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EXPAND INVESTMENT OPTIONS OF PUB. EMPLOYEE RET. SYSTEMS

House Bill 5925 as enrolled
Public Act 485 of 1996
Second Analysis (1-9-97)

Sponsor: Rep. Kim Rhead
House Committee: Appropriations
Senate Committee: Appropriations

THE APPARENT PROBLEM:

The authority of the state and of local governments to invest retirement funds is controlled partly by retirement statutes and partly by the Insurance Code. Public Act 314 of 1965 governs the investment of assets in public employee retirement systems operated in Michigan. This act has been amended occasionally to bring it up-to-date with current investment practices and patterns to ensure not only that investment fiduciaries meet minimum investment experience requirements, but also to ensure that they have flexibility in investing in different types of assets and at levels that would be most beneficial to the respective systems that they manage. In recent years, investments that in the past may have been considered risky have become an important part of balancing the portfolios of many private retirement systems. For instance, many investment fiduciaries have begun to utilize what are known as "derivatives," which derive their value from the underlying value in some other financial instrument or index, to help stabilize portfolios during certain financial conditions. Others, considering the fact that people today are living longer than a generation ago, are relying more on stocks--and particularly "growth stocks," which are securities involving relatively young and growing companies--to generate returns that are more likely to keep pace with or exceed the effects of inflation on retirement savings. The act was last updated in 1982, when the investment environment was dramatically different than it is today. Some people believe that in order for public employee retirement funds to be invested in ways most beneficial to the individual systems and for those who participate in them, amendments are needed both to expand the types of and levels of investments that fiduciaries may make and to ensure fiduciaries operate only in ways that best serve their individual systems.

THE CONTENT OF THE BILL:

The bill would amend Public Act 314 of 1965, which would be named the Public Employee Retirement System Investment Act, to establish guidelines that investment fiduciaries would have to meet in order to invest assets owned by systems governed by the act, add provisions that would raise the percentage limit that currently applies to amounts that may be invested in stocks, expand on the types of investments that could be made with public employee retirement funds under the act, and make certain other changes to investment provisions.

Definitions. The act currently defines "assets," for purposes of meeting limitations contained in the act, as the total of the cash, accounts receivable, and investments of a system "valued at cost." Under the bill, "assets" would include cash and investments "valued at market," rather than at cost. The bill also would define a number of new terms, including "defined contribution plan," "derivative," and "foreign security".

Fiduciary responsibilities, qualifications. The act specifies the investment authority of each retirement system and the responsibilities and minimum qualifications of investment fiduciaries. The bill provides that a system would have to be a separate and distinct trust fund and would require its assets to be for the exclusive benefit of the participants and their beneficiaries and for defraying reasonable expenses of investing system assets.

The bill would permit an investment fiduciary of a defined contribution plan to arrange for one or more investment options to be directed by the participants of the plan. The limitations on the percentage of total assets for investment specified in the act would not apply to a defined contribution plan in which a participant directs the investment of assets in his or her individual account, and that participant would not be considered an investment fiduciary under the act.

Under the bill, an investment fiduciary would be required to prepare and maintain written objectives, policies, and strategies with clearly defined accountability and responsibility for implementing and executing the system's investments, and to monitor the investment of the system's assets with regard to the limitations established under the act. If a fiduciary discovered that an investment caused the system to exceed the limitations prescribed in the act, he or she would be required to reallocate assets in a prudent manner in order to comply with the limitation.

The bill would prohibit a fiduciary, with respect to a system, from causing the system to engage in a transaction if he or she knew or should know that the transaction was, directly or indirectly, any of the following:

* A sale or exchange or a leasing of any property from the system to a party in interest for less than the fair market value, or from a party in interest to the system for more than the fair market value;

* A lending of money or other extension of credit from the system to a party of interest without receipt of adequate security and a reasonable rate of interest, or from a party in interest to the system with the provision of excessive security or at an unreasonably high rate of interest;

* A transfer to, or use by or for the benefit of, the political subdivision that sponsors the system of any of its assets for less than adequate consideration;

* The furnishing of goods, services, or facilities from the system to a party in interest for less than adequate consideration, or from a party in interest to the system for more than adequate consideration.

Also, an investment fiduciary, with respect to a system subject to the act, could not do any of the following:

* Deal with system assets in his or her own interest or for his or her own account;

* Act, as an individual or in any other capacity, in any transaction involving the system on behalf of a party whose interests were adverse to the system's interests or the interests of its participants or participants' beneficiaries;

* Receive any consideration for his or her own personal account from any party who dealt with the system in connection with a transaction involving system assets.

