

Date of Hearing: April 15, 2021

ASSEMBLY COMMITTEE ON PUBLIC EMPLOYMENT AND RETIREMENT

Jim Cooper, Chair

AB 539 (Cooley) – As Introduced February 10, 2021

SUBJECT: State teachers' retirement: investment managers and investment advisers: contracts

SUMMARY: Authorizes the Teachers' Retirement Board of the California State Teachers' Retirement System (CalSTRS) to contract with investment advisers, as specified, among other provisions. Specifically, **this bill:**

- 1) Amends existing law to permit the CalSTRS board to also contract with investment advisers, as defined, who have demonstrated expertise in advising the management of large and diverse investment portfolios to render service in connection with the investment program of the board.
- 2) Maintains existing law where the letting of a contract for these purposes is conditioned upon a finding by the board that the necessary investment expertise is not available within existing civil service classifications, and with approval by the State Personnel Board.
- 3) Authorizes the CalSTRS board, pursuant to a policy adopted by the board, to establish a competitive bidding process and specify the contract terms and conditions it solely deems necessary and prudent for such contracts.
- 4) Makes conforming changes for these purposes.

EXISTING LAW:

- 1) Establishes, pursuant to Section 1 of Article VII of the Constitution of California, that the civil service includes every officer and employee of the state, except as otherwise provided.
- 2) Requires, pursuant to the Civil Service Act, that state employment to be based on the merit principle; appointments are based upon merit and fitness ascertained through practical and competitive examination; tenure of civil service employment is subject to good behavior, and among other provisions, applicants and employees are treated in an equitable manner without regard to political affiliation, race, color, sex, religious creed, national origin, ancestry, marital status, age, sexual orientation, disability, political or religious opinions or non-job related factors.
- 3) Establishes, pursuant to Section 17 of Article XVI of the California Constitution that Provides, pursuant to California Constitution Article XVI, Section 17, that the boards of California's public retirement systems have "plenary authority and fiduciary responsibility for investment of monies and administration of the system."

- 4) Provides under the California Constitution that "the members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administrating the system...[and] the board shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return unless under the circumstances it is clearly prudent to do so."
- 5) Authorizes the board, upon a finding by the board that necessary investment expertise is not available within existing civil service classifications, and with approval of the State Personnel Board, to contract with qualified investment managers, as provided.
- 6) Defines "investment manager" and "investment adviser" to mean any person, firm, or custodian (i.e., bank or trust company), either appointed by or under contract with the board to engage in investment transactions or to manage or advise in the management of the assets of the Teachers' Retirement Fund with respect to the Defined Benefit and the Cash Balance Benefit Programs.
- 7) Establishes, pursuant to Chapter 47, Statutes of 2014 (Assembly Bill 1469, Bonta), the CalSTRS Full Funding Plan, which among other provisions, is designed for CalSTRS to achieve full funding by the year 2046.

FISCAL EFFECT: Unknown. This bill is flagged as fiscal by Legislative Counsel.

COMMENTS: According to the author, "[as] global markets increase in complexity and the assets of California's state retirement systems grow in size, the CalSTRS board is increasingly constrained by the traditional state procurement processes when contracting for investment expertise. Most of California's state agencies, including CalSTRS, must abide by the state contracting requirements. However, in recognition of the unique nature and mission of certain agencies, the Legislature has granted exemptions to certain prescriptive competitive bidding requirements.

"As fiduciaries, the CalSTRS board is already bound by standards set forth in our 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 already require fiduciaries to operate at a level that goes beyond the goals of the competitive bidding requirements.

"Consistent with existing authority set forth in the California State Constitution, [this bill] authorizes the board to seek and secure the highest value contracts for investment-related expertise and services under the board's terms and conditions, while still meeting the highest fiduciary standards of due diligence. This increased flexibility would allow CalSTRS to move quickly to capture investment opportunities and negotiate reduced fees or better terms."

1) Time Never Stops and Opportunities Do Not Wait: Pension Fund Strategies for Investing and Legal Standards of Duty

Previously iterated in a number of writings on behalf of this committee involving legislation affecting pension fund investments, a simple reiteration of the components regarding the subject will be reiterated here. For example, the very nature of the investment market is opportunistic.

Understanding, appreciating and respecting this nature of the investment market and investing is of utmost importance not just for institutional investors such as CalSTRS here, but also to anyone (e.g., private individual to large global hedge fund) who has interests in market investing. Where opportunities may exist at one time, they may not remain very long. Experienced investors such as CalSTRS understand, appreciate, and respect this key nature, among many others, relating to investments.

Another key tenet of market investing, also previously expressed in other prior writings on behalf of this committee generally related to this subject, is that, an attempt to “play the market” is akin to a “fool’s errand.” Investors either subscribe to a mid- or long-term approach where, historically, markets and particular investments show over a period of time that, depending on the nature and type of investment, the approach is more likely than not, to achieve positive returns that exceed losses during that period. Alternatively, investors may opt to base their investment decisions on sudden and ever-changing conditions, indicators, and information. While some have achieved a level of success based on the latter strategy, they are few. CalSTRS is a long-term investor.

CalSTRS must invest based on statutory, State constitutional, federal and state regulations, and legal duties that strictly inure to the benefit of its members and their beneficiaries above all else. To be clear, CalSTRS continues to be a long-term institutional investor bound by each of these requirements. These require, among others, CalSTRS to diversify investments, defray costs where reasonable and appropriate, and exercise prudence and skill towards providing and continuing to provide retirement benefits to its members.

