

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Senate Bill 269 **Senator Soto (As amended 5/12/03)**

Position: **Sponsor**

Proponents: **CalSTRS, CalPERS (Co-Sponsors)**

Opponents: **None known**

SUMMARY

Senate Bill 269 allows the Teachers' Retirement Board (Board) and the California Public Employees' Retirement System (CalPERS) Board of Administration (BOA) to set salary levels and performance standards for the positions of Chief Executive Officer (CEO), System Actuary, Chief Investment Officer (CIO) and investment managers.

HISTORY

The California Pension Protection Act of 1992 – Proposition 162 of 1992

Granted public retirement system boards plenary authority over investment decisions and administration of each retirement system in a manner to assure prompt delivery of benefits and related services to members and their beneficiaries.

CURRENT PRACTICE

Implementation of Proposition 162

Proposition 162 increased the Board's responsibilities, giving it plenary authority over budgetary, administrative and investment decisions affecting the California State Teachers' Retirement System (CalSTRS). In April 1993, the Board took steps to implement Proposition 162 by taking exclusive control over the administration of the System in such areas as procurement of services, equipment purchases and salary savings requirements. Prior to the passage of Proposition 162, CalSTRS was subject to the same level of oversight the Legislature, the State and Consumer Services Agency, the Department of Finance and the Department of Personnel Administration (DPA) gave to other state departments and commissions.

Under Article 7 of the California Constitution, all officers and employees of the state are included in the civil service except as otherwise provided by the Article. All state officers directly appointed by the Governor, for example, are exempt from civil service, as is one direct appointee of each officer appointed by the Governor. However, for Boards and Commissions, Article 7 provides for only one exempt position. In the aftermath of Proposition 162, CalSTRS (and CalPERS), operating under the "plenary authority" language and with the agreement of the control agencies, including DPA, were authorized to appoint additional exempt employees.

Prior to, and immediately following the passage of Proposition 162, CalSTRS' only exempt employee was the CEO, who was appointed by the Board. Because of this, the Board was compelled to contract with outside investment managers to manage all the day-to-day operations of the Teachers' Retirement Fund (TRF). Dissatisfied with outside management of the TRF and the limited control such an arrangement creates, the Board took action in 1993 to establish two exempt portfolio manager positions. In 1997, the Board created an internal position of CIO, who, like the CEO, was exempt from civil service and appointed directly by the Board.

The Board established a four member Executive Compensation Committee to set appropriate compensation levels for the CEO, the CIO, and other System executives exempt from the salary setting authority of the State civil service system. Since the passage of Proposition 162, the Committee has assessed performance and adjusted compensation levels for these senior administrative and investment executives. Prior to 1999, all requests for compensation were approved by the Committee, ratified by the Board, and submitted to the DPA for processing. DPA issued a pay letter authorizing the State Controller to pay in accordance with the Board's actions.

In addition, the Committee developed performance criteria and an incentive pay program to determine the extent to which performance and incentive pay should be awarded. In 1999, the Board commissioned a study on the development of incentive pay programs for all exempt positions, including a comparison of CalSTRS and CalPERS exempt positions. Upon review of the study, the Board directed staff to begin discussions with DPA to establish incentive pay programs and increase base pay levels for CalSTRS exempt positions. The Board dropped the incentive pay components and proposed a salary structure to DPA in response to the Department's opposition to incentive pay. The DPA later authorized a ten percent range adjustment for CalSTRS' Investment Directors, but not other exempt positions, effective January 1, 2000.

In April of 2002, the DPA delegated authority to the Board to set the compensation of CalSTRS' ten exempt employees: the CEO, Deputy CEO, Chief Counsel, System Actuary, CIO, and five Investment Directors, along with the ability to issue pay letters to the State Controller. As part of the agreement, the Board was also given blanket authority to establish and set compensation for additional investment management exempt positions. This occurred soon after the State Controller prevailed in Superior Court against CalPERS in a matter involving compensation for a number of their exempt employees. Prior to the court decision, CalSTRS had begun evaluating the application of its blanket authority to the next level of investment managers.

Connell/Westly v. CalPERS

Exempt salaries are under the jurisdiction of the DPA. The department's denial of compensation packages proposed by both retirement boards for exempt employees represented a change in policy by DPA. Prior to 1999, the DPA regularly approved exempt employee compensation levels determined by the CalSTRS and CalPERS Boards.

In 2000, a proposal by the CalPERS BOA to increase compensation for 10 of its exempt portfolio managers was denied by the DPA. Following DPA's denial of the CalPERS proposal, the BOA asked the State Controller to issue payroll checks at the increased salary levels; however, the Controller determined she could not do so without DPA approval. In response, the BOA, acting under what it believed to be its constitutional authority, proceeded to remove the portfolio managers from the state's master payroll system and used an alternative payroll agent to pay them at a level the BOA had proposed was necessary to retain qualified investment managers.