An investment fiduciary, however, would not be prohibited from 1) receiving any benefit to which he or she may be entitled as a participant or participant's beneficiary of the system; 2) receiving any reimbursement of expenses properly and actually incurred in performing system-related duties; 3) serving as an investment fiduciary in addition to being an officer, employee, agent, or other representative of the sponsoring political subdivision; or 4) receiving agreed upon compensation for services from the system. And except for an employee of a system, this state, or the political subdivision sponsoring the system, when acting in the capacity as an investment fiduciary, a fiduciary who was otherwise qualified would have to be one of the following: a registered investment advisor under the federal Investment Advisors Act and the Michigan Uniform Securities Act, a bank as defined under the Investment Advisors Act, or an insurance company qualified under the insurance company provisions of the act.

Further, the bill would prohibit an investment fiduciary from investing in a debt instrument issued by a foreign country that has been identified by the U.S. State Department as engaging in or sponsoring terrorism.

The bill would require a system to annually publish and make available to plan participants and beneficiaries a list of all expenses paid by "soft dollars" (brokerage commissions that are used by the system to purchase goods and services).

Stocks. The act currently prohibits an investment fiduciary from investing more than 60 percent of a system's assets in stock. The bill would raise this threshold to 65 percent. In addition, the act now specifies that to qualify as an investment option, a stock must have paid dividends in at least three of the past five consecutive years, and during that period aggregate net earnings must have exceeded aggregate dividends paid. Depending on the size of the system, the act specifies a minimum percentage amount of all stock invested in by an investment fiduciary that must meet this dividend requirement (i.e., at least 90 percent in a system with assets of less than $250 million, and so forth.) The bill would delete all of these provisions.

Mutual funds. Currently, the act allows system fiduciaries to invest in so-called mutual funds ("investment companies registered under . . . the [federal] Investment Company Act") and specifies that for a mutual fund to qualify as an investment, the management company of that mutual fund must have been in operation for at least five years and have assets under management of more than $100 million. The bill would raise this threshold to $500 million.

The act also provides that an investment in a mutual fund company is considered an investment in stock only for purposes of determining the 60 percent maximum investment limitation, and that investing in a mutual fund company is not considered a stock investment if the stated purpose of the mutual fund is investing in fixed income securities (i.e., bonds) or other types of short- or long-term debt. The bill would delete these provisions from the act.

Annuity investment contracts. The act permits fiduciaries to invest in annuity investment contracts or participations in separate real estate, mortgage, bond, stock, or other special investment accounts of a life insurance company authorized to do business in the state, but specifies that the company offering participation in a separate account must have been in operation for at least five years and have assets under management of more than $100 million. The bill would raise this threshold to $500 million, and would require that such an insurance company be rated for its ability to pay claims at no less than A, according to A.M. Best & Company standards, or AA-, according to Duff & Phelps Credit Rating Corporation. Also, the company's overall company financial strength rating could not be less than Aa3, according to Moody's Investors Services, or less than AA-, according to Standard & Poor's Ratings Group.

"Yankee bonds". The act specifies numerous types of other investments that an investment fiduciary may invest in, such as obligations of "solvent entities," obligations of the U.S. or of its territories, highly rated commercial paper, and various other investments. The bill would include in this list dollar denominated obligations issued in the U.S. by foreign governments, supranationals, banks, or corporations (known as "Yankee bonds") that were of investment grade. The bill also provides that, relative to all these types of investments, an investment fiduciary could not invest in more than five percent of the outstanding obligations of any one issuer, nor invest more than five percent of a system's assets in the obligations of any one issuer.

Real estate investments, other entities. The bill would permit investing of up to five percent of a system's assets in publicly or privately issued "real estate investment trusts" (REITS), in real or personal property otherwise qualified under other provisions in the act, or in otherwise qualified investments. Currently, a retirement system with assets of more than $250 million may invest directly in, own, lease, or acquire real or personal property and may develop, maintain, operate, or lease out that property. The bill would lower this threshold to $100 million.

In addition, the bill would permit a fiduciary to form one or more limited partnerships, corporations, limited liability companies, trusts, or other organizational entities (for which liability of an investor cannot exceed the amount of the investment under the laws of the U.S., any state, or any U.S. district or territory) to hold title to, improve, lease, manage, develop, maintain, or operate real or personal property whether currently held or acquired after the bill's effective date. An entity formed under this provision would have the right to exercise all powers granted to it by the laws of the jurisdiction where it was formed, including, but not limited to, the power to borrow money in order to provide additional capital to benefit and increase the overall return on property held by it.

