Approved February 26, 1992
Date

MINUTES OF THE HOUSE COMMITTEE ON PENSIONS, INVESTMENTS & BENEFITS

The meeting was called to order by Representative Don Rezac at
Chairperson

12:21 a.m./p.m. on February 19, 1992 in room 521-S of the Capitol.

All members were present except:
Representative Aldie Ensminger (excused)
Representative Ken Grotewiel (excused)

Committee staff present:
Alan Conroy - Legislative Research
Richard Ryan - Legislative Research
Gordon Self - Revisor's Office
Juanita Blasdel - Committee Secretary

Conferees appearing before the committee:
Senator Wint Winter, Jr.
Representative Tim Carmody
Jarold Boettcher - Vice Chairman KPERS Board of Trustees

Others attending: see attached sheet

Meeting was called to order at 12:21 p.m. by Chairman Rezac who called on Alan Conroy of Legislative Research to give a brief on SB 526 to present for hearings.

SB 526 - KPERS creating a new board of trustees, investment practices and standards

Senator Wint Winter, Jr. was then called on to present testimony on this bill. Senator Winter is Chairman of the Joint Committee on KPERS Investment Practices. He told the committee that the function of the Joint Committee was to hear testimony and evidence regarding the status of the investments, particularly the direct placements of the system. In general, the Joint Committee concludes that the KPERS direct placement and real estate programs expanded rapidly over a short period of time and losses were caused by breach of responsibility on the part of many participants (Attachment #1). The Joint Committee is however relying on the resulting investigations by federal and state authorities to eventually provide the answers on KPERS investment practices.

Questions were then asked of Senator Winter.

Representative Tim Carmody then spoke in favor of this bill. He felt that direct placements would and were working in other states with adequate safeguards. He also felt that one safeguard is to have co-investors and not be the only financier in a particular investment.

Questions were asked of Representative Carmody.

The chairman then introduced Jarold W. Boettcher, Vice Chairman of KPERS Board of Trustees. He spoke from material previously handed out (Attachment #2). He commented on several sections of the bill that he felt should be deleted or changed, namely experience for the six appointed members of the Board, investment advisory committee, compensation of investment managers and insurance coverage and reporting and financial statements.

Questions were asked of Mr. Boettcher after which the chairman announced that we would conclude hearings on this bill at 5:00 due to being out of time. There would also be a meeting at 5:00 tomorrow on Thursday, February 20, to complete hearings and take possible action on the bill and HB 2773.

Meeting adjourned at 1:20 p.m.

GUEST LIST

COMMITTEE: Pensions, Investments & Benefits Date: 2-19-92

Name (Please Print)	COMPANY ORGANIZATION	ADDRESS
RUTHELLA McBRIDE	SEK-Area Agency on Aging	Chanute
Marvella Markley	SEK-Area Agency on Aging	Chanute
SUZANNE FROST	Community Action Inc.	Topeka
HAROLD PITTS	AARP-CCTF	Topeka
Meredith Williams	KPERS	Topeka
Jarold Boettcher	KPERS Trustee	Beloit, Ks.
Liz Miller	KPERS	Topeka, KS
Jack Hawn	KPERS	Topeka
Mary Allen	LAS	Topeka
Marita Litz	LAS	Topeka
Craig Grant	KNEA	Topeka
Clyde Meyer	Kansas City Star	Kansas City, MO.
Basil Covey	KRTA	TopeKA

EXECUTIVE SUMMARY OF THE JOINT COMMITTEE ON KPERS INVESTMENT PRACTICES

Charge of the Joint Committee

The Joint Committee on KPERS Investment Practices was created by concurrent resolution of the 1991 Legislature to conduct an investigation into KPERS investments, to determine if there have been investment losses, determine what action might be appropriate to recover such losses and recommend legislation to prevent future losses.

