

# **PUBLIC PENSION OVERSIGHT BOARD**

## **Minutes of the 7th Meeting of the 2019 Interim**

**September 23, 2019**

### **Call to Order and Roll Call**

The 7th meeting of the Public Pension Oversight Board was held on Monday, September 23, 2019, at 1:00 PM, in Room 154 of the Capitol Annex. Senator Jimmy Higdon, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Senators Christian McDaniel, Dennis Parrett, and Mike Wilson; Representatives Jerry T. Miller, Russell Webber, and J. Michael Brown, John Chilton, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Mike Harmon, Auditor, Tiffany Welch, Audit Manager of Public Accounts; David Eager, Executive Director, Kentucky Retirement Systems; Beau Barnes, Deputy Executive Secretary of Operations and General Counsel, Teachers' Retirement System; Chris Biddle, Executive Director, Kentucky Public Employees' Deferred Compensation Authority; and Joe Bowen, former Senator of the Kentucky General Assembly.

LRC Staff: Brad Gross, Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

### **Approval of Minutes**

Sharon Mattingly moved that the minutes of the August 26, 2019 meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

### **Examination of Certain Policies, Procedures, Controls, and Transparency Compliance Activities of Retirement Systems in Kentucky**

Mike Harmon, Auditor of Public Accounts, began by noting that his office had recently completed and released on August 28, 2019, a special examination related to the transparency of all three state-administered retirement systems: Kentucky Retirement Systems (KRS), Teachers' Retirement System (TRS), and Judicial Form Retirement System (JFRS). He noted that with passage of SB 2 in 2017, a high level of interest from the Public Pension Oversight Board (PPOB), as well as members of the public, has been focused on whether the retirement systems were in compliance.

Mr. Harmon outlined the scope of the audit, which primarily focused on evaluating the systems compliance with the increased transparency requirements of SB 2. The audit

also reviewed a couple other special topics, such as delinquent employer balances and benefit payments to deceased individuals. The audit reviewed the period between July 1, 2017, and June 30, 2018, with additional data supplied through August 2019.

Mr. Harmon stated that KRS and TRS had failed to comply with the basic requirement to post all contracts, with both systems failing to post more than 80 percent of contracts on their websites. SB 2 required the posting of all contracts, and applied equally to contracts signed before its passage in 2017. During the audit, his office also discovered that both systems had contracts that referred to side letters that contain additional provisions of the contractual agreement, but none of those side letters were posted on the system's websites as required.

With regards to contracts posted online, KRS had abdicated its responsibility under the Open Records Act by delegating the redactions of confidential and proprietary information to external investment managers. He referred to KRS 61.645(20), which states that "the systems shall separate the excepted material by removal, segregation, or redaction, and make the nonexcepted material available for examination." KRS had not required any justification or documentation to support the requested redactions, nor had the system made any redactions themselves. The system has argued that their process is correct, based on an Opinion of the Attorney General issued in 2016, but he noted that SB 2, which amended the law, was passed in 2017.

In response to a question from Senator Higdon regarding whether the Auditor had been provided access to fully unredacted versions of the contracts as required by SB 2, Mr. Harmon confirmed that his office had been given unredacted versions of the contracts that were requested.

Mr. Harmon provided a couple of examples of redacted information that is not proprietary, but has been redacted from contracts posted on the KRS website.

In response to a question from Senator Higdon regarding the items redacted, Mr. Harmon stated, in his opinion, some of the items redacted was proprietary, but that there were several items, like those shown in his presentation, which should not have been redacted.

In response to a question from Representative Miller regarding contracts signed after the passage of SB 2, Mr. Harmon stated his office were provided some contracts signed after SB 2, but not all the contracts had been posted online, and those online were still redacted by the investment managers instead of KRS as required.

Mr. Harmon noted another finding not directly related to SB 2 compliance: the failure of KRS staff to meet annually with investment managers as required by their investment policy. He noted that given staff shortages, the systems had waived the

requirement in some cases. Mr. Harmon also called attention to the number of investment managers used by KRS, which totaled 110 as of June 2018, compared to only 41 investment managers for TRS and one for JFRS. SB 2 did not limit the number of managers, but having so many may impact KRS's ability to properly manage its investments and contracts.

With regards to TRS, Mr. Harmon noted the system has a process in place to redact confidential and proprietary contract information but that some redactions have been made without a request from the investment manager over concern the information would compromise the system's ability to competitively invest.

