

COMMITTEE ON LEGISLATIVE RESEARCH
OVERSIGHT DIVISION

FISCAL NOTE

L.R. No.: 1663S.03I
 Bill No.: SB 436
 Subject: Attorney General; Liability; Retirement - Local Government; Retirement - Schools; Retirement - State; Retirement Systems and Benefits - General
 Type: Original
 Date: March 27, 2023

Bill Summary: This proposal modifies provisions relating to fiduciary duties for investments of public employee retirement systems.

FISCAL SUMMARY

ESTIMATED NET EFFECT ON GENERAL REVENUE FUND			
FUND AFFECTED	FY 2024	FY 2025	FY 2026
General Revenue	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
Total Estimated Net Effect on General Revenue	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)

ESTIMATED NET EFFECT ON OTHER STATE FUNDS			
FUND AFFECTED	FY 2024	FY 2025	FY 2026
State Road Fund	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
Various Other State Funds	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
Total Estimated Net Effect on <u>Other</u> State Funds	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)

Numbers within parentheses: () indicate costs or losses.

ESTIMATED NET EFFECT ON FEDERAL FUNDS			
FUND AFFECTED	FY 2024	FY 2025	FY 2026
Federal Funds	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
Total Estimated Net Effect on <u>All</u> Federal Funds	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)

ESTIMATED NET EFFECT ON FULL TIME EQUIVALENT (FTE)			
FUND AFFECTED	FY 2024	FY 2025	FY 2026
Total Estimated Net Effect on FTE	0	0	0

Estimated Net Effect (expenditures or reduced revenues) expected to exceed \$250,000 in any of the three fiscal years after implementation of the act or at full implementation of the act.

Estimated Net Effect (savings or increased revenues) expected to exceed \$250,000 in any of the three fiscal years after implementation of the act or at full implementation of the act.

ESTIMATED NET EFFECT ON LOCAL FUNDS			
FUND AFFECTED	FY 2024	FY 2025	FY 2026
Local Government	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)

FISCAL ANALYSIS

ASSUMPTION

Officials from the **Joint Committee on Public Employee Retirement (JCPER)** state this proposal has no direct fiscal impact to the Joint Committee on Public Employee Retirement. The JCPER's review of this legislation indicates it will not affect retirement plan benefits as defined in Section 105.660(9).

Officials from **MoDOT & Patrol Employees' Retirement System (MPERS)** state this proposal, if enacted, would significantly modify provisions relating to fiduciary duties for investments of public employee retirement systems. The proposed changes to the definition of "investment fiduciary" would eliminate most investment opportunities for MPERS, except perhaps for assets generating lower returns like fixed income, thereby lowering overall investment return expectations, reducing plan funded status, and increasing the cost to covered employers.

The change in the definition of "investment fiduciary" in section 105.687(5) to include investment managers and proxy advisors as fiduciaries would attempt to create a fiduciary relationship that investment managers do not agree to as part of industry practice. In some cases, an investment manager may agree to create a special purpose vehicle (SPV) for an individual investor, but the costs associated with this arrangement would be prohibitive for an organization like MPERS. Only much larger plans with bigger fund commitments would be in a position to consider this option, assuming it is available. If a manager agreed to the SPV and the investor agreed to pay the fees, it would have the direct consequence of reducing overall investment return due to the higher than usual fees.

In addition, there is language intended to prevent retirement plans from investing in funds that contemplate environmental, social, and governance factors. Plan fiduciaries are already required to make investment decisions based on the best financial interests of plan beneficiaries. Additional prohibitions may have the effect of limiting investment opportunities that would otherwise be in the best interests of plan beneficiaries.

It is not possible to accurately quantify the fiscal impact, however, it could be expected to exceed millions annually in lost investment returns once the existing investments are replaced with lower return options, such as fixed income (as opposed to alternative investments).

The fiscal impact is unknown, but likely exceeding millions annually in lost investment returns.

Current Status of MPERS:

As of June 30, 2018

Market Value of Assets:	\$2,314,530,148
Actuarial Value of Assets:	\$2,274,248,122
Liabilities:	\$3,981,838,941

Active Employee Payroll as of June 30, 2018: \$351,496,555

Recommended Contribution Rate for FY 2020: 58% of payroll. Projected dollar contribution is \$216,283,563. Employees hired for the first time on or after January 1, 2011 contribute 4% of compensation to MPERS.