Joint Committee Activities

The Joint Committee held meetings on 32 separate days from February 22 through December 17, 1991. A total of 89 individuals appeared before the Joint Committee to provide testimony or information to the Joint Committee, most of it under oath. The Joint Committee has over 3,850 pages of verbatim transcripts from the Committee proceedings and received over 5,000 pages of attachments to the official committee minutes. The Committee through the exercise of subpoenas received literally thousands of documents from the former KPERS direct placement money managers and others sources. In addition, the Kansas Legislative Division of Post Audit conducted six performance audits on various KPERS related areas at the request of the Joint Committee.

Evidence and Testimony Presented

The Joint Committee received a great deal of testimony and information concerning KPERS investment practices. KPERS statutory background, investment policies, and investment manager compensation were all reviewed in detail by the Joint Committee. The Joint Committee also focused especially on direct placement investments and retained the law firm of Hinkle, Eberhart and Elkouri of Wichita to assist in the investigation of direct placement investments made by the investment firms of Reimer and Koger and Peters, Gamm, West and Vincent. The report of the firm on selected KPERS direct placement investments is published as Appendix G in Volume II of the Joint Committee's Report. The Joint Committee focused in part, on the leadership of Mike Russell as Chair of the KPERS Board of Trustees, the breakdown in reporting by the investment managers and the lack of oversight and management by KPERS. **The Joint Committee identified actual and potential losses in the KPERS direct placement portfolio of over $225 million or 57 percent of the direct placement investment.**

Conclusions

The Joint Committee concluded the following:

In general, the Joint Committee concludes that the KPERS direct placement and real estate programs expanded rapidly over a short period of time and losses were caused by breach of responsibility on the part of many participants. The rapid and mismanaged expansion was an unintended result of the desire of Governor Carlin to gain a higher rate of return for KPERS funds and simultaneously improve the Kansas economy. The massive loss of KPERS funds was far out of the ordinary for alternative (private) placement programs by other public pension systems. The excessive losses and poor returns of the direct placement program were a result not of the existence of the program itself, but of extreme mismanagement and breach of responsibility on the part of individuals and firms charged with designing and implementing the program, some who benefited from receipt of the direct placement funds, certain professionals, and others. Theoretically, the direct placement funds would have earned almost as much if KPERS had placed them in a simple savings account, and would have earned more if the funds had been invested in risk-free 91-day U.S. Treasury Bills.

In particular, the Joint Committee received considerable evidence that the massive loss and poor performance of the direct placement program was caused or contributed to by the negligence, breach of contract, conflict of interest, and self dealing on the part of many participants in the program including direct placement managers, former Board Chairperson Mike Russell, KPERS Fund investment consultants, and Board members, officers, employees, and agents of recipients of program funds. Additionally, evidence was received which suggests that professionals such as accountants, consultants, law firms, and others failed to discharge their duties to KPERS and fund beneficiaries. Evidence suggests that the breaches on the part of these individuals and firms rose to the level which would create liability to the State of Kansas for the losses.

As a result of the very rapid expansion of the direct placement program, KPERS staff, governors, the Legislature, and interested citizenry groups lacked the skill, experience, resources, and structure to properly monitor, report on, and provide the oversight necessary to discover and correct the problems. This inability was worsened by the reliance in 1987 on the part of many on the report of the Office of the Attorney General and Public Disclosure Commission, which essentially cleared KPERS Chairperson Mike Russell and others of suggestions of unlawful conduct and conflict of interest. It should be noted that some of the executive branch appointments to the KPERS Board of Trustees had no investment experience and were not familiar with financial matters. There appears to have been a lack of communication and oversight by the executive branch including the offices of Governor and State Treasurer, which each had responsibility for safeguarding state funds, concerning KPERS investment practices. The Legislature, due in part to the fact there is no direct responsibility for appointments to the KPERS Board of Trustees, has not been as vigilant as the circumstances now appear to warrant. The lack of a standing committee to monitor KPERS investments has not given the Legislature the mechanism to closely monitor KPERS. Finally, had not the Joint Committee began its investigation into KPERS investments there appears a strong possibility that the uncontrolled KPERS direct placement would have continued on with no oversight resulting in additional investment losses. The Joint Committee did not discover answers to all of the questions surrounding KPERS investment practices. The Joint Committee is however relying on the resulting investigations by federal and state authorities to eventually provide the answers on KPERS investment practices. Should those investigations fail to provide adequate answers, the Joint Committee is ready and willing to continue the legislative investigation on KPERS investment practices.

