Approved 2-4-92

MINUTES OF THE SENATE COMMITTEE ON WAYS AND MEANS.

The meeting was called to order by Senator August "Gus" Bogina, Chairperson, at 11:07 a.m. on January 28, 1992 in Room 123-S of the Capitol.

All members were present except:

Senator Parrish, who was excused

Conferees appearing before the committee:

Jeff Wagaman, Office of the Majority Leader of the Senate
Emil Lutz, Director, Legislative Administrative Services
Jim Wilson, Revisor of Statutes
Senators Winter and Petty and Representative Rezac, members of the Joint Committee on KPERS Investment Practices
Meredith Williams, Executive Director, Kansas Association of Public Employees

SB 498 - Fees and receipts of legislative agencies, disposition

Jeff Wagaman, Administrative Assistant to Senator Kerr, distributed and reviewed Attachment 1. In answer to a question, he stated that surplus property would include outdated computers, old office furniture, etc.

Emil Lutz, Director, Legislative Administrative Services, told the Committee that there have been no changes in the limits placed on office supplies in the past year, but noted that the ongoing concern has been that any monies received are transferred to the general fund and are not used to offset expenses. Mr. Lutz stated that to date, $100,000 has been received for the special revenue fund.

Senator Rock expressed concern that mandated transfers do not provide for flexibility or changes in priority from year to year.

Jim Wilson, Revisor of Statutes, gave a brief analysis of the policy changes contained within SB 498.

Senator Gaines moved, Senator Winter seconded, that SB 498 be recommended favorable for passage. The motion carried on a roll call vote.

SB 526 - Prescribing certain investment practices and standards for KPERS investments

Senator Winter distributed and reviewed copies of Attachment 2, a tentative preliminary draft which incorporates changes that were suggested by the Joint Committee. He noted that this document had not yet been distributed to committee members. He explained increased fiduciary responsibility, alternative investments, KPERS investment practices, new KPERS Board of Trustees, KPERS Investment Advisory Committee, Joint Standing Committee on KPERS, Kpers audits, reporting and budgeting, and the anti-raiding of KPERS funds. He noted that items 8, 9, 10, 12, 13, 14 and 15 would appear in other bills.

In answer to a question, Senator Winter stated that recommendations that would restrict alternative investments came directly from alternative investment managers.

In answer to Senator Brady's question, Senator Winter noted that one purpose of the proposed Joint Committee recommendations(Attachment 2-7, Sec. 6) is to have required input on confirmation of the Board of Trustees members.

Representative Don Rezac distributed and reviewed copies of Attachment 3.

Meredith Williams, Executive Director, KPERS, distributed and reviewed Attachment 4. In discussing Section 2, Mr. Williams noted that it might be advisable to eliminate the current investment committee which is in current statute.

Senator Winter requested that the minutes reflect that both the Joint Committee and the Senate Ways and Means Committee believe the principal-agent relationship between the Retirement System and its managers and others already exists.

In answer to a question regarding the suggestion that the Retirement System be allowed to report lower market values on an aggregate basis (Attachment 4-2, Section 4), Mr. Williams stated that this suggestion relates only to those investments where KPERS has a controlling interest. Senator Winter noted that it is important to weigh the imbalance of the right of the public and Legislature to know the facts versus the possibility of public disclosure causing some losses.

The Chairman announced that the hearing on SB 526 would be continued January 29, 1992 and, in addition, the Committee would hear SB 505. He adjourned the meeting at 12:36 p.m.

