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FISCAL IMPACT REPORT

SPONSOR Trujillo **ORIGINAL DATE** 01/31/11
LAST UPDATED 03/14/11 **HB** 38/aSJC
SHORT TITLE PERA Custodian Bank & Attorney Fees **SB** _____
ANALYST Haug

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total	NFI	NFI	NFI			

(Parenthesis () Indicate Expenditure Decreases)

Relates to SB 86

SOURCES OF INFORMATION

LFC Files

Responses Received From

Attorney General (AGO)

Public Employees Retirement Association (PERA)

SUMMARY

Synopsis of SJC Amendment

The Senate Judiciary Committee amendment to House Bill 38 removes the authority for PERA to hire attorneys on a contingent fee basis.

Synopsis of Original Bill

House Bill 38, introduced on behalf of the Investments Oversight Committee, authorizes the Public Employees Retirement Board to: (a) enter into attorney contingent fee contracts and (b) select its own custodian bank.

FISCAL IMPLICATIONS

The PERA states:

Senate Bill 38 will have no direct general fund impact. PERA's operating budget is not funded with any general fund appropriations.

PERA's ability to enter into its own custodial bank contractual relationship will have a positive fiscal impact on PERA. Given its \$11.5 billion in assets, PERA will be able to negotiate a similar or more favorable fee structure independent of the other state investing agencies. Transitioning custodial bank services will be under the authority of the PERB, rather than the State Board of Finance.

The ability to enter into legal services contracts for securities litigation will have no impact on PERA's operating budget; contractors will be required to advance costs of litigation and legal fees will be paid from any monetary recovery received.

Should the PERA's assertions regarding negotiation of more favorable fee structures independent of the other state investing agencies prove true, the PERA should more than offset the costs of preparing and evaluating separate procurements for both custodial bank services and contingent fee attorney contracts. The NFI statement in the table above reflects this assumption.

SIGNIFICANT ISSUES

The PERA notes with respect to attorney contingent fee contracts that 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.

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.

With respect to the custodial bank authorization, the PERA states:

PERB is statutorily responsible for investing the pension trust fund and requires custodial banking services for settlement of investment transactions, safekeeping assets, administration of corporate actions, foreign currency exchanges, fund accounting,

reporting, and to function as “book of record” for all investment activity. Historically, the State Board of Finance (BOF) procured a single custodial banking contract for use by the State’s four investing agencies: PERA, the State Investment Council (SIC), the Education Retirement Board (ERB) and the State Treasurer’s Office (STO). In 2010, the SIC was granted the authority to contract for its own custodial bank.

In January 2010 the Legislative Council Service (LCS) retained Ennis, Knupp & Associates to conduct an independent operational and fiduciary review of the governance, organizational structure, policies and procedures and practices of the Public Employees Retirement Association (PERA). LCS sought an independent evaluation of the adequacy of PERA’s policies and compared current PERA practices to both those of industry standards and best practices.

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.”)

The best fit for a public pension system is to use a custodial bank with sufficient experience to meet a pension fund’s specialized needs. For example, accurate and timely investment accounting reports are a fundamental deliverable of the custodial banking arrangement specifically for PERA. Fiduciary best practices would allow the PERB to choose its own custodial bank and negotiate the scope of responsibilities, servicing levels, and fees to meet its needs. In addition to interacting and reconciling with PERA’s investment managers, the custodian must also be readily available and responsive to PERA’s internal investment staff for cash management, capital calls, asset transitions, and resolving investment-related issues. Historically, the custodial team assigned to the State’s investing needs is shared between all four investing agencies and the limited staff hasn’t been accommodating of PERA-specific timelines.

Independent procurement of custodial banking services allows PERA to search for and select the bank best-suited to PERA’s specific banking requirements. PERA investments are 100% externally managed and include more than 120 different investment mandates. The nature of PERA’s diversified investment portfolio requires a custodian capable of successfully settling complex global investment transactions.

With over \$11.5 billion in assets, PERA will be able to obtain at least as favorable a fee structure as that obtained through the BOF.

ADMINISTRATIVE IMPLICATIONS

According to the PERA:

Senate Bill 38 will have a positive administrative impact on PERA. Currently, the State Board of Finance controls the request for proposal (RFP) process. Since 2002, the State

of New Mexico has changed custodial banks three times. PERA did not request or initiate any of these changes, but was required to participate in each of the RFPs required. Given the complexity and time-consuming task of transitioning an \$11 billion portfolio, identifying a custodian that can provide a scope of services tailored to a public pension plan is paramount to fiduciary best practices.

The ability to contract for legal services on a contingency fee basis will also have a positive impact on PERA. PERA's operating budget is insufficient for the costs and legal fees associated with complex securities litigation. PERB should be given the tools to recover losses resulting from fraud or mismanagement of its investments.

RELATIONSHIP

House Bill 38 is related to Senate Bill 86 which contains a similar provision for attorney contingent fee contracts for the State Investment Council.

GH/svb