Officials from **Missouri State Employee's Retirement System (MOSERS)** state this proposal would modify the existing fiduciary statutes to exclude consideration of social, political or ideological interests. As described in the broad categories in the proposal, topics prohibited from consideration included in subsection 105.687.3 RSMo., range from greenhouse gas emissions to firearms and ammunition. The proposal further modifies the fiduciary duties of investment fiduciaries by equating the external manager's fiduciary duty with that of the MOSERS Board of Trustees. MOSERS' Board is statutorily required to manage the system's assets in the best interest of its membership. However, MOSERS utilizes external managers who also invest on behalf of numerous other clients with fiduciary duties to their respective membership. The fund manager's scope of fiduciary duty is to the investors of the fund and the fund as a whole.

Additionally, the proposal introduces a new definition of "fiduciary commitment" which provides a broad listing of what could be considered as evidence of an investment fiduciaries purpose and introduces a significant amount of ambiguity and subjectivity.

In addition, the proposal would authorize the Attorney General to enforce its provisions, which include treble, or triple, damages for violations. The prospect of incurring triple damages could have a dramatic effect on the willingness of a manager or fund to engage in business with a Missouri system, limiting the pool of potential external managers to those with less desirable investments and returns.

Any move away from managed investments and related returns would significantly increase the percentage and overall dollar amount required of MOSERS participating employers over the long term.

Existing Statutes in Proposal

Currently, Chapter 105 RSMo requires that an investment fiduciary of a public employee retirement system to "discharge his or her duties in the interest of the participants in the system and their beneficiaries." § 105.688 RSMo. These fiduciaries are also required to act as would a

“prudent person” acting “in a similar capacity” and to “[m]ake investments for the purposes of providing benefits to participants and participants’ beneficiaries, and of defraying reasonable expenses of investing the assets of the system.” Id. at (1), (3). Similar obligations also already exist in Missouri’s Prudent Investor Act at sections 469.900 - 469.913 RSMo.

Changes in Proposal: Summary of Provisions and Application

Section 105.687

This proposal adds and defines “fiduciary commitment” and “financial.” With the ambiguity and subjectiveness introduced by these definitions, complexity will arise when an investment fiduciary’s purpose is examined to determine compliance. While there may be clear cut situations where an investment fiduciary expressly admits to an improper purpose in an investment or vote under these provisions, there will likely be far more cases where purpose is ambiguous under the circumstances.

Section 105.688

This section modifies the duties of investment fiduciaries. It equates the external manager’s fiduciary duty with that of the MOSERS Board of Trustees. MOSERS’ Board is statutorily required to manage the system’s assets in the best interest of its membership. In doing so, MOSERS utilizes external managers who also invest on behalf of numerous other clients. The fund manager’s scope of fiduciary duty is to the investors of the fund and the fund as a whole. As a result, this proposal could cause MOSERS to move away from managed investment structures.

High quality managers may not want to take on the risk of navigating the aspects of the new definitions contained in this proposal. Particularly with the additional new remedy of triple damages for “all moneys paid to the company by the system for the company’s services” as outlined in subsection 11 of section 105.688. These additional risks would work to limit the pool of high-quality managers that would allow MOSERS to invest with them and thereby reduce the investment opportunity set and increase costs. This reduced opportunity set would have a detrimental impact on the portfolio by causing investment with lesser quality managers and/or not utilizing certain asset classes, and thereby lowering investment returns, thus decreasing the overall value for the long term.

Further clarification is necessary regarding the phrase “economically practicable alternative” in subsections 5 and 6 of section 105.688 RSMo.

It is important to remember, MOSERS, like other institutional investors, hires external managers that invest across different asset classes, such as private equity, hedge funds, real estate, etc. Some of these asset classes cannot be passively invested and therefore require implementation by hiring external managers. These managers are investment fiduciaries. If these managers will not allow MOSERS to invest with them due to the new provisions created in this proposal, the investment opportunity set is diminished.

Fiscal Impact

The MOSERS Board of Trustees sets the asset allocation of the portfolio in consultation with external investment consultants. From the asset allocation analysis, along with MOSERS actuarial professionals, the Board also adopts actuarial assumptions including the assumed investment rate of return (currently 6.95%).