GUEST LIST

COMMITTEE: SENATE WAYS AND MEANS

DATE: Jan. 28, 1992

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
Gene Meyer	1729 Grand, KC, MO 64108	KC STAR
Kim Vickers	Topeka	Intern (Karr)
Craig Grant	Topeka	K-NEA
Debbie Green	Topeka	Sen. Kerr's staff
Emil Lutz	Topeka	LAS
Jeff Wagaman	Topeka	Sen Kerr's Staff
DAN HERMES	"	DOB

STATE OF KANSAS

SENATOR FRED KERR
ROUTE 2
PRATT, KANSAS 67124
(316) 672-6605

SENATE MAJORITY LEADER
STATE CAPITOL BUILDING
TOPEKA, KANSAS 66612
(913) 296-2497

TOPEKA

SENATE CHAMBER
OFFICE OF MAJORITY LEADER

TESTIMONY; SB 498
Senate Ways & Means Committee
January 28, 1992
Senator Fred Kerr

On behalf of the Legislative Coordinating Council, I want to explain the reason for the introduction of SB 498. The bill would establish a legislative special revenue fund whereby fees for certain legislative charges and revenues from surplus property expenditures could be deposited.

The impetus for this bill is the effort by the LCC to control legislative costs. One of the areas that seemed out of control was the category of printing costs. Provisions adopted by the Council late in 1991 would attempt to get a handle on this by providing printing materials for legislators up to a specified limit and then charge, at cost, fees for materials ordered above that limit. This bill would allow the deposit of such fees in the legislative special revenue fund rather than the state general fund. There are other such examples.

Representatives of the Revisor of Statutes office and Legislative Administrative Services office will be available to answer further questions. Your prompt consideration of this bill would be appreciated because some legislators are waiting to make such purchases under the provisions of this proposed fund.

SWAM
January 28, 1992
Attachment 1

November 19, 1991 -- Criminal charges are filed against former KPERS Board of Trustee Chair Michael K. Russell for alleged securities fraud.

December 23, 1991 -- Additional lawsuits are filed by KPERS against a total of 22 individuals and corporations relating mainly to the lost investment in Home Savings Association.

Joint Committee Conclusions

The Joint Committee on KPERS Investment Practices reached several conclusions as a result of the ten-month investigation into KPERS financial matters. The conclusions are as follows:

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 a breach of responsibility on the part of many participants. The rapid and mismanaged expansion was a 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 Chairman Mike Russell, KPERS Fund investment consultants, 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, Governor's, 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 Public Disclosure Commission and Office of the Attorney General, 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 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 vigilante as the circumstances now appear to warrent. 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 of continued on with no oversight resulting in only additional investment losses.

Some of the specific failures and deficiencies are as follows:

SWAM
January 28, 1992
Attachment 2

A. Major Failures by Participants Resulting in Potential Liability

Money Managers and Other Professionals. They did have an excessive amount of authority delegated to them by the KPERS Board of Trustees. KPERS did not require adequate insurance of the money managers to protect the amount of KPERS funds that they were entrusted to handle. Managers were responsible for investment organization and investment monitoring and reporting, giving rise to a built-in conflict of interest. Because the investment managers reported the value of each investment as equal to whatever amount of money the managers had put in the investment (plus some mark-ups for capitalized unpaid interest or expense) the add-on investments had the effect of postponing the discovery of investment losses. In addition, the money mangers made no attempt to reflect the investments at a value commensurate with the actual prospects, assets or equity of the underlying businesses, many KPERS's direct placement investments were made to look much better on paper than they actually were in reality. Also, the delegation of the authority to hire professionals by the money managers appeared to have coopted the loyalty away from KPERS of lawyers and other professionals hired by the managers. Investments were made in which money managers, trustees, professionals, and others had the potential of conflicts of interest or the appearance of self dealing. In fact some attorneys retained by KPERS through their money mangers have stated that they had no obligation to KPERS, but only to the KPERS money managers. The Joint Committee strongly disagrees with such a position and in fact concludes that certain KPERS attorneys breached their contractual duty to KPERS, breached their fiduciary duty to KPERS and were negligent to the retirement system. One example of how the money mangers as early as January, 1987 were concerned about future litigation was a memo by Ken Koger to his staff and his attorney Tom Van Dyke. The Koger memo stated the following:

> "As we start out this new year it wise to remember that if we address communications to our counsel and label it confidential and privileged then, of course, should prying hands try to get that information, they would be unable to do so.
>
> My suggestion is for any information you write regarding a specific company which you think might be controversial or derogatory, we would be well served to label the memo confidential and privileged and address it to our counsel.
>
> Have a Happy and Prosperous 1987."

