SB 727

Department of Legislative Services

Maryland General Assembly
2022 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 727 (Senator Rosapepe)
Budget and Taxation

State Retirement and Pension System - Investment Management Fees

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This bill requires the Board of Trustees of the State Retirement and Pension System (SRPS) to require each alternative investment vehicle in which it invests to disclose annually specified information related to fees, expenses, and carried interest. SRPS must then disclose the same information in an annual report to the General Assembly. The bill applies only to new contracts that SRPS enters into on or after January 1, 2023, and to all existing contracts under which the board makes a new capital commitment on or after the same date.

Fiscal Summary

State Effect: Nonbudgeted expenditures for staffing increase by $200,000 annually beginning in FY 2023. State pension liabilities and contributions (all funds) increase, potentially significantly, due to foregone investment returns, as discussed below. A reliable estimate is not feasible.

Local Effect: Local pension liabilities and contributions similarly increase, potentially significantly, due to foregone investment returns. As with the State, a reliable estimate is not feasible.

Small Business Effect: Minimal.

Analysis

Bill Summary: An "alternative investment" means an investment in a private equity fund, a venture fund, a hedge fund, or an absolute return fund. An "alternative investment vehicle" means the limited partnership, limited liability company, or similar legal structure through which SRPS invests in an alternative investment. "Carried interest" means any share of profits from an alternative investment vehicle that is distributed to a fund manager, general partner, or related parties.

Alternative investment vehicles must disclose to the SRPS board:

- fees and expenses that the State Retirement Agency (SRA) pays directly to the alternative investment vehicle, the investment manager, or related parties;
- the system's pro rata share of fees and expenses not included above that are paid from the alternative investment vehicle to the investment manager or related parties;
- the system's pro rata share of carried interest distributed to the investment manager or related parties; and
- the system's pro rata share of aggregate fees and expenses paid by all of the portfolio companies held within the alternative investment vehicle to the investment manager or related parties.

The annual report submitted to the General Assembly must also include the gross and net rate of return for each alternative investment vehicle, since inception. SRA may independently calculate the information required based on information contractually required to be provided by the alternative investment vehicle to the board. If the board independently calculates the information, the alternative investment vehicle may not be required to provide the information specified in the bill.

For existing contracts not covered by the bill, the SRPS board must make reasonable efforts to get the same information and comply with the reporting requirements.

Current Law:

Fiduciary Duties

A fiduciary of the SRPS system is defined as (1) a member of the Board of Trustees; (2) a member of the Investment Committee or other specified committees; or (3) an employee of SRA who exercises any discretionary authority or control over the management of the system or its assets.

A fiduciary must discharge his or her duties solely in the interest of the participants and:

- for the exclusive purposes of providing benefits to the participants and for reasonable expenses;

- with the care, skill, prudence, and diligence under circumstances, then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use;
- by diversifying investments so as to minimize the risk of large losses, unless it is clearly prudent not to do so; and
- in accordance with the laws, documents, and instruments governing the system.

Investment Committee and Division

The SRPS Board of Trustees is vested with the responsibility for the management, general administration, and proper operation of the system. The board has full power to invest the system's assets. The SRPS board must, by resolution, specify the number of members of the Investment Committee, which must include specified members of the board and three representatives from the public with related experience. The board must also, by resolution, specify the powers of the Investment Committee, which must advise the board and make recommendations on (1) the investment programs; (2) compliance with board policies; and (3) bonding for SRA employees as required by law.

The SRPS Board must adopt objective criteria for setting the qualifications and compensation of the Chief Investment Officer and for positions within the Investment Division. The Chief Investment Officer may (1) hire external investment managers to invest the system's assets; (2) select and invest in specific investment vehicles, including limited partnerships, private equity investments, and private real estate fund investments; and (3) may terminate external investment managers.

The board is subject to a 0.5% cap on the fees it can pay to external investment managers, not including assets invested in real estate or alternative asset classes. There is no cap on the fees that the board can pay for external real estate or external alternative asset management. Investment management fees are nonbudgeted and paid from the pension trust fund.

State Fiscal Effect: The bill's effect on SRPS falls into two categories: staffing to carry out the bill and possible foregone investment returns.

Staffing

SRA advises that it requires two additional positions in the Investment Division to manage the data collection, calculation, and reporting requirements in the bill. The SRPS board has the authority to create its own positions within the Investment Division and to establish compensation for those positions within specified guidelines. All costs for the Investment Division are nonbudgeted and paid out of the pension trust fund. Therefore, nonbudgeted expenditures increase by $200,000 for the two additional positions required by SRA for the Investment Division.

Potential Foregone Investment Returns

As of June 30, 2021, the system's holdings in asset categories affected by the bill (absolute return, private equity, and private real estate funds) totaled at least $22.5 billion, or roughly one-third of its $67.9 billion in total assets. The system has only minimal holdings in venture capital. Returns for these classes vary year to year but can often exceed returns in public markets. In fiscal 2021, for instance, private equity returned 52%, but returns for private real estate and absolute return lagged returns from public markets.

Alternative investment vehicles such as private equity and hedge funds typically have strict confidentiality provisions in their contracts that restrict or preclude disclosure of specified expenses and fees, such as carried interest. SRA has begun reporting fees and carried interest for these investments in the aggregate, but the bill requires the SRPS board to report them for individual funds and at a much greater level of detail than currently done or allowed by existing contracts. The bill is modeled closely on similar legislation enacted in California in 2016 and subsequently in several other states. Based on feedback provided by public pension funds in California, SRA advises that some high-performing alternative fund managers have opted to no longer work with California funds in order to avoid the fee disclosure requirements.

Thus, there is a strong likelihood that one outcome of the bill is that some alternative investment managers refuse to comply with the bill's disclosure requirements, thereby precluding investments from SRPS in those vehicles. Top-performing managers are the most likely to refuse to comply because they can recruit other investors to replace commitments by SRPS. To the extent that SRPS loses the opportunity to participate in top-performing vehicles, it likely experiences foregone investment returns that could total tens of millions, or possibly hundreds of millions of dollars. Foregone returns of that magnitude affect the system's unfunded pension liabilities (currently estimated to be about $20 billion), which in turn causes State pension contributions (all funds) to increase to make up for lost returns. A reliable estimate of any such effect on pension contributions is not feasible as it depends on future investment performance, but it may be significant.

Additional Information

Prior Introductions: None.

Designated Cross File: HB 905 (Delegate Reznik) - Appropriations.

Information Source(s): State Retirement Agency; Department of Legislative Services

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Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510