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

SPONSOR Bratton **ORIGINAL DATE** 03/02/11 **LAST UPDATED** **HB** 548

SHORT TITLE Disclosure of 3rd Party Investment Agents **SB**

ANALYST Golebiewski

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	**FY12**	**FY13**		
	Negative and potentially large but indeterminate	Negative and potentially large but indeterminate	Recurring	Funds controlled by SIC, ERB, PERA

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicates, Relates to, Conflicts with, Companion to

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		Indeterminate but large	Indeterminate but large		Recurring	SIC, ERB, PERA, and STO

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Public Employee Retirement Association (PERA)
Educational Retirement Board (ERB)
Attorney General's Office (AGO)
State Investment Office (SIO)
State Treasurer's Office (STO)

SUMMARY

Synopsis of Bill

HB 548 would have the State Investment Council, the State Treasurer, ERB & PERA discontinue investments in a fund or investment vehicle provided by an investment management

company represented by a third-party agent. When it has been determined that such a placement agent was employed and paid relative to a state investment, the bill seeks return of investment and all fees, or if greater, the investment plus interest of LIBOR plus 5%. The bill also requires potential sales agents to disclose the principals they represent, and certify they will receive no additional compensation for their work in representing the potential investment. HB 548 would also remove the existing statute which requires disclosure of third party marketers and their fees and commissions.

FISCAL IMPLICATIONS

Small investment firms often hire third-party placement agents to avoid the additional overhead during periods when they are not in the market raising funds; they would incur this cost if they had marketing agents in-house. It is not economically feasible to hire placement agents on a fixed fee basis, so they are usually compensated upon successfully obtaining an investment. Limiting the types of investment management firms with which the state investment agencies can invest also limits how well the state funds can be diversified among alternate companies. HB 548 would effectively require that all investments be made with large firms, which tend to have lower fees, but also have lower investment returns.

ERB:

> In addition, without such placement agents, ERB might not learn about certain investment opportunities, especially from foreign and emerging investment funds, or would be less likely to learn of such investment funds in a timely manner. The ban would preclude the ERB from making a number of good investments and could adversely affect ERB's overall return on investment…
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> Investment manager in the 'alternatives' area (principally real estate, private equity, and funds of hedge funds) typically stay fully invested. In order to achieve higher returns, their investment contracts contain lock-up provisions requiring the commitment of invested monies for certain periods. Early withdrawals are limited as it will adversely affect investment yields. The ERB would have to negotiate special withdrawal provisions to comply with HB 548. Many reputable investment managers would not agree to such provisions as they could adversely affect investment yield. Further, many other investors would not allow the investment managers to agree to terms what could adversely affect the yields on their investments. As a result of requiring those provisions in investment contracts, ERB might be precluded from investing with many reputable investment managers. Again, such provisions could adversely harm the ERB more than the investment managers. In lieu of the investment termination provision, the ERB suggests that the HB 548 include provisions which would require a manager who was found not to have made proper disclosures to reimburse the ERB the greater of any management or advisory fees for a period of two years or an amount equal to the amounts paid or promised to be paid to the placement or sales agent. Advisory contracts could still be terminated upon learning of a violation as those terminations would not adversely affect an existing investment.
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> The ERB wishes to make it clear that ERB does not pay placement or sales agent fees. Investment managers pay placement or sales agents out of the fees that the manager earns. The ERB includes clauses in its investment contracts stating that (1) the cost

associated with hiring a placement or sales agent cannot be passed through to the ERB, and (2) that the ERB cannot be charged a higher management fee than other public pension funds of a similar size making a similar size investment with the investment manager.

SIC:

HB 548 would have indeterminate but extremely significant fiscal impact due to the almost certain litigation involved due to the required termination of existing contracts and investments where a third party marketer was previously involved. In 2009 when the SIC identified issues of concern surrounding a number of payments made by SIC managers to certain politically connected individuals, the agency developed a spreadsheet of significant detail. In that spreadsheet, which is contained in the following public report:http://www.sic.state.nm.us/PDF%20files/101214%20PLACEMENT%20AGENT%20STATUS%20REPORT.PDF, the Council identified nearly 5 dozen instances over the last decade where placement agents had been paid by SIC investment managers, relative to specific SIC investments. While the newly reconstituted Council has terminated several managers and sold additional assets over the past months with connections to questionable payments, in some cases termination or sales would be unprofitable if not impossible due to existing contractual agreements. Specifically in the case of many private equity limited partnerships, the SIC cannot simply terminate those partnerships and faces significant penalties for failure to fund future capital calls.