Possible Self Dealing by Certain KPERS Board Members. Significant evidence was received by the Joint Committee which raises questions about serious conflicts of interest and possible self dealing by certain former KPERS Board members. For example, the Special Counsel Report states as follows:

> ". . . several of the KPERS investments initiated by Reimer and Koger appear to have been influenced by the personal interests of Mike Russell, who was placed on the KPERS Board by Governor Carlin in 1983 and was elected Chairman of the Board at the request of the Governor's office during 1985. Most of the investments involve Kansas City banker Frank Morgan or his related business entities in some aspect of the transaction, and some also involve broker George K. Baum, attorney Tom Van Dyke, Mr. William Thomas of the George K. Baum & Co. brokerage, Messrs. Tom Olofson and Jerry Haney, formerly of Marion Labs, and other associates and business acquaintances of Mike Russell."

Additionally, an internal memo dated April 9, 1985 of Ken Koger regarding a phone conversation with Marshall Crowther, contains the following statement:

> "Had about a 45' conversation with Marshall today and among the many interesting things we talked about was Mike Russell's offer at the last meeting to get area real estate developers together with the governor and the KPERS trustees for a meeting.
>
> Nobody said no and so there is a meeting on May 2, presumably in a Johnson County motel room.
>
> I am very pleased that we have not been invited to attend.
>
> Marshall refers to Russell as a walking conflict of interest."

Further, the Special Counsel Report notes the following:

> "Mr. Russell, as indicated by Kenneth Koger's contemporaneous memos, became increasingly aggressive in his efforts to push Reimer and Koger into investments with Frank Morgan, Bill Thomas, George K. Baum, and other Russell acquaintances."

Further evidence from the Special Counsel Report which points out concerns over conflicts is as follows:

> "The January 6, 1986 Kenneth Koger memo referring to the December 31, 1985 draft commitment letter shows that the commitment letter Mr. Koger was discussing with Michael K. Russell had been issued at a time when Mr. Russell served both on the Home Savings Board of Directors and as Chairman of the KPERS Board."

A final example of possible self dealing by certain KPERS Board members was in testimony given by former KPERS Board Chair Tom Hamill. In that testimony, Mr. Hamill expressed his serious concerns about the proper conduct of former KPERS Board members Donald Barry and B. B. Andersen. Mr. Hamill in his testimony stated the following concerning Mr. Barry:

> "It came to my attention that a real estate investment in Topeka which was being refinanced or restructured was a building housing a group of physicians, and that restructuring was getting ready to close, and I was called and-- by the money manager and told that in looking through the closing documents-- I think it was a corporation was to be the new owner and the owner/substantial stockholder was Don Barry and I said to the manger, 'That will not close with his name in there, do not close it.' I talked to Don. I asked him what the deal was, and he said, well, they owed him a fee, and this was how he was going to get the fee. And I said, 'Well, if that's what you want to do, then let's put that topic on the agenda today of the Board and we'll discuss it in open public meeting. The Board will vote on it, and if the Board thinks that's appropriate, fine. Otherwise it won't close that way."

Mr. Hamill in his testimony concerning Mr. Andersen stated the following:

> "Well, it's my understanding that he approached one of our real estate managers after his appointment, or at least after his appointment had been made public before he ever sat on the Board, and basically asked the manger if there was some way that he could become involved in the real estate transactions and receive a commission."

B. Other Systematic Deficiencies Involving KPERS Investments

Direct Placement and Real Estate Programs. The commencement of the direct placement and real estate programs was done without careful planning and experienced staff. The social goals were adopted without giving proper credence to economic concerns and the potential impact on the KPERS Fund. No substantial effort was made to check out the qualifications of the direct placement managers prior to their selection as money managers. Perhaps, most importantly, the program was expanded too rapidly, outstripping the ability of staff to properly monitor the programs.

