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## FISCAL IMPACT REPORT

ORIGINAL DATE 03/01/11  
 SPONSOR SJC LAST UPDATED 03/10/11 HB \_\_\_\_\_  
 SHORT TITLE Educational Retirement Board Bank and Attorneys SB CS/269/aSFL#1  
 ANALYST Aubel

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
<b>Custodial</b>		NFI				ERB
<b>Contingency-fee</b>		Indeterminate costs savings				ERB

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to House Bill 38 and Senate Bill 86

### SOURCES OF INFORMATION

LFC Files

Responses Received From (SJCS)  
 General Services Department (GSD)

Responses Used for Substitute Bill Received From (For Original Bill)  
 Educational Retirement Board (ERB)  
 General Services Department (GSD)  
 Office of Attorney General (AG) (For House Bill 38)

No Responses From  
 Department of Finance and Administration (Contractual Services)

### SUMMARY

#### Synopsis of HFL Amendment #1

The Senate Floor Amendment #1 adds language to require the Attorney General complete the review of the contingency-fee contract within 30 days after receiving the contract. This will ensure a timely review process and not hold up litigation that might be subject to statute of limitations. In addition, the amendment adds a third provision under Section B that specifies that, in regard to contingency-fee contracts, nothing in this section “shall prejudice or impair the rights of a qui tam plaintiff pursuant to the Fraud Against the Taxpayers Act.”

Synopsis of Original Bill

The Senate Judiciary Committee Substitute for Senate Bill 269 amends the Educational Retirement Act so that the board is authorized to select its own custodial bank for investment assets and hire attorneys on a contingency-fee basis. However, the bill includes a requirement that proposed attorney contracts would be submitted to the Attorney General (AG) for review of contingency fees. If the AG deems a fee not to be reasonable, the board could approve a contract and the fee upon a vote of a least four members for approval. Attorneys seeking contract work would be required to disclose to the board all campaign contributions to the governor, attorney general, state treasurer, or to a board member, or to a political committee of any candidate for state office. The bill also adds a provision that creates an Educational Retirement Suspense Fund into which would be deposited all amounts received by private attorneys on behalf of the board. The fund would be used to pay fees, costs and expenses to the attorneys. After disbursements are made the balance of each deposit would be distributed to the Educational Retirement Fund.

**FISCAL IMPLICATIONS**

The bill will not have any immediate fiscal impact due to allowing ERB to contract directly for custodial services. Authorizing ERB to hire attorneys on a contingency-fee basis could provide an indeterminate amount of cost savings, which would depend on the number of cases, the fee, the type of case and the amount of any recovery. In general, ERB gains by not having to pay up-front costs but most likely will end up paying a higher fee as a percentage of any recovery to compensate the attorney for risk-sharing. However, if there is no recovery, then ERB is ahead with the contingency-fee rather than contracting on an hourly-fee basis.

Permitting an agency to enter into contingency fee contracts for litigation services presents the risk of abuse through law firm selection or case selection (or non-selection) involving “pay to play” schemes involving favorable settlement terms. There would also be opportunities for frivolous lawsuits against political targets. There is a clear need for both transparency and strong oversight to avoid the above and other possible risks from having this method of litigation available.

The bill’s structure appears to address the issue of potential for “pay to play” by having the AG review the contracts and requiring disclosure of all political contributions.

The bill creates in the State Treasury the “educational retirement suspense fund” into which all amounts received in satisfaction of a claim brought by private attorneys on behalf of the board shall be deposited. The board shall disburse the compensation due to the private attorneys in terms of the contract and the balance of each deposit shall be distributed to the educational retirement fund. The State Treasurer shall make the disbursements from the education fund or the educational retirement suspense fund only on warrants issued by the Department of Finance and Administration (or approved through any process by DFA). Warrants for the disbursements shall be issued by DFA only upon voucher of the ERB director.

**SIGNIFICANT ISSUES**

All three investing agencies (ERB, The Public Employees Retirement Association and State Investment Council) are seeking the authority to seek legal remedy on a contingency-fee basis while PERA and ERB are also seeking the authority to directly hire their own custodial banks.

SIC already was granted this authority through 2010 legislation.

### **Custodial Bank**

Current statute requires ERB and the Public Employees Retirement Association (PERA) to operate under the state-wide custodial services contract negotiated and executed by the Board of Finance (BOF) in the Department of Finance and Administration (DFA).