Recommendations

The Joint Committee made the following recommendations:

- **Increased fiduciary responsibility** be statutorily established for KPERS fiduciaries.
- **Alternative investments (direct placement and real estate)** be limited to no more than 10 percent of the KPERS Fund and that such investment practices would have greater investment restrictions.
- **KPERS investment practices** in general would be improved and strengthened through increased oversight.
- **New KPERS Board of Trustees** consisting of nine members, with four appointed by the Governor, two members elected by KPERS members, two appointed by legislative leadership and the State Treasurer.
- **KPERS Investment Advisory Committee** to the KPERS Board of Trustees would be created.
- **Legislative Joint Committee on KPERS** would be created to establish a permanent oversight committee.

- **KPERS Audits, Reporting, and Budgeting** would be strengthened and improved for greater visibility and accounting.

- **Extension of the Statute of Limitations** of civil and criminal matters where KPERS is the alleged victim.

- **Recklessness as Related to Fiduciary Duty** would be broadened to include "recklessness" in that portion of the criminal law regarding the execution of fiduciary duty.

- **Public Record of Settlement** would be required when public funds are involved.

- **Anti-Raiding of KPERS Funds** would be stated and the actuarial assumed rates would be required to reflect the needs of the system.

- **KPERS Funding of Joint Committee Investigation** instead of State General Fund financing, which will require a shift in funding and the note that additional funding will be required by the Joint Committee for the Special Counsel.

- **Encourage the Senate** to be more diligent in the confirmations process.

- **Adequate Funding for the Office of KPERS Special Prosecutor** is recommended so the special prosecutor may do a thorough and complete criminal investigation.

- **Joint Committee Monitor Resulting Investigations** by other agencies who have direct responsibility and are equipped to conduct a thorough investigation of KPERS investment activities.

- **Joint Committee Continue to Meet** through the end of 1992 to monitor KPERS litigation activities.

STATEMENT OF JAROLD W. BOETTCHER
VICE CHAIRMAN, BOARD OF TRUSTEES
KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM
TO
HOUSE PENSIONS, INVESTMENTS AND BENEFITS COMMITTEE
REPRESENTATIVE DON M. REZAC, CHAIR
FEBRUARY 19, 1992
REGARDING SENATE BILL 526

Mr. Chairman and members of the Committee, I am Jarold Boettcher. I am the Vice Chair of the Board of Trustees of the Kansas Public Employees Retirement System. I was appointed to the Board by Governor Finney on May 1, 1991.

There are several areas in SB 526 which I would like to address -- these are provisions in the bill which are either not needed or which will create currently unanticipated problems for present and future Trustees and, at the same time, not meet the goals of the bill and the Special Committee. Many of the sections of the bill are constructive and provide needed reforms. I will restrict my comments, however, to those issues which I believe should be deleted or changed substantially.

Section 1, subsection e, calls for the six appointed members of the Board of Trustees to have at least five years of experience in investment management or analysis, actuarial analysis, or administration of an employee benefit plan. I think I understand the intention here but the way it is worded, it manages to be both too broad and too narrow. To require such experience and background of all six appointed members will create serious problems in finding such people who are a) able to serve and take the time away from their profession and b) who will make the commitment to serve. I think the intention here is to have people serve as Trustees who might be familiar with investment issues such as the Board has faced. You can't necessarily get that kind of experience with an actuary nor an administrative person. It is a judgment call, but I nevertheless believe these requirements will be major impediments to having a serious Board of Trustees such as I believe the Legislature wants and the participants in the plan deserve and demand. I fully support the idea that some members of the Trustees should have an investment background. This just makes good common sense. I just think this provision unrealistically proscribes qualifications and may eliminate many otherwise qualified and committed people. By way of suggesting an alternative, I offer the idea of having three of the six appointees have some kind of investment background or experience.