Over the last 20 years, MOSERS has added additional value to the trust fund of 1% over the policy benchmark due to external management in various assets classes (approximately \$2 billion). Should the opportunity set be reduced through requiring different structures, utilizing suboptimal managers, or requiring the use of limited asset classes, the Board would likely need to modify the asset allocation and likewise reduce the current assumed investment rate of return from 6.95%. A reduction of this investment assumption would increase the actuarial accrued liabilities and, thereby, cause an increase in the actuarially determined employer contribution and a decrease the funded ratio of the system, ultimately resulting in an increased cost to employers to fill a larger gap between obligations and funding.

Information supplied by MOSERS external actuarial professionals indicates a 1% reduction in MOSERS assumed investment rate of return (from 6.95% to 5.95%) would increase the actuarial accrued liabilities by an estimated \$1.8 billion. As a result, the employer contribution rate and employer contribution dollars are projected as follows:

	Employer Contribution Rate	Employer Contribution Dollars
Baseline - 6.95% - FY24	27.26%	\$572,894,118
Reduced - 5.95% - FY24	33.42%	\$702,352,217
INCREASE	6.16%	\$129,458,099
Baseline - 6.95% - FY25	27.97%	\$598,677,495
Reduced - 5.95% - FY25	33.94%	\$726,461,001
INCREASE	5.97%	\$127,783,506
Baseline - 6.95% - FY26	28.39%	\$619,570,927
Reduced - 5.95% - FY26	34.21%	\$746,584,058
INCREASE	5.82%	\$127,013,131
Total Estimated 3-Year Increase		\$384,254,736
Total Estimated 10-Year Increase		\$1,301,789,047

Projections are based on the June 30, 2022 actuarial valuation and assume that all assumptions are met in the future.

Current Status of MOSERS:

As of June 30, 2022

Funded Ratio 57.7%

Market Value of Assets:	\$8,248,414,597
Actuarial Value of Assets:	\$8,894,328,756
Liabilities:	\$15,408,995,032
Unfunded Actuarial Accrued Liability	\$6,514,666,276

Covered Payroll as of June 30, 2022: \$2,004,688,456

Recommended Contribution Rate for FY 2022: 23.51% of payroll. Employees hired for the first time on or after January 1, 2011 contribute 4% of compensation to MOSERS. Estimated employer contribution is approximately \$471.3 million.

Officials from the **City of Kansas City, Kansas City Supplemental Retirement Plan** and the **Kansas City Firefighter's Pensions System** state this legislation could have a negative fiscal impact on Kansas City in an indeterminate amount if it impedes the City's Retirement Boards' investment managers from making a financially advisable investment.

Officials from the **Missouri Local Government Employees Retirement System (LAGERS)** assume this legislation would create multiple mandates for its investment fiduciaries, as defined in the act, which are expected to impact LAGERS' ability to invest system assets in a manner that provides the best risk adjusted returns for the system and its membership. LAGERS is working to fully evaluate the impact to the system, and will update their response in due course.

Officials from the **County Employees' Retirement Fund (CERF)** state this proposal may have an unknown fiscal impact to the County Employees' Retirement Fund.

The County Employees' Retirement Fund's Investment Policy requires managers to acknowledge that investment decisions will be made in the sole interest and for the exclusive purpose of providing benefits to participants. Investments are held to the prudent person standard and it is intended that managers be held to the prudent expert standard. CERF's Investment Policy also requires each manager to vote all proxies in the best interest of CERF participants by maximizing the value of the securities in the portfolio.

One of CERF's managers has pointed out that numerous publicly traded companies are currently disclosing emissions. For example, of the 2500 companies in the Russell 2500 index, about 400 of them disclose emissions. For the S & P 500, about 290 companies disclose emissions. Depending on how this legislation is interpreted and enforced, this legislation might result in eliminating a portion of the investable universe. Certain investment managers may need to request a list of restricted securities on an ongoing basis in order to comply with the legislation. In such a situation, this legislation may require CERF to modify how its investment managers

invest CERF funds. This may result in increased costs to CERF but it is difficult to determine the amount of such costs.

Officials from the **Public Schools and Education Employee Retirement Systems (PSRS/PEERS)** state the Systems have an actuary firm, PricewaterhouseCoopers (PWC), that prepares actuarial cost statements on any proposed legislation as well as the annual actuarial valuation reports for the Systems. This legislation will be submitted to them for an actuarial statement. As soon as the actuarial statement is available, they will be amending their fiscal response to include their analysis.