Certain KPERS Board Procedure and Staff. The KPERS Board of Trustees has held too infrequent meetings to monitor a $4 billion pension plan. And in absence of the Board meeting, there was excessive delegation to staff and to the consultant in the area of investment matters. The Board did not provide adequate oversight to the KPERS money managers, particularly in the direct placement and real estate areas. The Joint Committee notes that former KPERS Board Chair Tom Hamill could not adequately define what a "direct placement investment" was in his testimony. The facts relating to the Home Savings Association investment once again appear to indicate lack of sufficient oversight of the investment manager's activities, resulting in a failure to timely detect conduct rising at least to the level of reckless disregard on the part of the investment manger. This conduct included failure to conduct due diligence on the merits of the investment before approaching the KPERS Board for approval, failure to secure the Board's approval in a formal meeting, and failure to exercise reasonable caution in correctly evaluating the collateral offered to secure the loan. The KPERS staff lacked the experience in direct investments and real estate in order to provide the Board with the necessary support services and information. The KPERS staff was not of sufficient size to provide that necessary support and oversight information to the Board. Finally, there was a fundamental conflict with Callan Associates helping in the manager selection process, reporting the manager's results, and then evaluating the manager's performance.

Lack of State Government Oversight and Safeguards. The present system does not provide adequate safeguards and oversight functions for either the executive or legislative branches of government over the investment functions of the KPERS fund. Neither branch of government has provided sufficient oversight to monitor the activities of the KPERS investments.

1. Governor. In particular, some of the executive branch appointments to the KPERS Board of Trustees had no investment experience and were not familiar with financial matters. Such financial backgrounds would have been helpful to the trustees in order to closely monitor the direct placement and real estate portfolios of KPERS. In addition, there appears to have been a lack of communication and oversight by the executive branch concerning KPERS investment practices. Finally, during the KPERS Board Chairman election process, at least once there was direct gubernatorial intervention that resulted in the reconsideration of the election process for the Board Chairperson one month after the original election.

2. Legislature. The Legislature, due in part to the fact that there is no direct responsibility for appointments to the KPERS Board of Trustees, has not been as vigilante as the circumstances now appear to warrant. The Legislature has not actively and aggressively monitored the confirmations process for trustees to the KPERS Board. The lack of a standing committee to monitor KPERS investments has not given the Legislature the mechanism to closely monitor KPERS. The Legislature also has not taken an aggressive role in reviewing expenditures of the

KPERS investment program. Such expenditures are "off-budget," meaning that the expenses related to the investment program are paid from the investment income and are not specifically appropriated or approved by the Governor or Legislature. It should be noted that a legislative offer to provide investment staffing to KPERS was declined by Executive Secretary.

Recommendations

The Joint Committee recommends the following changes be made to prevent any future loss of KPERS funds similar to the ones that have occurred in the direct placement and real estate areas. Legislation to implement the following recommendations is attached as Appendix F.

1. **Increased Fiduciary Responsibility.** The Joint Committee recommends that an increased benchmark of fiduciary responsibility be statutorily established for KPERS fiduciaries. The Joint Committee models the higher fiduciary responsibility on the federal Employee Retirement Income Security Act of 1974 (ERISA). The new standards for the Board and money managers, when investing KPERS' funds, would be the following:

   "exercise the judgement, care, skill, prudence and diligence under the circumstances then prevailing, which persons of prudence, discretion and intelligence acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims by diversifying the investments of the fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so, and not in regard to speculation but in regard to the permanent disposition of similar funds, considering the probable income as well as the probable safety of their capital."