The Public Employees Retirement Association is also seeking the authority in House Bill 38 for direct control of the custodial contract. In its analysis for that bill, PERA noted that direct board control is a “best practice” for institutional funds:

Having an outside department such as BOF responsible for negotiation of PERA’s custodial bank does not reflect best practices for a public pension fund. *See*, Ennis Knupp Report, page 50. (The Ennis Knupp Report states “While having an outside department or statewide officeholder select the custodian bank is not unusual, it does not reflect best practices. We believe that as the highest governing fiduciary body responsible for the investment program, the Board should have the ability to freely choose its own custodian and negotiate the scope of responsibilities, the service levels, and fees. Likewise, the Board should be able to extend custodian contracts or terminate them at any time in the best interest of the fund.”)

One of the justifications for a single state-wide contract is that pooling assets would reduce the cost. However, The ERB fund, valued at about \$9 billion, is sizable enough on its own to qualify for the most favorable fee schedule. Thus, as also pointed out in the Ennis Knupp report, the state does not derive any economies of scale in requiring the pension plans to participate as part of the BOF contract. Allowing ERB to be able to negotiate its own contract in the future may actually improve its ability to derive a contract with more favorable terms that are more specific to the investment fund’s needs.

### **Contingency-Fee Attorney**

ERB asserts the following (response for original Senate Bill 269 remains relevant to the SJC Substitute):

In some, but not all, investment-related litigation it is economical and fiscally prudent for ERB to pursue damages on a contingency fee basis rather than an hourly fee basis. SB269 will likely result in a cost savings for ERB in the area of outside counsel attorney fees; however, there is no data on which to estimate that savings at this time.

PERA provided some additional background information in its response to HB38 that relate directly to the Substitute for SB269:

“...the Office of the Attorney General has contracted with several national securities law firms to allow the state investing agencies to become active litigants in securities cases in hopes of increasing recovery of damages. Absent specific statutory authority, the Attorney General has deemed professional services contracts for legal services cannot be entered into on a contingency fee basis. Given the complexity and cost of pursuing securities litigation against large financial institutions, the ability to retain outside counsel is imperative to PERA. Advancing costs for discovery and paying legal fees on an hourly basis is outside PERA’s existing operating budget. National securities firms are available and willing to perform securities litigation services on behalf of public pension funds on a

contingency fee basis, drawing their fee when a successful settlement is reached. PERA would pay nothing if no monetary settlement or order is entered. Absent the authority to contract on a contingency fee basis, PERA would be required to request a BAR for legal fees or forgo certain potential recovery of securities losses to the PERA Fund.’

The FIR for HB38 notes the following issue that is germane to this bill:

Permitting an agency to enter into contingency fee contracts for litigation services presents the risk of abuse through law firm selection or case selection (or non-selection) involving “pay to play” schemes for favorable settlement terms to parties other than the state. There would also be opportunities for frivolous lawsuits against political targets. There is a clear need for both transparency and strong oversight to avoid the above and other possible risks from having this method of litigation available. Including language in the bill to specify that procurement of services in this way be subject to PERB review and approval, along with concurrent approval by an outside entity such as the Department of Finance and Administration’s Contracts Review Bureau or the State Purchasing Agent might help insure that this procurement method only be used for appropriate cases and maximizing possible returns to the state.

GSD notes that the attorney service arrangement would be subject provisions in the Procurement Code. There has been some question as to whether investment-related attorney fees can be exempted from the Procurement Code under the provision that exempts investment managers. This bill explicitly reflects ERB’s position that they are not exempted.

This bill does not include an emergency clause as does the SIC bill, SB86.

## **ADMINISTRATIVE IMPLICATIONS**

The ERB and PERA funds are unique to the state’s custodial banking needs in that the portfolios are widely diversified beyond normal banking assets, such as cash or short term assets. Included are a wide range of assets types, including hedge funds and private equity, as well as the more traditional stocks and bonds. In addition, a significant portion of the portfolios are committed to global assets, which require custodial relationships and recording around the world. Thus, the funds pose unique challenges to the custodial relationship that may not be best addressed from the DFA point of view. The changeover from Northern Trust to Merrill Lynch, for example, created a significant disruption to the administration of the funds, not only due to the reconciliation between the two custodial agents but due to having to record the change in foreign countries for global assets. The result was a material delay in investment return reporting. Allowing ERB to govern its own custodial relationship rather than being subject to decisions made by DFA will improve the administration of the funds in this critical regard.

## **RELATIONSHIP**

Senate Bill 269/SJCS relates to House Bill 38, which seeks the same authority for PERA.

Senate Bill 269/SJCS relates to SIC’s request to seek the authority for contingency-based legal contracts.

**WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

ERB will continue to operate under the DFA custodial services contract and will hire attorneys on an hourly-fee basis.

MA/mew:svb