchange Board have been granted blanket exemptions. In addition, CalPERS is exempt from competitive bidding requirements when contracting with health

plans and long-term care insurance plans. General exemptions also apply for any state agency when obtaining expert witnesses, or for contracts for legal defense, legal advice or legal services or the development, maintenance, administration or use of licensing or proficiency testing examinations.

The overall purpose of the competitive bidding requirements set forth in the Public Contract Code is to stimulate competition conducive to sound fiscal practices; protect the public from the misuse of public funds; and guard against favoritism, fraud and corruption. As fiduciaries, the CalSTRS and CalPERS boards are bound by standards set forth in the California State Constitution and federal law to invest plan assets in a manner that is solely in the interest of members and beneficiaries. These strict standards require fiduciaries to discharge duties with care, skill, prudence and diligence at a level that goes beyond the goals of competitive bidding requirements.

In addition to competitive bidding, state law requires that contractors certify compliance with a myriad of California-specific statutes and regulations, some of which require certification prior to even being considered. Many of these certifications are entirely inapplicable to the highly specialized nature of investment management. As a result, firms that desire to compete for a contract must allocate the necessary time and resources to decipher contract laws when their expertise is and should be more centered on the management of investments.

Consequently, oftentimes smaller emerging manager firms that do not employ the extensive marketing staff of larger firms cannot afford to allocate critical investment staff capacity to compete for these contracts. This could even dissuade those emerging investment managers that are already managing CalSTRS funds through the Developing Manager Program from seeking to compete to be graduated to the core portfolio. In addition, successful firms, both small and large alike, that have long-proven track records of above industry standard returns are in high demand and can afford to ignore cumbersome procurement requests. Ultimately, these disincentives to compete reduce the universe of potential manager firms with which to contract. This can prevent CalSTRS from being able to invest timely in certain hard-to-reach sectors of the marketplace, thus resulting in opportunity costs to the funds.

This Bill:

Consistent with existing authority set forth in the California State Constitution, AB 1052 authorizes the CalSTRS and CalPERS boards to contract for specific investment-related services under the boards' terms and conditions and, except under specified circumstances, utilizing competitive processes in lieu of state contracting requirements to enable the boards to successfully ensure that plan assets are invested in a manner that is solely in the interest of members and beneficiaries.

Utilizing competitive processes established by the CalSTRS board, CalSTRS staff would continue to employ extensive due diligence to conduct a thorough analysis of qualifications and capabilities in order to research, evaluate and contract with investment contractors with the expertise best suited to meet the board's investment objectives. In order to continually promote opportunities for future business partners, information on how to do business with CalSTRS would be posted on CalSTRS.com. Staff would continue to utilize designated, appropriate industry-standard investment

informational sources, such as databases and registers, to search for qualified investment-related services firms.

Once qualified firms are identified, the CalSTRS board would identify those terms and conditions under which potential contractors would compete. Potential contractors would continue to be evaluated utilizing the most appropriate methods, such as background checks, interviews and reference checks, to ensure they have the sufficient qualifications relevant to the business need in question. Once the desired firm is identified, CalSTRS would move forward with the standard contracting process, which would include certifications, warranties and disclosures that the board determines are necessary consistent with its fiduciary duties to procure the services required, including all certifications and disclosures required by the Political Reform Act.

Finally, AB 1052 authorizes CalSTRS to contract directly with emerging investment managers that were previously funded through the Developing Manager Program without requiring an additional competitive bidding process. Consistent with fiduciary requirements, CalSTRS would similarly employ extensive due diligence to conduct a thorough analysis of qualifications and capabilities in order to research, evaluate and contract with those former emerging managers with the expertise best suited to meet the board's investment objectives. These potential investment managers would be evaluated utilizing the most appropriate methods, such as background checks, interviews and reference checks, to ensure they have the sufficient qualifications relevant to the business need in question. After CalSTRS enters into a contract with a former emerging investment manager, the board is required to continue to monitor and assess the performance of that manager as it would any other manager consistent with its fiduciary duties.

LEGISLATIVE HISTORY

AB 59 (Elder, Chapter 542, Statutes of 1989), among other things, specified that the incorporation of the board's fiduciary duties into an investment manager contract shall be evidence that the board acted with care, skill, prudence and diligence.

AB 652 (Papan, Chapter 1043, Statutes of 1983) removed the requirement that investments be made under the terms, conditions, limitations and restrictions that are imposed by the state upon savings banks. Repealed requirements for the issuance of bonds as investments and added explicit authority for the board to contract with investment manager firms. Several provisions were operative upon the passage of Proposition 21 on June 5, 1984, which enshrined fiduciary obligations in the California State Constitution and removed the constitutional restrictions limiting the amount of public retirement fund assets that could be invested in equities.