2. **Alternative Investments (Direct Placements and Real Estate).** The Joint Committee recommends a statutory limitation on the amount of KPERS funds invested in alternative investments be limited to no more than 10 percent of the KPERS Fund. Alternative investments would be defined as nontraditional investments outside the established nationally recognized public stock exchanges and government securities market. Alternative investments would include, but not be limited to, private placements, venture capital, real estate investments, partnerships, limited partnerships, and leveraged buyout partnerships. In addition, alternative investments would be subject to the following statutory limitations:

   a. have at least two other institutional investors as defined by section 301 of the federal Securities and Exchange Act of 1933;

   b. KPERS could own no more than 20.0 percent of an investment;

   c. KPERS would receive an appropriate recommendation from a qualified outside investment expert concerning the investment;

   d. an individual alternative investment could not exceed more than 2.5 percent of the total KPERS alternative investments;

   e. managers would be required to bring their due diligence to the Board of Trustees for consideration; and

   f. KPERS must establish and have in place appropriate oversight and reporting systems to monitor the investment.

3. **KPERS Investment Practices.** The Joint Committee also recommends that the following requirements be made statutory provisions relating to KPERS investment practices:

   a. increase the maximum KPERS stock limitation from 50 percent to 60 percent;

   b. KPERS shall adopt policies for all assets that establish stop-loss criteria: for direct placements the criteria shall include risk versus return spread; immediate reporting to all members of the Board when an investment goes into default; when a default occurs the manager must bring a plan to Board with options to address the default; periodic independent valuations, and guidelines when add-on investments could not be made;

   c. KPERS investment policies/objectives shall be reviewed and readopted annually by the Board, working with the investment consultant;

   d. by January 1, 1993, the KPERS Board must adopt or present a specific plan regarding the internal management of some or all KPERS investments and the required staff to implement such a plan;

   e. expenses of investment managers cannot be paid; managers may only receive a fee for their services; however, with Board approval KPERS may pay directly certain investment related expenses;

   f. all investment managers would be required to have errors and omission insurance in the same volume as the KPERS funds they manage;

   g. managers shall be considered agents of KPERS for all purposes, and any individuals hired by the managers shall have an obligation to KPERS; and

   h. clarification by statute of the constitutional prohibition against investing in banks, including savings and loans and credit unions.

4. **New KPERS Board of Trustees.** The Joint Committee recommends legislation that would abolish the existing KPERS Board of Trustees on July 1, 1993 and that would create a new nine-member board. The terms of the new members would be staggered. The new Board members would receive the same daily compensation as legislators. In addition, no individuals could serve on the Board if they had a direct or indirect financial interest in any investment made with moneys of the KPERS Fund. Board members would be prohibited for a period of two years after their tenure on the Board from being employed with any organization in which KPERS funds were invested. The new Board would consist of the following:

   a. four members appointed by the Governor;

   b. two members elected by the members of KPERS from their own ranks;

   c. one member appointed by the President of the Senate;

   d. one member appointed by the Speaker of the House; and

   e. the State Treasurer.

The appointees of the Governor and legislative leadership would be required to be individuals who have a minimum of five years of experience in the financial or investment area. Kansas Bureau of Investigation background checks would be required on all nominees to the Board. The reports would be available in executive session to the Senate Confirmations Committee.

5. **KPERS Investment Advisory Committee.** The Joint Committee recommends legislation that would create an investment advisory committee to the KPERS Board. The committee would be composed of at least five members, all of whom would be required to have at least five years' experience in the field of investment making or analysis, actuarial analysis, or administration of an employee benefit plan. The advisory committee would be appointed by the KPERS Board. The committee would be required to meet at least quarterly to review and make recommendations on KPERS investment strategies, goals, and guidelines.

6. **Joint Standing Committee on KPERS.** The Joint Committee recommends legislation that would create a permanent legislative Joint Standing Committee on KPERS. This Committee would monitor investment practices and also review and deal with benefit changes for KPERS members. The proposed Joint Committee would also make recommendations on all individuals nominated to serve on the KPERS Board of Trustees and have access in executive session to KBI background checks on nominees.