Further, while many placement agent fees identified by the SIC and now being investigated by federal authorities were questionable in nature, there have yet to be any related criminal charges in New Mexico. The SIC also identified some agents who acted solely as marketers while providing legitimate sales services and organizational/presentational deliverables to funds across the country, without any specific influence, political or otherwise.

SIGNIFICANT ISSUES

Although the bill is intended to limit the misuse of state funds improperly paid to third-party placement agents, it will have a negative effect on the performance of various state funds. First, the requirements to invest only through investment companies that have no third-party marketing agents limit the diversification potential of the state funds. It also limits choices to large firms, who have placement agents in-house. These firms tend to offer fewer high-yield opportunities than smaller firms because of the size of their portfolios. With this understanding, the implications of HB 548 may be inconsistent with the Uniform Prudent Investor Act.

In addition, HB 548 requires that the state investment agencies take back their investment dollars and fees upon discovering a third-party placement agent employed by an investment management firm, with which investments have been made. To perform this required action will likely translate to substantial additional costs for attorneys and litigation.

Current statute requires the disclosure of third-party marketing agents to state investment agencies. This contributes to transparency within government and relationships between government and investment management firms.

SIC:

The language suggested in HB 548 penalizing funds by forcing repayment of investments, fees and interest of LIBOR plus 5% was actually lifted from a previous version of the SIC's disclosure and transparency policy. That policy, as evaluated in practice, proved to be overly onerous to many investment managers with whom the SIC sought to invest with. The SIC is looking to reformat that language to something more practicable.

STO:

STO is not aware of, and does not use any marketing agents in its selection of broker dealers and other outside parties in investment activities. All broker-dealer selections are based on experience, qualifications and legal compliance, reviewed by STO and finally approved by the State Board of Finance. The broker-dealer list is assessed and reviewed annually.

All investment decisions are made by an in-house investment committee and reported to the State Treasurer's Investment Committee (STIC). All securities transactions by STO are implemented using a competitive bid process.

ADMINISTRATIVE IMPLICATIONS

SIC:

If passed, the SIC would have to spend significant resources trying to get out of dozens of funds and investment agreements. Additional legal resources would be necessary.

PERA:

PERA would be required to inform the managers and/or general partners of potential non-publicly traded investments that the use of third-party sales agents is banned in the State of New Mexico. PERA would be required to demand that the third-party sales agent who secured prior investments terminate the investment and pay PERA a specified sum of money. Given the fact that the PERA would not have a contractual relationship with the third-party sales agent, PERA would be required to file litigation to seek a judgment for the monies.

OTHER SUBSTANTIVE ISSUES

PERA:

It is presumed HB 548 is an effort to prevent future investment scandals that have implicated the state investment council and educational retirement board. An outright ban on the use of third-party sales agents (otherwise known as third-party marketers) will have a negative impact on PERA's ability to fund its direct alternative portfolio.

Third party marketers are prevalent in private equity, real asset and real estate investments. Many top tier multi-billion dollar private funds utilize the legitimate

business services of third-party marketers. Many third-party marketing firms are registered with the FINRA and provide a legitimate service to investors. HB 548 will limit PERA's ability to participate in certain non-publicly traded investment opportunities.

PERA's investment advisor for all its alternative investments serves in a gatekeeper capacity. The investment advisor is responsible for conducting due diligence efforts for all potential investments and/or partnerships PERA may enter into for alternative investments. This includes providing detailed reports, analyses, and summaries as appropriate to the PERA Board and staff. PERA's internal policies prohibit third-party marketers from directly contacting PERA investment staff.

ALTERNATIVES

ERB:

Rather than banning investments in which placement or sales agents are involved, HB 548 should be amended as described below to: (1) require placement or sales agent to be registered with the SEC, (2) require investment managers and the agents to disclose the terms of their contract, including compensation, and (3) prohibit investments in which the management firm hired a placement or sales agents *solely* for the purpose of securing an investment from New Mexico state investment agencies. Abuses of the types that HB 548 and the ERB's current Placement Agent Policy (described below) seek to prevent are most likely to occur in cases where a placement or sales agent is hired solely for the purpose of obtaining an investment from New Mexico's state investment agencies. A ban on those types of contracts, coupled with disclosure requirements, would be effective tools to prevent such abuses while not precluding the state investment agencies from working with investment managers which hire reputable placement agent firms.

JAG/mew