In response to a question from Senator Higdon regarding the requirements for KRS and TRS, Mr. Harmon confirmed the statutory requirements for both systems are the same, although neither system is in compliance. In response to a follow up question regarding compliance with just contracts signed post-SB 2, Mr. Harmon stated there was no exception and thus his office had considered all contracts.

Mr. Harmon continued with his findings, and stated that TRS was not reporting carried interest as required by SB 2, while KRS was reporting carried interest accurately and reflecting it as a line item on financial statements. TRS argues that carried interest information is proprietary and exempted from disclosure.

In response to a question from Senator Higdon regarding a description of carried interest, Mr. Harmon explained that carried interest is the amount of a private equity or hedge fund's profits that the general partner or investment manager receives as compensation. In response to a follow up question regarding if other states were reporting carried interest, Mr. Harmon stated that many states are reporting carried interest in a manner that is consistent with SB 2 requirements.

In response to a question from Representative Miller regarding whether or not the plans had common investment managers, Mr. Harmon stated his office would have to report back.

In response to a question from Senator Higdon regarding if the carried interest information was provided to during the Audit, Mr. Harmon stated that his office was given access to the carried interest information. In response to a follow up with regards to whether disclosure would put the system at a competitive disadvantage, Mr. Harmon responded that he did not believe releasing carried interest information would result in unfair competitive advantage.

Mr. Harmon provided a summary of findings for each of the systems. With regards to KRS, he pointed out a few additional findings, which included KRS staff's inability to recalculate one investment manager's fee, delinquent employer balances, and benefit payments to deceased individuals during the most recent fiscal year.

In response to a question from Senator Higdon regarding fee caps utilized by TRS, Mr. Harmon explained that TRS contracts included language that would allow TRS to postpone or withhold the payment of fees if a limit or cap was reached during the fiscal year. He noted that KRS did not include this kind of fee monitoring in its contracts.

Mr. Harmon continued his summary of audit findings and pointed out one finding with regards to JFRS, which was a small amount of benefit payments made subsequent to death of a retiree. JFRS had chosen not to seek recovery of the overpayment.

In closing, Mr. Harmon noted that the full audit report included recommendations for each finding to improve internal controls and oversight, as well as overall transparency and accountability. Additionally, he recommended that the PPOB work with stakeholders to develop an enforcement mechanism for full compliance with transparency requirements.

In response to questions from Mr. Chilton regarding the noncodified language included in the bill, Mr. Harmon responded that SB 2 did include noncodified provisions primarily related to procurement that specifically applied to contracts executed or renewed after July 1, 2017.

In response to a question from Representative Miller about the audit's recommendation regarding contract disclosure, Mr. Harmon stated that the audit recommended that, as to the posting requirement, the General Assembly should prohibit the systems from entering into any future contracts with managers that would not fully comply with SB 2. In response to a follow up question, Mr. Harmon stated that neither KRS nor TRS were in complete compliance even with contracts completed since passage of SB 2.

In response to a question from Senator Higdon regarding if all contracts had gone before contract review, Mr. Harmon stated that his office did not review that matter. In response to a follow up question regarding the term of the contracts, Mr. Harmon stated that most contracts would have renewal provisions and, once a contract is renewed, compliance should be carried out.

Senator Higdon asked former Senator Joe Bowen, as the sponsor of SB 2, to provide testimony regarding his intent for the legislation. Mr. Bowen stated that the intent of SB 2 was to give legislators and the public the opportunity to look inside the systems, see what was transpiring, and how money was being invested. He stated that the systems were gravely challenged with their level of funding, but it was hard for a legislator to make any recommendations or promulgate any type of corrective action without the opportunity to look inside to see what was going on.

### **Response to Auditor's Report – KRS & TRS**

David Eager, KRS, in his opening remarks thanked the committee for the opportunity to testify and stated that he had some real concerns about the audit. KRS staff had worked extremely hard to become more transparent and build confidence with the General Assembly. He referenced materials KRS makes available online, which includes a list of every investment manager, assets under management, as well as fees paid. All board meetings are live-streamed to the public.