7. **KPERS Audits, Reporting, and Budgeting.** The Joint Committee recommends legislation that would require Legislative Post Audit to annually conduct a performance and financial audit of KPERS. The financial audit would include a review of alternative investments, and a review of any permanent impairment to KPERS assets. The performance audit would include an evaluation of the performance of investment managers, an assessment of total compensation received for the planned year by investment managers by individual investment classification, and inclusion of comparisons of performance of other states' pension programs. The financial audit would have to be completed within six months of the end of the preceding fiscal year. KPERS would be required to reimburse Legislative Post Audit for the cost of the financial audit. All expenditures of KPERS, including payments to managers, would have to be within the KPERS budget and could no longer be an "off-budget" item.

8. **Extension of the Statute of Limitations.** The Joint Committee recommends legislation that would extend for a period of ten years the statute of limitations on civil and criminal matters where KPERS is the alleged victim. The extension would apply only if the statute of limitations has not already expired.

9. **Recklessness as Related to Fiduciary Duty.** The Joint Committee recommended that the current Kansas criminal statutes be broadened to include "recklessness" in that portion of the law regarding the execution of fiduciary duty.

10. **Public Record of Settlement.** The Joint Committee recommends legislation that would amend the civil procedure statute relating to public records, to prohibit any journal entry or order from being kept secret when public funds are involved.

11. **Anti-Raiding of KPERS Funds.** The Joint Committee recommends legislation that the actuarial assumptions and consequent employer contribution rate shall reflect the financial needs of the retirement system in order to provide for the long-term payments of benefits to participants, and such rate shall not be set for any other purposes, including relief to the State General Fund.

12. **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.

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

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

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

91-1035/adc

STATE OF KANSAS

DON M. REZAC
REPRESENTATIVE, SIXTY-FIRST DISTRICT
PARTS OF POTTAWATOMIE,
WABAUNSEE, MARSHALL & LYON COUNTIES
(913) 535-2961

TOPEKA

COMMITTEE ASSIGNMENTS
CHAIRMAN: PENSIONS, INVESTMENTS AND BENEFITS
VICE CHAIRMAN: AGRICULTURE
MEMBER: ENERGY AND NATURAL RESOURCES
TRANSPORTATION

HOUSE OF
REPRESENTATIVES

TESTIMONY ON SB 526
WAYS AND MEANS COMMITTEE
January 28, 1992

Thank you, Mr. Chairman and members of the Committee. My name is Don Rezac; I am Vice Chairman of the Special Committee on KPERS Investments. I am here today in support of SB 526.

We learned a lot about KPERS. We've heard, 89 people, over 3850 pages of transcript.

Direct Placement - This was done by money managers. The money managers invested in a lot of buyout. They made loans for the business then made operating loans.

We learned some managers capitalize interest and expenses. Some managers let the company issue new stock for interest. It appeared to me that some managers were more worried about loaning the money for the fees than the return of the money.

The money managers were recommended by Callan and Asociates of San Francisco. Ron Payton had to recommend you as a money manager or you didn't get hired.

Direct placement losses so far are $225 million or 57% of the fund. Peter Gamm, West, returned an overcharge of $74,000 plus due to the committee investments. No one at KPERS was looking at the bills and invoices. They were just paying them. It looked to me like a lot of real estate investments were put together just to make work.

SWAM
January 28, 1992
Attachment 3

What goes around comes around - that is why the state needs Senate Bill 526.

Carlin started KPERS Direct Placement; Hayden didn't do anything about it; and we are in this mess today.

I want to thank Legislative Leadership and the Legislators for the support you have given the Special Committee on KPERS Investments.

A special thanks to Lawyers, David Elkouri and Terry Moore. Without their investigating team, we would not have the misdealing documented.

DON REZAC

KPERS
Kansas Public Employees Retirement System

January 28, 1992

Senator August "Gus" Bogina, Jr., P.E., Chairman
Senate Ways and Means Committee
Room 120-S, Statehouse
Topeka, Kansas 66612

Dear Senator Bogina:

I appreciate the opportunity to comment on the provisions of Senate Bill No. 526 as recommended by the Joint Committee on KPERS Investment Practices. Outlined below are my preliminary comments on the proposed legislation. In the days ahead I would hope to provide the Committee with additional information concerning the fiscal ramifications of the legislation.