2) CalSTRS Investments and Pension Fund Authority

As previously stated under “Existing Law,” pursuant to California Constitution Article XVI, Section 17, that the boards of California's public retirement systems have "plenary authority and fiduciary responsibility for investment of monies and administration of the system," and that, "...the members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries..."

Pursuant to the California Constitution, it is unambiguously certain that funds invested by CalSTRS for the retirement of its members do not belong to CalSTRS, the public, the state, nor the Legislature. Such funds are managed by CalSTRS and held in trust solely and expressly for its members who pay a portion of their wages towards their own financial security in retirement.

CalSTRS is legally obligated to prudently manage these funds solely and specifically for this purpose. While external influences on pension fund investments may opine and perceive that such funds belong to the public, the Legislature, or the State for purposes beyond CalSTRS' legal obligations; quite simply, they are not. Such monies exist, belong, and must be used, to benefit CalSTRS members.

3) Existing Laws May Hinder Progress and Opportunity For California's Pension Funds: The State's Procurement Process for State Agencies

Information provided by the author states that, "[m]ost California state agencies, including CalSTRS, must abide by state contracting requirements set forth in the Public Contract Code (PCC), including [Sections] 10295, 10335, and 10335.5... [of the Code]." In addition, the author submits that Section 10351 of the PCC "exempts services and consultant services if the contract is under \$150,000; [whereas, Section 11256] provides blanket approval for contracts for state agencies subject to the approval of the Director of the Department of General Services."

Here, the author acknowledges the importance and relevance of the PCC, including a few salient provisions therein, which, serve the purposes of public interests regarding transparency and accountability as to the expenditure of taxpayer monies by state government agencies.

Regarding the existing state procurement process, it may take numerous weeks or perhaps months for state agencies, including CalSTRS, to successfully complete the process of approval to engage in procurement for various needs. However, a slight recollection of the immediate discussion above regarding time and market opportunities may serve as a guide for the need of this bill, and as stated by the author.

4) Importance of this Bill Relating to the CalSTRS Full Funding Plan

As previously discussed under "Existing "Law", the primary purpose of the CalSTRS Full Plan is to ensure that CalSTRS is in the financial position to be fully funded by the year 2046. Currently, the funded status of CalSTRS ranges from 69 percent to 71 percent which, when compared to other similarly situated institutional investors, is relatively on par, but remains low when all other things are considered.

A few things that impact this funding plan are complex, but essentially they include factors such as risk adjusted investments, investment earnings, public policies at both federal and state government levels, and other global, national, state and local conditions that affect investment markets and their participants, to name a few. While some factors are beyond the control of the Legislature, the factor of state-level public policies such as this bill that would grant CalSTRS certain flexibility towards achieving the success of this plan are within legislative control.

This measure proposes to afford some flexibility to CalSTRS, similar to what currently is afforded to the California Public Employees' Retirement System, that may be considered reasonable and prudent, and only when there are absolutely no other options available in state civil service to provide the necessary expertise.

Despite market volatility in 2020, CalSTRS continues to be on track to reach full funding by 2046. In addition, CalSTRS recently approved new long-term asset allocation targets which are an important part of reaching full funding. This committee continues to closely monitor the progress of CalSTRS achieving the goals of the Full Funding Plan, and this bill may help to accelerate that success.

5) CalSTRS' Policies for Procurement

Regarding internal policies for procurement, CalSTRS' procurement process can be found on its internet website.¹ In addition, the Teachers' Retirement Board has embarked on establishing a new procurement process for investment managers and advisers which includes desired qualifications, strategy, and a streamlined process for procurement in this regard that include factors such as evaluation, selection, contract negotiation, and execution. For each of these, CalSTRS would apply board-governed policies, intentions, and multiple layers of oversight.

6) Comments by Supporters

CalSTRS states that, "The investment world is increasingly fast paced and competitive, with top-performing managers and advisers often having both their pick of partners and limited capacity. Conversely, CalSTRS operates under the umbrella of sometimes inapplicable and restrictive state procurement requirements when contracting for investment expertise. While CalSTRS expends significant time on this process, the landscape may change, costs may increase, and the circumstances driving favorable investments may disappear altogether.

"[This bill] gives the board authority to establish a process that includes the highest fiduciary standards of due diligence. Unlike other examples of contracts that utilize general state procurement requirements, CalSTRS' internal investment experts continuously monitor the investment marketplace and are very cognizant of the fees and performance of potential applicants for investment manager and adviser contracts."

7) Prior or Related Legislation

Assembly Bill 2510 (Cooley, 2020) was substantially similar to the current measure; however, it was held in the Assembly Committee on Public Employment and Retirement at the request of the author due to the COVID pandemic and subsequent disruption to the legislative calendar.

Assembly Bill 1052 (Cooley, 2016) would have authorized CalSTRS to contract for specified investment-related services under the board's terms and conditions and utilizing the processes the board deems necessary and consistent with its fiduciary duties. This bill was held on the Assembly Inactive File.

¹ <https://www.calstrs.com/general-information/solicitationpurchasing-methods-0>

Chapter 542, Statutes of 1989, (Assembly Bill 59, Elder) which, 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.

Chapter 1043, Statutes of 1983 (Assembly Bill 652, Papan) that, among other things, removed the requirement that investments be made under the terms, conditions, limitations and restrictions that are imposed by the state upon savings banks, and repealed requirements for the issuance of bonds as investments and added explicit authority for the board to contract with investment manager firms.

REGISTERED SUPPORT / OPPOSITION:**Support**

California State Teachers' Retirement System (*Sponsor*)

Opposition

None on file.

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