Section 2, subsection 6, provides for a five member investment advisory committee. In my view, making the important assumption that people can be found to serve, this committee will end up being either redundant or perfunctory OR the experience qualifications of the six Trustees are unnecessary. The indicated qualifications overlap directly with the six appointed Trustees. If the Governor and Legislative Leadership are unable to find and retain six Trustees with the required qualifications, then the Trustees will have trouble finding five more people of like background. In my view, should this duality persist in the final form of the bill, an extremely cumbersome and essentially unworkable system will have been created. Both the Trustees and the investment advisory committee will end up reviewing the same material, meeting with the same people separately, and then meeting together. One committee or the other's function will be redundant and repetitive. An individual member of either committee will be frustrated by any attempt to exercise their responsibility.

I understand the Legislature's desire to build a system whereby the abuses of the recent past will not be repeated. Had the current appointment system been taken more seriously, however

and the appointed Trustees taken their responsibilities accordingly, it is my view that much of what happened need not, and indeed would not, have happened. In addition, there have been serious shortfalls in the KPERS staff - some of which have already been addressed. Adding more volunteers and more committees, are not, in my opinion, the solutions. Responsibility will be diffused and spread out, thereby making it more likely that at some future date, some other kind of oversight problems will result. In my judgment, the investment advisory committee provision is not needed, will not work, and should, therefore, be taken out of the bill. If you have a Board of Trustees which is responsive to their responsibilities, have a measure of qualifications for the tasks to be performed, and importantly, are supported by adequate staff and resources, this kind of internal oversight is not needed and will not work.

Section 9, subsection 7, deals with compensation of investment managers and insurance coverage. The investment management business is fee-based, using a percentage of assets. It is highly competitive, both as to fees and to performance. The Legislative Post Audit Division has already issued a report which concludes the fees paid to KPERS investment managers were comparable to those in the marketplace. I have personally reviewed the fee structure for KPERS managers and found them to be reasonable as compared to funds of similar size and objectives. There have been some past abuses, it appears, in the fees of private placement managers. The responsibility for the negotiation of fees lies squarely with the internal staff at KPERS and with the Trustees. Given adequate information and members on the Board of Trustees as all believe are needed, making the compensation of managers subject to the appropriation process is redundant, inefficient, and not needed.

Insurance coverage is of major concern. The kind of coverage described in the bill is either not available or so expensive as to be a major monetary burden upon the KPERS funds. In short, the premium would be paid indirectly by the beneficiaries, just as the fees are. There is simply no precedent to require an investment manager of publicly traded securities to carry errors and omissions insurance, for example, in an amount equal to the funds under management. This section would set E&O coverage at $500 million for a manager of $500 million in KPERS assets. Some members of the committee may be in the insurance business and would have a feel for what the premium might be for this kind of coverage. I would be interested in anyone's thoughts on this subject. You have already received copies of correspondence KPERS has received from several investment managers. Perhaps some reasonable minimum amount could be specified in the contracts KPERS negotiates with each manager, depending on the type of asset and the amounts under management.

Section 4, subsection 2, provides for reporting and financial statements. The statement of concern to me is the requirement of reporting of individual and specific alternative investments. If KPERS is required to be very specific as to the market value of each alternative investment, such disclosure could, and would in my judgment, create a situation whereby the current management of such alternative investment would not result in the maximization of value to the KPERS beneficiaries. If it becomes public knowledge that an investment is troubled, but may be salvageable, the disclosure of the troubled status may cause the business to fail. Trade credit will disappear. In our own little company in Beloit, I can assure you that if we became aware that such a customer was having problems, we would take action to protect our own interests. Disclosure such as would be required in this section would create real problems with specific alternative investments -- and substantially offset the argument of the public's right to know. The defacto result will be that alternative investments will be eliminated over a period of time - perhaps to the long term detriment to the investment performance of the portfolio. Given an active and responsible Board of Trustees and an adequately supported professional staff at KPERS, such disclosure has the potential to create more problems than whatever interest might otherwise be served.

Thank you for the opportunity to make these remarks.