The Controller later filed a lawsuit in Sacramento Superior Court on the grounds that the BOA's actions did not comply with existing statutory and constitutional law. Among other things, the lawsuit asserted that the Controller is responsible for maintaining a uniform payroll system for state employees and it was unlawful for the BOA to establish an alternative payroll system. In addition, the Controller maintained that the BOA's classification of 10 portfolio managers as employees exempt from civil service violated Article VII, Section 4 of the Constitution and the civil service laws.

On appeal, the Court ruled in favor of the Controller and voided the existing legal basis for the existence of more than one exempt employee at CalPERS and CalSTRS. It also ruled that the BOA and, by extension, the Board, must follow current statute which provides that the DPA determine appropriate compensation levels for exempt state employees. It reached this decision as a matter of law and did not consider evidence on the necessity that the Board be able to recruit and retain high-level employees with the knowledge, skills and abilities to carry out complex investment and administrative functions at CalSTRS the Board requires in order to effectively discharge its duties.

The court ruling earlier this year has placed the future employment of CalSTRS' senior administrative and investment executives in question. Under an agreement with the DPA, System employees impacted by the court's decision received a temporary appointment, which allows them to continue to be compensated at existing levels until this winter. After that time, the Controller will not have the authority to process pay warrants for more than one exempt employee.

DISCUSSION

Specifically, Senate Bill 269:

- Expresses legislative intent that in order for the Board to meet its fiduciary obligation to its members, it must be able to attract and retain employees in key senior executive and investment management positions with compensation that is consistent with the compensation paid to employees of other public retirement and financial service organizations;
- Authorizes the Board to set the compensation for the CalSTRS' CEO, the System Actuary,

CIO and other senior investment officers and portfolio managers whose positions are classified managerial by state civil service standards. These are the positions that were already exempt from civil service, or being evaluated to become exempt. The level of compensation could be guided by the principles contained in existing civil service laws, to compensate employees at levels competitive with the compensation paid to employees in other retirement and financial service entities;

- Requires that when these positions are filled through a general civil service appointment, candidates be selected from an eligible list based on an open examination;
- Allows the Board to take action to remove these employees according to state civil service discipline standards, for failure to meet specified performance objectives and other causes related to the Board's fiduciary responsibility to its members;
- Is an urgency measure that becomes effective the day it is signed by the Governor.

The Board believes that in order to secure the financial future and sustain the trust of California's educators, it must have the ability to recruit and retain top talent. The current civil service structure does not provide for salary levels needed to attract seasoned professionals able to manage a retirement system with over 640,000 active and retired members and the third largest public pension fund in the country with assets totaling over \$90 billion invested both domestically and internationally across all asset classes. The Board believes that without legislation, CalSTRS will experience widespread departures among its senior executive and investment staff with no hope of attracting qualified replacements due to lower civil service salaries.

In-house investment managers are far more cost effective than outside managers. Internal managers enable the System to maximize control of the TRF and allows the Board to monitor investment performance more closely. In addition, staff estimates that outside fund managers would cost four to five times what the System pays its current investment managers. For example, a survey released by the Association of Investment Management and Research and Russell Reynolds Associates in May, 2003, indicates that the median total compensation for a large mutual fund CIO was \$1,129,000 per year.

CalSTRS competes with both public and private financial services organizations for top executive and investment management talent. Over the past five years, the Board has actively sought qualified candidates interested in senior administrative and investment positions at CalSTRS, including the CEO, CIO and various Investment Director positions. However, the pool of qualified candidates interested in these positions was very small on each occasion. Executive search firms retained by the Board indicate this was due in large part to the low level of compensation the System is authorized to pay. During late 2001, when the Board sought to hire a new CEO, the consultant retained to assist the Board advised it that the current salary for the position was lower than that paid by several smaller pension systems. This situation continues to limit the Board's ability to attract otherwise qualified candidates and stretches the time needed to

fill vacant positions.

CalSTRS members and beneficiaries need to have their retirement system and money managed by top talent. The Board has explored several alternatives for paying senior administrative and investment executives no longer eligible to be classified as exempt employees and concluded that this proposal best meets the needs of the system, its members and beneficiaries.

FISCAL IMPACT

Benefit Program Costs – The performance of the investment portfolio affects CalSTRS' ability to fund the benefits for its membership and the level of contributions required from the state General Fund. Improving CalSTRS' ability to recruit top administrative and investment professionals may increase the amount of money available for benefits and diminish taxpayer's burden.

Administrative Costs – Minor and absorbable costs associated with posting exam notices and following other civil service procedures as the System does for its other civil service employees. If internal investment management positions are left unfilled, the Board may utilize external investment managers to oversee CalSTRS assets at much greater cost than would otherwise be the case.

BOARD POSITION

Sponsor. Now more than ever, it is vital to have the best talent managing the day-to-day operations of CalSTRS and the TRF. With today's investment challenges and the need to maximize investment income, the Board needs the ability to retain existing senior staff and recruit the same caliber of staff in the future. Without legislation, widespread departures are likely, disrupting CalSTRS operations and limiting the Board's ability to manage and monitor the System and the TRF.