This legislation modifies provisions relating to duties of fiduciaries for public employee retirement systems and provides public employee retirement systems additional provisions on the voting of proxies as shareholders. Provisions are also included allowing the Attorney General to enforce this act.

This Legislation would significantly impact the Public School Retirement System of Missouri (PSRS) and the Public Education Employee Retirement System (PEERS), collectively referred to as the Systems. The proposed legislation would impact all System investment management contracts, including both public and private markets. Private markets include private equity, private credit, and private real estate. The Systems are evaluating the proposed legislation and the overall impact on the Systems' investment portfolios.

Officials from the **Police Retirement System of Kansas City** state the fiscal impact is undetermined. The Police Retirement System of Kansas City and the Civilian Employees' Retirement System of the Police Department of Kansas City are too small to not employ an investment fiduciary to manage pension system assets. It is not economically feasible for the plans to invest those funds internally. The managers selected by the Retirement Board may very well be index managers who, at a very low cost, will replicate equity holdings of an appropriate index fund. Neither the investment manager nor the Retirement Board can dictate which investments are included in the index fund. The new provisions of section 105.688 RSMo., contained in SB 436 could prevent the Retirement Board from investing in funds that could add value to the plans.

Officials from the **Kansas City Public School Retirement System (KCPSRS)** state they do not have an in-house investment staff as the fund is under \$1B in assets. The System uses Segal Marco Consulting as a fiduciary to manage the Pension Fund's investments. The new provisions of section 105.688 RSMo., contained in SB 436 could prevent the Retirement Board from investing in funds that could add value to the plans. As for cost increases, it is undetermined at this time. The proxy voting provisions of SB 436 would require either additional KCPSRS staff or hiring a firm specifically for proxy voting. There would be additional cost for either option, the cost of which cannot be determined at this time. Investment managers fees would increase as a result of the potential liability implied in RSMo 105.688.11.

Officials from the **Missouri Sheriffs' Retirement System** state this may have a negative impact if this legislation passes. The Retirement System hires investment managers to invest its assets based on the investment policy. Setting constraints on investment guidelines has a potential of limiting investment earnings used to finance the retirement system. At this time the negative impact is unknown.

Officials from the **City of Springfield, Rock Community Fire Protect District Retirement Plan** and the **St. Charles Community College** each assume the proposal will have no fiscal impact on their respective organizations. **Oversight** does not have any information to the contrary. Therefore, Oversight will reflect a zero impact in the fiscal note for these agencies.

Officials from the **Kansas City Employees' Retirement System** anticipate a fiscal impact but did not provide any additional details.

Officials from the **Kansas City Police Retirement System** and the **Kansas City Civilian Police Employees' Retirement** state the impact is undetermined. The Police Retirement System of Kansas City and the Civilian Employees' Retirement System of the Police Department of Kansas City are too small to not employ an investment fiduciary to manage pension system assets. It is not economically feasible for the plans to invest those funds internally. The managers selected by the Retirement Board may very well be index managers who, at a very low cost, will replicate equity holdings of an appropriate index fund. Neither the investment manager nor the Retirement Board can dictate which investments are included in the index fund. The new provisions of section 105.688 RSMo, contained this proposal could prevent the Retirement Board from investing in funds that could add value to the plans.

The proxy voting provisions this proposal would require either additional internal staff for the Retirement Systems or hiring a firm specifically for proxy voting. There would be additional cost for either option, the cost of which cannot be determined at this time. Investment managers fees would increase as a result of the potential liability implied in 105.688.11. RSMo.

Officials from the **Metro St. Louis Sewer District Employees Pension Plan** state Section 105.687(3) appears to say that any fiduciary "may be determined" to have violated this proposed legislation based upon a commitment to ESG principles even if they were not a factor in a particular investment decision or a proxy voting decision. Some fiduciaries run index funds set to match a benchmark, like the S&P 500 or Russell 1000. If that fiduciary has a commitment to ESG principles but continues to run certain funds without regard to those principles, are they violating this law?

Also, emerging technologies and products in the ESG space may prove to be strong long-term investments. Partisan legislation to limit the investment management choices of qualified fiduciaries could hurt long-term performance of retirement assets.

Officials from the **St. Louis Employees Retirement System** state it is too speculative to put a cost on the implementation of the bill's requirements.

Officials from the **University of Central Missouri** state there is an indeterminate fiscal impact.