The five percent of assets cap would apply to all of these types of investments, and the purchase price of any such investment could not exceed the appraised value of the real or personal property. Qualifying assets in which the underlying asset was an interest in real or personal property would constitute an investment for purposes of meeting the act's asset limitations, even if the investment could qualify under another section of the act, and an investment in stock under these provisions would not be considered an investment in stock under the act's provisions covering stocks.

Second mortgages. The act currently allows investments in second mortgage loans as long as the fiduciary has the right, but not the obligation, to pay the underlying first mortgage and the proceeds of the second mortgage are sufficient to do so. The bill would delete the provision relating to the availability of sufficient funds from the proceeds of the second mortgage and, instead, would add to the criteria that would have to be met in order to invest in these 1) that the total balance owed on the first mortgage and the amount of the second mortgage did not exceed 80 percent of the appraised value of the real property at the time of the second mortgage, and 2) the second mortgage did not have a term longer than 30 years.

Basket clause minimum. The act allows a system with at least $10 million but less than $250 million to invest up to five percent of its assets in any investments not specifically authorized by the act. The bill would remove the $10 million floor requirement that applies to the size of the system.

Loan of securities. The act permits a system to loan bonds, stocks, and other securities when they are secured by collateral insured or guaranteed by the U.S. government equal to 100 percent of their full market value, and requires that the collateral remain at least 95 percent of the securities' market value during the course of the loan, but never in an amount that is more than $100,000 less than the full market value. The bill would raise these percentage levels to 102 percent and 100 percent, respectively, and would delete the requirement that the collateral cannot be in an amount that is more than $100,000 less than the full market value.

Annual actuarial valuation. A system with assets of $20 million or more would be required to have an annual actuarial valuation with assets valued on a market-related basis. (A system with less than $20 million in assets would be required to have such a valuation every other year.) A system would be required to prepare and issue a summary annual report, and make it available to plan participants and beneficiaries and to the citizens of the political subdivision sponsoring the system. The report would have to include the name of the system and the names of its investment fiduciaries, and the system's assets and liabilities, funded ratio, investment performance, and expenses.

Loan guarantees. Currently, a system established by a city with a population of one million and having assets of $50 million or more may invest in certain loan guarantees. The bill would revise this provision to delete the population requirement and increase the asset threshold to $100 million.

Derivatives. The bill would permit an investment fiduciary to invest in any of the following kinds of derivatives, as long as all qualifications specified in the act were met:

* One that hedges positions of a nonderivative component of a portfolio that "clearly reduces a defined risk";

* One that replicates the risk/return profile of an asset or asset class, as long as these were allowable investments under the act;

* One that rebalances the country or asset class exposure of a portfolio;

* A derivative in which the investment fiduciary had examined the price, yield, and duration characteristics in all market environments both at the time of investment and on an ongoing basis;

* Commingled or pooled investment funds that used derivatives, if this use was consistent with guidelines set forth in the bill;

* Over-the-counter derivatives if, in the case of an over-the-counter security, a minimum of two competing bids or offers were obtained. All counter party risk in such transactions would have to be examined when the investment occurred and on an ongoing basis.

Under the bill, the aggregate market value of the underlying security, future, or other instrument or index involving a derivative could not exceed 15 percent of the assets of the system. However, for purposes of this asset limitation, a derivative would not include any of the following:

* Asset-backed pools, mortgage-backed pools, or collateralized mortgage obligations (CMOs) that were otherwise qualified and were no more exposed to prepayment risk or interest rate risk that the underlying collateral, including planned amortization classes and sequential-pay CMOs;

* Convertible bonds, convertible preferred stock, rights or warrants to purchase stock, bonds, notes, or partnership interests, floating rate notes, zero coupon securities, stripped principal securities, or stripped interest securities, all of which were otherwise qualified by the act;

* Exchange-listed derivatives trading on a daily basis and setting in cash daily or having a limited and fully defined risk profile at an identified, fixed cost, including futures contracts and purchased options;

* Currency forwards trading on a daily basis and setting in cash daily or having a limited and fully defined risk profile at an identified, fixed cost.

The bill, however, explicitly would prohibit, notwithstanding other provisions in the act to the contrary, investment in derivatives for the purpose of leveraging a porfolio or shorting securities as a sole investment.

