F I S C A L   I M P A C T   R E P O R T

SPONSOR Garcia, M.P. **ORIGINAL DATE** 2/21/09 **LAST UPDATED** 3/2/09 **HB** 876/aHJC

SHORT TITLE Third-Party Investment Marketer Disclosure **SB**

ANALYST White

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY09	**FY10**	**FY11**		
NFI	NFI	NFI		

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to SB 611, SB 612

SOURCES OF INFORMATION
LFC Files

Responses Received From
Attorney General's Office (AGO)
State Investment Council (SIC)
Regulation and Licensing Division (RLD)

Responses Not Received From
Public Employees Retirement Association (PERA)
Educational Retirement Board (ERB)

SUMMARY

Synopsis of HJC Amendment

The House Judiciary Committee Amendment to House Bill 876 strikes language in all three sections of the bill in order to broaden the definition of third-party marketer. The definition as stated in the original bill would require disclosure of a third-party marketer only if the marketer has had direct communication with members of the State Investment Council (SIC), the Educational Retirement Board (ERB), or the Public Employees Retirement Association (PERA) or their investment staff. As amended the definition would apply to all third-party marketers utilized in a relative transaction whether or not they directly contact state employees or relative board/council members. This amendment addresses a technical issue voiced by SIC staff in the technical issues section below.

The amendment also strikes language in all three sections pertaining to someone who "fails to disclose" the information required by this legislation. The language as amended now only applies to those individuals who "knowingly withhold" the information required by this legislation. This addresses an issue voiced by the Securities Division of the Regulation and Licensing Department (RLD) discussed in more detail in the other substantive issues section below.

Synopsis of Original Bill

House Bill 876 seeks to incorporate additional transparency in the alternative investment process by requiring investment managers seeking the investment of state funds to disclose the use of third-party marketers. The bill states that the State Investment Council (SIC), the Public Employees Retirement Association (PERA), and the Educational Retirement Board (ERB) are prohibited from making investments in assets other than "publicly traded equities or publicly traded fixed-income securities" unless the recipient of the investment discloses the use of any third-party marketers and how they are being compensated. If any person were to fail do disclose "or knowingly withhold" this information they would be guilty of a "fourth degree felony."

FISCAL IMPLICATIONS

This bill places the responsibility of disclosing the use of third-party marketers on those seeking investment from the SIC, PERA, and ERB and not the state investment agencies themselves. Although this legislation would require the investment agencies to compile this information for periodic reports, this bill should have no additional fiscal impact on the state.