Section 1

Subsection (a) calls for the expansion of the Board of Trustees from its current seven members to nine. This enlarged Board would have a fiscal impact, although not significant. The election of two Trustees by active and retired members of the Retirement System would also entail some new expenditures. The Retirement System will provide the Committee with a fiscal estimate as soon as possible.

Subsection (e) calls for certain members of the Board of Trustees to have experience in one of several specified areas. One of those areas is listed as "investment making." This particular term, which also appears in several later sections, is unclear. Members may wish to consider alternate language, perhaps "investment management."

Subsections (f) and (g) both contain restrictions on the investment and employment activities of members and former members of the Board of Trustees. These restrictions may be too broad. Given the wide-ranging Retirement System portfolio, including, over time, substantial portions of publicly traded stock universe, Board membership could be severely limited. The Committee may wish to consider a similiar restriction relating to the System's non-publicly traded investments.

Section 2

Subsection (6) calls for the creation of a five-member investment advisory committee. As no provisions are included for compensating or reimbursing the members of this advisory committee, no measurable fiscal impact is anticipated.

Section 3

Subsection (3) establishes a new, higher level of compensation for Trustees. The Retirement System will provide the Committee with a fiscal estimate as soon as possible.

SWAM
January 28, 1992
Attachment 4

Capitol Tower ■ 2nd Floor ■ 400 W. 8th ■ Topeka, Kansas 66603-3911 ■ Phone (913) 232-6665
KPERS Telephone Facsimile (913) 232-3041
In Kansas, Call Toll Free 1-800-228-0366

Section 4

Subsection (2) contains new language calling for the Retirement System to prepare its *Annual Report* in accordance with generally accepted accounting principles. This commendable addition should provide great assurance to System members and Kansas citizens that the annual results of the System's operations are fairly and consistently presented.

Additional language in the same subsection calls for the Retirement System to annually report for every individual alternative investment the cost and the lower of cost or market value for each such alternative investment. This additional language raises a significant public policy issue for the Committee's consideration. The requirement that the market value of individual alternative investments be publicly disclosed can come into conflict with the Retirement System's statutory and fiduciary responsibility to maximize the value, income, and safety of the System's assets. The problem with the public disclosure of such information relate solely to those direct placement and real estate investments in the System's current portfolio where the System currently holds the controlling interest in a non-publicly traded investment. I trust that the problem is of a temporary and declining nature as the Board of Trustees has placed a moratorium on future investments of this nature, the direct placement portfolio is being restructured and liquidated to eliminate such controlling interests, and legislation seems likely to prohibit such investments in the future. During this period of adjustment, the Committee may wish to consider language that would allow the Retirement System to report the lower market values on an aggregate basis through the establishment of a loss reserve, reporting on individual investments when the loss is actually recognized and a writedown is charged against the previously established loss reserve.

Section 5

Subsection (3)(a) contains new language stating that employer contribution rates will be based only on the needs of the System. Similiar language is contained in following sections of the proposed legislation. This language is most welcome as it serves to preserve and strengthen the actuarial funding basis of the Retirement System.

Section 6

Subsection (11) calls for the Board of Trustees to develop a plan to manage a portion of the System's assets using Retirement System staff. Such a move will have a fiscal impact and that impact may well be a positive one. As you know, the Board of Trustees has already initiated actions in this arena, beginning with the August hiring of the System's first Investment Officer. The State Finance Council has provided additional resources to facilitate the same goals.

Section 9

Subsections (2) and (3) discuss the investment purposes of the Board of Trustees. Subsection (3) in particular specifies that "economic development" and

"social purposes or objectives" are not sufficient stand-alone investment objectives. The Committee may wish to consider the advisability of adding additional language to cover related situations such as the current prohibition on South Africa related investments.

Subsection (4) adds new language containing the prudent expert standard. The Board has already initiated actions to incorporate the prudent expert standard in its contractual relationships with managers and consultants.

Subsection (5)(a) increases the common stock limitation to 60 percent of the total book value of the fund. This additional discretionary authority will serve the Retirement System well in future years.