PROGRAM BACKGROUND

Allocation of CalSTRS' assets between public and private, and between fixed income and equity, is the most important factor in determining the fund's total rate of return. In order to realize the gains from investment allocation strategies set forth by the board, it is imperative that the fund expeditiously secure both established and emerging manager firms. Under state contracting requirements, the procurement of investment-related services takes an extremely long period of time and does not allow for the flexibility

required to timely fund new investment opportunities, including those with emerging manager firms that may lack the resources necessary to submit proposals in accordance with all specific aspects of existing law.

Many state requirements are entirely inapplicable to contracting for investment-related services and, consequently, dissuade potential top-quality, high-value manager firms. For example, contractors are required to certify compliance with certain contracting requirements up front in order to compete. While providing notice in a solicitation that a potential manager firm would be required to comply with applicable requirements is appropriate, requiring all potential investment manager firms to certify future compliance is not necessary. Such certification requirements are likely to cause many successful firms to avoid competing—they are in the business of managing investments, not deciphering statutes and regulations.

There are certain other requirements that are inapplicable to this type of business, and even their disclosure could be a deterrent. For example, the requirement that a contractor certify the percentage of post-consumer material sold to the state is inapplicable to investment-related services. There is also a requirement that the contractor comply with state and federal air and water pollution requirements. However, this requirement is only applicable to building materials, chemical or other types of manufacturing companies for which air and water emissions are a necessary byproduct of regular business. This section was never intended to apply to the types of firms that provide investment-related services, and requiring these types of companies to certify compliance is unnecessary.

Under the Developing Manager Program, CalSTRS invests with emerging investment managers through a contract with a manager-of-managers investment firm. However, as emerging managers experience success and the concomitant growth of assets under management, they run the risk of no longer qualifying as emerging investment managers and being eliminated from the Developing Manager Program. Under current law, these proven managers are required to commit precious resources to enter the bidding process from the very beginning. Allowing managers who have performed well in terms of investment performance and overall business operations to move into direct relationships with CalSTRS when there is a need for a specific sub-asset class or investment style in the portfolio would eliminate an estimated six months from the procurement process. A low estimate of the opportunity cost for six months on an allocation of \$500 million is about \$1.5 million.

In an increasingly dynamic and competitive market where attractive opportunities may exist with smaller emerging manager firms that may lack the staff and resources necessary to overcome these procurement hurdles, the opportunity costs incurred as a result of this process will only grow. Furthermore, the complexity of the services required further necessitates that staff utilize negotiating strategies severely constrained by the current process. In the past, CalSTRS has been forced to miss out on potentially lucrative investment opportunities because the process took a year or more from start to finish. Every delay in securing the desired services ultimately hinders CalSTRS' ability to carry out the decisions of the board as fiduciaries in the manner intended.

OTHER STATES' INFORMATION

In recognition of the unique nature of investment-related contracts and the higher standard set forth by fiduciary obligations, many state public pension funds across the country are exempt from state-mandated procurement processes. All 11 state pension funds contacted by CalSTRS are not required to abide by the same state-mandated procurement processes required for the procurement of other types of goods and services by other state agencies. For example, the board of the Ohio Public Employees Retirement System has the full power to invest the funds solely in the interest of participants and beneficiaries, including the power to adopt policies and criteria for selecting investment manager firms.

FISCAL IMPACT

Program Cost – Potential unknown savings. To the extent that CalSTRS' allocation strategy meets performance objectives, opportunity costs associated with the current process would be reduced, thus allowing CalSTRS to take advantage of favorable market dynamics and to maximize gains while minimizing losses.

Administrative Costs/Savings – Unknown savings from reduced staff work required for a faster and more efficient procurement process.

SUPPORT

CalSTRS (Co-Sponsor)

CalPERS (Co-Sponsor)

OPPOSITION

None known.

ARGUMENTS

Pro: Enables CalSTRS to fulfill fiduciary obligations to successfully ensure that the assets of the plan are invested in a manner that is solely in the interest of members and beneficiaries.

Creates a faster, more efficient and cost effective way to hire investment manager firms and proactively implement investment allocation strategies.

Expected to increase participation by emerging manager firms because it would be less costly to respond to solicitations for investment-related services.

Eliminates the potential disqualification of highly qualified candidates.

Brings procurement processes in line with those used by many other public pension plans throughout the country.

Con: Creates potential sensitivity around the perception of an effort to bypass the traditional state competitive bidding process.

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