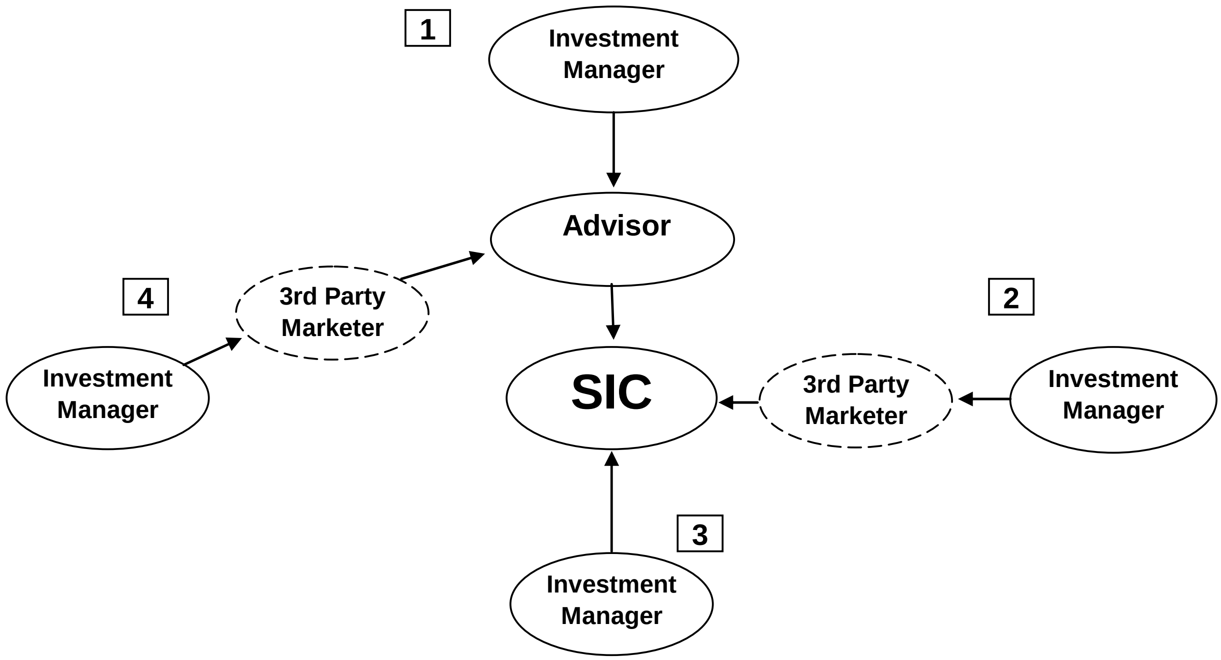
SIGNIFICANT ISSUES

After the enactment of the Prudent Investor Act in 2005, all state investment agencies began to move aggressively into a variety of alternative investments. These types of investments, (hedge funds, private equity funds, collateralized debt obligations, etc.) typically require a direct investment with a fund manager as opposed to an open-market purchase through a broker. In order to raise sufficient capital for investment, many of these fund managers utilize third-party marketers which have become quite common throughout the investment world. According to the Third-Party Marketers Association, third-party marketers "assist in increasing institutional assets for their…investment manager clients." They have become necessary due to the long and at times arduous process of soliciting a direct investment of public money. Figure 1 shows four methods of soliciting a direct investment of public money, using SIC as an example.

Method one shows an investment manager going through an advisor in order to solicit an investment from SIC. The use of advisors is extremely common when dealing with such specialized assets and currently all of the state investment agencies utilize advisors for the majority of their alternative investments. Advisors apply an extra layer of due diligence to these complex assets and can serve to filter out poor investments before they reach state investment staff. Although a third-party marketer circle is not included in method one, they can be present in these types of scenarios by advising the investment manager on how to contact and present to the advisor and or SIC staff.

Method two shows a scenario in which an investment advisor directly utilizes a third-party marketer. In this instance the investment manager is using the third-party market to contact and solicit investments from the SIC staff without going through an advisor. This method is more common for debt instruments such as collateralized debt obligations (CDO) than for private equity or hedge funds.

Figure 1: Four Methods of Soliciting Direct Investment



Method three shows an investment manager soliciting investment directly from the SIC at a staff level. This approach is once again more in line with debt instruments than with private equity or hedge funds. Method three is similar to method one in that it does not include direct participation with SIC staff by a third-party marketer, however a third-party marketer may be advising the investment manager on how to proceed throughout the investment process.

Method four is most common among private equity and hedge funds. The investment manager in this scenario is directly utilizing a third-party marketer and going through an advisor. If the advisor, after applying thorough due diligence, agrees that this type of investment may be in the best interest of the SIC than the third-party marketer may also be in contact with SIC staff.

State Investment Council (SIC):

The SIC currently requires significant disclosure of third party marketer information by its alternative asset managers and investment partners, though not always the specific terms and conditions. HB 876 would require the SIC, ERB, and PERA to request such information for disclosure on a monthly and yearly basis. Primarily this exercise would be administrative in nature, and would not be a significant change for the SIC, while at the same time offering greater clarity to the public regarding the investment process.

RELATIONSHIP

Senate Bill 611 relates to the process of investing state money by prohibiting financial contractors from contributing to various elected officials or related political committees.

TECHNICAL ISSUES

State Investment Council (SIC):

> In Section D of the bill (the definition of third-party marketer)…language is problematic, as under current practice, not every, and perhaps not even a majority of third party marketers acting on behalf of a fund or person seeking state investment, actually talk to the SIC or its representatives. Many third party marketers are apparently hired for their expertise in understanding the investment process or strategies pertinent to whatever investment is being posed to the investment agency. As many of these marketers never actually "communicate" with the SIC, it would appear that a fair number of third party marketers currently operating and being paid for their services or expertise, would not be required to report under HB 876.

The House Judiciary Committee amendment addresses this issue by striking language requiring a third-party marketer to have direct communication with SIC, ERB, or PERA members or their respective staffs.