Based on the responses received, **Oversight** assumes there could be costs and investment losses to retirement systems as a result of this proposal which would result in an increase the actuarial accrued liability and a subsequent increase in the actuarially determined employer contribution rates.

<u>FISCAL IMPACT – State Government</u>	FY 2024 (10 Mo.)	FY 2025	FY 2026
GENERAL REVENUE			
<u>Costs</u> – increase in employer contribution rates	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON GENERAL REVENUE	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
STATE ROAD FUND			
<u>Costs</u> – increase in employer contribution rates	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON STATE ROAD FUND	\$0	(Unknown, could be substantial)	(Unknown, could be substantial)

<u>FISCAL IMPACT – State Government</u>	FY 2024 (10 Mo.)	FY 2025	FY 2026
VARIOUS OTHER STATE FUNDS			
<u>Costs – increase in employer contribution rates</u>	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON VARIOUS OTHER STATE FUNDS	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)
FEDERAL FUNDS			
<u>Costs – increase in employer contribution rates</u>	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON FEDERAL FUNDS	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)

<u>FISCAL IMPACT – Local Government</u>	FY 2024 (10 Mo.)	FY 2025	FY 2026
LOCAL POLITICAL SUBDIVISIONS			
<u>Costs – increase in employer contribution rates</u>	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON LOCAL POLITICAL SUBDIVISIONS	<u>\$0</u>	(Unknown, could be substantial)	(Unknown, could be substantial)

FISCAL IMPACT – Small Business

No direct fiscal impact to small businesses would be expected as a result of this proposal.

FISCAL DESCRIPTION

This act modifies provisions relating to duties of fiduciaries for public employee retirement systems. Under this act, an investment fiduciary shall discharge his or her duties in the interests of the participants in a public employee retirement system and their beneficiaries for the exclusive purpose of providing financial benefits and paying reasonable expenses for administering the public employee retirement system. Additionally, when discharging fiduciary duties, which shall be the same as a member of the board of trustees of a system, an investment fiduciary shall take into account only financial factors. The term "financial" is defined in the act as a material effect on the financial risk or the financial return of an investment, but does not include any action taken, or factor considered, by an investment fiduciary with a purpose to further social, political, or ideological interests.

This act further provides that all shares held by or on behalf of a public employee retirement system, the participants, and their beneficiaries shall be voted solely in the financial interest of participants in the system and their beneficiaries. Unless no economically practicable alternative is available, the following actions shall not be allowed unless there is a practice and commitment to follow guidelines that match the system's obligations to act solely upon financial factors:

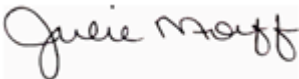
- (1) The board of a system granting proxy voting authority to persons not on the board;
- (2) The system entrusting assets to investment fiduciaries; and
- (3) The system adopting a practice of following the recommendations of a proxy advisor or other service provider.

The Attorney General may enforce the provisions of this act, or any contract subject to the provisions of this act. If the Attorney General has reasonable cause to believe that a person is engaging in a violation of this act, the Attorney General may require such person to file a written statement or report, under oath, as to all the facts and circumstances concerning the violation, and provide other necessary data and information. Additionally, a system or a participant or beneficiary of a system may bring an action for damages or injunctive relief against any person violating this act. In addition to any other remedies available, a company who serves as an investment fiduciary and who violates this act shall be obligated to pay damages in an amount equal to three times all moneys paid to the company by the system.

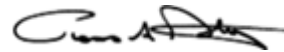
This legislation is not federally mandated, would not duplicate any other program and would not require additional capital improvements or rental space.

SOURCES OF INFORMATION

Joint Committee on Public Employee Retirement
MoDOT & Patrol Employees' Retirement System
Missouri State Employee's Retirement System
County Employees Retirement Fund
Kansas City Civilian Police Employees' Retirement
Kansas City Employees' Retirement System
Kansas City Firefighter's Pension System
Kansas City Police Retirement System
Kansas City Public School Retirement System
Kansas City Supplemental Retirement Plan
Local Government Employees Retirement System
Metro St. Louis Sewer District Employees Pension Plan
Public Schools and Education Employee Retirement Systems
Rock Community Fire Protection District Retirement Plan
Sheriff's Retirement System
St. Louis Employees Retirement System
City of Kansas City
City of Springfield
University of Central Missouri
St. Charles Community College



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