Foreign securities. The bill would permit, notwithstanding a percentage of total assets limitation for an investment specified elsewhere in the act, investment of not more than 20 percent of a system's assets in foreign securities. Except as otherwise allowed, a fiduciary could not however invest in more than five percent of the outstanding foreign securities of any one issuer, nor invest more than five percent of a system's assets in the foreign securities of any one issuer. Investments in foreign securities could be made only by an investment fiduciary who was qualified as specified in the bill.

FOIA requests. The bill would exempt from the disclosure requirements of the Freedom of Information Act the following information:

* Records, materials or other data received, prepared, used, or retained by an investment fiduciary in connection with the investment of a system's assets relating to financial or proprietary information pertaining to a portfolio company in which the fiduciary had invested or had considered an investment that was considered by the portfolio company and acknowledged by the fiduciary as confidential;

* Any records, materials, or other data utilized by a fiduciary pertaining to a system's assets that related to

financial or proprietary information whether prepared by or for the investment fiduciary regarding loans and assets directly owned by the fiduciary and acknowledged by him or her as confidential.

MCL 38.1132 et al.

FISCAL IMPLICATIONS:

The House Fiscal Agency says the bill would not affect state or local budget expenditures. (9-16-96)

According to the Senate Fiscal Agency, the fiscal impact of the bill on the valuation of pension assets is unknown; it would depend on the quality of investment decisions made on behalf of each pension fund. (12-5-96)

ARGUMENTS:

For:

The bill represents an effort to give those who invest public employee retirement funds the flexibility to take advantage of market opportunities while ensuring that their activities do not go beyond what is prudent to ensure the continued strength of a specific retirement system. Many people believe Michigan's pension funds could perform significantly better than they do now if system fiduciaries were given the ability to utilize other investments or to increase the amount they may invest in stocks, and particularly in those whose value derives primarily from their growth over time rather than the dividends they pay stockholders. The bill would expand investment options involving the following types of asset classes and maximum investment percentages:

* Investment fiduciaries could invest up to 65 percent, rather than just 60 percent, of the total amount of assets of a portfolio in stocks. Over the last several dècades, common stocks have greatly outperformed more conservative securities. Although stocks may be volatile in the short term, history proves that over a longer period of time they offer an excellent return on an initial investment. Since most of the systems involved are aiming toward ensuring the best returns for employees planning to retire, it seems reasonable to expect that their portfolios will be substantially weighted toward investments with the best potential to grow, such as that offered by stocks. The bill also would delete current provisions requiring that stocks provide dividends in three of the last five years in order for them to be purchased, which would enable fiduciaries more options to invest in growth stocks.

* Many pension funds are utilizing derivatives more often today to help their systems weather fluctuations in the market caused by various domestic and foreign factors--such as changes in interest rates in the U.S. or currency fluctuations on the world market. The bill recognizes the proper and prudent use of derivatives for specific purposes, but also establishes a 15 percent asset limitation for derivative securities considered more risky. The bill also explicitly prohibits the use of derivatives for "leveraging" or "shorting" securities as a primary investment device, which acknowledges the fact that major losses--for example, in the infamous Orange County, California case--have been incurred by other public pension systems that relied too heavily on them.

* The bill expands the use of other types of investments. For example, it authorizes the use of so-called Yankee bonds, which are dollar-denominated obligations issued in the U.S. by foreign governments, supranationals, banks, or corporations. It also revises provisions governing investments in mutual funds to fit with the stock limitations of the bill, and would require a mutual fund company to have assets of at least $500 million, rather than just $100 million, to ensure that only the strongest mutual fund companies are invested in. Similar provisions would apply to annuity contracts offered by insurance companies. In addition, the bill would allow for the investment of up to five percent of a retirement system's assets in indirect real estate investment vehicles and make other changes to provisions governing investment in real estate, which would enable investment fiduciaries to utilize real estate investments to further diversify their portfolios. And finally, the bill recognizes the existence of defined contribution plans, where assets are directed by an individual participant in the system rather than by an investment fiduciary.

For:

The bill adds additional protective measures to guard the integrity of public employee retirement systems and to ensure that those who manage them operate according to standards established by the Government Accounting Standards Board. This is reflected in new definitions that would be added to the act as well as revisions that would be made to existing definitions by the bill. In addition, the bill would more clearly delineate acceptable actions of an investment fiduciary, and would require that each one be registered under both the federal Investment Advisors Act and the Michigan Uniform Securities Act. And finally, the bill would limit the amount of proprietary financial information relating to a pension system's assets that would have to be provided to someone who requested it under the Freedom of Information Act. These changes, in concert with the provisions that would expand investment options for fiduciaries, should prove beneficial both to the state's public employee retirement systems and to those who participate in them and their beneficiaries.

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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.