Attorney General's Office (AGO):

> The bill does not regulate the conduct of a "third party marketer," or require them to disclose information relating to their relationship with an investment fund. The bill appears to require disclosure by the ultimate "recipient" of the funds. The bill assumes that there will be direct contact between the state officials mentioned in its provisions, and the ultimate "recipient" of the investment.

OTHER SUBSTANTIVE ISSUES

Regulation and Licensing Department – Securities Division (RLD):

> HB 876 places a limitation on the SIC, PERA, and ERB but does not specify what penalties or consequences would accrue to the SIC, PERA, or ERB for violation of the limitation. The entity that received the investment, but failed to report would be guilty of a fourth degree felony, but it is not clear whether the validity of the underlying investment would be affected.
>
> The bill imposes a criminal penalty on a person who "fails to disclose" as well as a person who "knowingly withholds" information required to be reported. One standard (knowingly withholds) requires some element of intent, while the other standard (fails to disclose) does not.

The House Judiciary Committee Amendment addresses this issue by striking language which would penalize any person who "fails to disclose" information and instead limits the criminal liability to those persons who "knowingly withhold" information required to be disclosed as per this legislation.

ALTERNATIVES

State Investment Council (SIC):

> The SIC suggests an alternative, striking the following language in Paragraph D: "communicates with the state investment council the state investment officer or an agent or employee of the state investment council or state investment officer and…" The SIC believes this removes the burden of communication while still identifying all third party agents or marketers working on the behalf of and getting paid in connection with an investment by the state.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The state investment agencies would be allowed to continue making direct investments in a number of different assets without full disclosure of the use of any third-party marketers. This would allow there to be a continued lack of transparency associated with the use of third-party marketers leaving room for potential misuses of state investment funds.

DMW/mc:mt

Appendix A
Examples of Direct Investments

Hedge Funds – SIC, ERB, and PERA all currently invest in hedge funds through one manner or another and all require a direct investment. Hedge funds are typically set up as "absolute return" funds, meaning that they use aggressive active management strategies to try and beat "passive" indexed investment returns. PERA is the only one who invests directly into hedge funds themselves, while SIC and ERB both invest in funds of funds. Funds of funds are collective funds which can consist of hundreds of different hedge funds. This allows SIC and ERB to have exposure to hedge funds as an asset class without too much exposure to one fund in particular. This method of hedge fund investing is becoming more and more popular throughout the public fund community due to the high level of diversification it allows investors.

Private Equity Funds – Private equity funds are also currently part of SIC, ERB, and PERA's investment portfolios. Private equity funds come in many different types and sizes depending on the type of strategy they employ. Private equity funds are similar to hedge funds in that they require a direct investment and seek to outperform "passive" indexed investment returns. However, private equity funds deal solely with investments in private businesses or buyouts of public companies that result in that company becoming private. Private equity funds usually select one type of strategy (leveraged buy-out, mezzanine, venture, special situation, etc.) and then select investments based upon those strategies.

Real Estate/Real Assets – SIC, ERB, and PERA all currently invest in real estate assets however, the majority of ERB's investments do not require direct investment. ERB's real estate exposure is made up primarily of Real Estate Investment Trust (REIT) investments which can be bought and sold publicly through a broker. SIC invests in a variety of different real estate investments as does PERA who also invests in real assets (buildings etc.).

Structured Investment Vehicles – At one point in time, SIC, ERB, and PERA have all invested in some type of Structured Investment Vehicle (SIV). The SIC has moved the most aggressively into these types of assets as can be seen in Table 1 below. This asset category includes a wide variety of different assets including collateralized debt obligations (CDOs). CDOs, which include mortgage backed securities, can be extremely complicated assets and have been blamed by many as a cause of the current economic crisis.

Table 1: Asset Exposure by Investment Fund as of 12/31/08

	LGPF	STPF	ERB*	PERA
Hedge Fund Assets	$ 1,040.00	$ 449.00	$ 587.00	$ 471.00
Private Equity Assets	$ 803.00	$ 553.00	$ 155.00	$ 155.00
Real Estate/Real Assets	$ 360.00	$ 187.00	$ 319.00	$ 78.00
Structured Investment Vehicles	$ 175.00	$ 76.00	$ -	$ -

* The only SIV that ERB has invested in to date has been written down but is still kept its books at $0.