Subsection (5)(b)(1) caps the System's total "alternative" investments at ten percent of the total. The System's current size would place this cap at approximately $440 million. Language is provided to cover the contingency that such investments exceed the cap at the effective date of the cap. However, the Committee may wish to consider additional language to cover the potential contingency where the System is fully invested at the ten percent level in "alternative" investments and market forces act to arbitrarily increase the value of such investments relative to the rest of the System's portfolio.

Subsection (5)(b)(2) would require at least two other "sophisticated investors" involvement in any "alternative" investment. The requirement for institutional coinvestors provides additional safeguards against the abuses that have taken place in the past by ensuring that each potential investment is subjected to a minimum of three independent due diligence reviews.

Subsection (5)(b)(3) places a 20 percent limit on the System's interest in any one investment. This restriction should ensure that the Retirement System would not have a majority interest in a particular "alternative" investment.

Subsections (5)(b)(4), (5), (7) and (8) require that "alternative" investments be proceeded by several determinations, all in keeping with the prudent expert standard of care.

Subsection (5)(b)(6) restricts the Retirement System from investing more than 2.5 percent of its "alternative" investments in any one "alternative" investment. While this restriction is certainly appropriate to actual individual investments, it may arbitrarily restrict the System's ability to participate in multi-investor pools such as venture capital funds if the restriction is placed on the investment in the pool itself and not on the underlying individual assets of the pool or fund.

Subsection (5)(b)(8) also contains language defining "alternative" investments. This is a most important definition given the many confusing definitions in this area. For the Committee's consideration we would also offer this definition provided by Carol Proffer, FSA, Managing Director of William M. Mercer Asset Planning, Inc.: "Alternative investments are defined by what they are not. Alternative Investments are defined as forms of investments not inluding marketable stocks, bonds, or typical real estate properties; usually involving private equity investing and limited partnerships, and are illiquid." The Mercer firm was recently selected as the Retirement System's investment consultant.

Subsection (6) requires the Board of Trustees to develop specified policies and objectives to govern the System's investment practices. Generally, these requirements seem quite reasonable. However, I would direct the Committee's attention to the language in Subsection (6)(c) concerning the "investment committee." Members may wish to consider whether this should be the "investment advisory committee" referred to in Section 2, Subsection (6) and elsewhere. Additionally, the Committee may wish to revisit the language in Subsection (6)(e) of Section 9 concerning "stop-loss criteria." The Retirement System does not believe that this concept can be practically applied in the "alternative" investment arena due to the illiquid nature of these types of investments.

Subsection (7) requires the Retirement System to compensate its investment managers and others subject to legislative appropriations. This provision would only present a problem in the hypothetical instance where appropriations were made on an historical basis and the System was subsequently confronted with market shifts that called for dramatic portfolio restructurings and the resulting unpredictably high levels of brokerage expenses. I expect that this contingency could be effectively addressed through the annual appropriation process.

The same subsection calls for the System's mangers and others to obtain errors and omissions coverage in an amount equal to the funds entrusted to the manager. Retirement System staff are currently obtaining cost estimates of the fiscal impact of such a requirement. Likewise, staff will develop a range of cost estimates for the mandated fidelity bond.

Finally, the Retirement System supports the addition of language specifying the principal-agent relationship that has always existed between the Retirement System and its managers and others.

Subsection (12) specifies annual audit coverage for the Retirement System. I would only comment on the provision calling for the Retirement System to reimburse the Legislative Division of Post Audit for the expenses associated with the annual financial-compliance audit. Traditionally, that expense has been borne by the State General Fund. This legislation would shift the expense to the Retirement System, increasing the System's administrative costs and reducing the investment earnings available to cover current and future benefit payments.

I again appreciate the opportunity to comment on Senate Bill No. 526. In the event I have overlooked some element of this legislation, please let me know. All of us on the Retirement System staff are available at your convenience.

Sincerely,

Meredith Williams
Executive Secretary

cc: Members, Board of Trustees