Mr. Eager identified three primary findings that KRS wanted to address: (1) the posting of all investment manager contracts, (2) the redaction process, and (3) adherence to the CFA Code of Conduct. First, with regards to the posting of contracts, he stated there are two time periods, before and after SB 2 that must be considered. He referenced KRS 446.080, which states that statutes are not retroactive unless otherwise specified. He stated that all 13 contracts signed since the passage of SB 2 have posted online, while 41 contracts that were signed pre-SB 2 are also online even though KRS believes they are under no obligation to do so. Mr. Eager stated that all contracts not posted were in place prior to June 17, 2017, and are primarily private equity and alternative investments that account for only 12 percent of the plans' total assets. Mr. Eager identified existing confidentiality clauses as the primary reason these contracts were not posted, but also noted that liquidating these illiquid investments was a very costly alternative when all of them will mature over time.

In response to a question from Senator Higdon regarding if contracts were made available to the Government Contract Review Committee, Mr. Eager confirmed that all contracts not posted are made available unredacted to the committee.

In response to a question from Senator Higdon in regards to the length of the investment period, Mr. Robben stated that the vast majority of unposted contracts are private equity investments, which typically last from 9 to 15 years. In response to a follow up question regarding length of contracts, Mr. Robben stated that there could be one or two contracts that are in real return that may not have a stated termination date, while Mr. Eager added that traditional public equity and fixed income manager agreements typically have an exit clause with a 30 to 90 day notice.

Secondly, Mr. Eager discussed the audit findings related to contract redactions and stated that KRS should not be in primary control of that process. He referenced KRS 61.878(1) and indicated that KRS should not be put in the untenable legal position determining what is confidential or proprietary and what is not on behalf of a manager. He emphasized the legal concern of having KRS staff control the process. Again, he noted the Auditor and Government Contract Review Committee had access to all the systems' contracts.

Senator Higdon commented that several issues were resolved for TRS and KRS with the passage of HB 489 during the 2019 Regular Session. However, as to the other issues

that systems are expressing concern about, the PPOB has not heard from the systems until the auditor's report was issued. If there are matters that require legislative intervention, the systems need to bring these concerns to the attention of the PPOB.

In response to a question from Representative Miller regarding the different approaches to redacting by TRS and KRS, Mr. Robben responded that he agreed with the Auditor that items were likely redacted that did not necessarily need to be, but his lack of legal expertise limited his ability to make such decisions. In addition, KRS as a whole, does not have legal staff with a level of expertise to discuss and challenge redaction items with each of their managers. Lastly, he noted the access available to legislators, the Auditor, and other decision makers and expressed that managers are not as concerned with the public having access, but rather their competitors.

In response to a follow up question from Representative Miller regarding the TRS redaction process, Mr. Barnes stated that with regards to the publicly-traded investment managers, TRS staff is handling the redaction process. As it relates to private equity contracts and general partnerships, TRS is working with those managers, but the final redacted version is handled by staff.

Senator Higdon reiterated that an unredacted version of every contract was available for review by the Government Contract Review Committee and the Auditor. In response to a question from Senator Higdon regarding other access, Mr. Barnes stated that the Executive Branch and Legislative Branch also has the opportunity to seek unredacted versions, subject to a nondisclosure agreement.

In response to a question from Senator Higdon regarding if the system had lost investment opportunities due to the required transparency laws, Mr. Eager stated that KRS has had two investment managers decide to no longer do business with KRS, while Mr. Robben noted that a handful of managers have declined opportunities after reviewing the plan's gating process and requirements.

Mr. Eager continued to discuss KRS's redaction process and referred to an opinion from the Attorney General from 2016, which stated "Since investment services are the essence of [an investment manager's] business, conducted in a competitive field, there is no reason to doubt that such information is generally recognized as confidential or proprietary. Nonetheless, we do not find justification for KRS to withhold the partnership agreements in their entirety." Mr. Eager commented that KRS agreed with that opinion.

Lastly, Mr. Eager discussed issues KRS had with adhering to the CFA Code of Conduct, which was included in the original SB 2. He noted that most of KRS's managers do not belong to the CFA Institute and, therefore, refused to abide by its code of conduct and code of ethics. In addition, the CFA Institute did not have punitive powers and does

not conduct on-site audits. Mr. Eager highlighted HB 489, which removed the language and allows KRS to operate in compliance with current law.

Senator Higdon commented that HB 489 was a model piece of legislation, chiefly with regards to how the legislative process is supposed to work with the systems and legislators collaborating to find solutions to issues. He stated there needs to be additional discussions before the next session so some of the audit findings can be discussed and solutions can be addressed.

In response to questions from Mr. Jefferson with regards to posting carried interest, Mr. Robben stated that KRS started posting carried interest on their website because they felt like it was the right thing to do.

Mr. Eager concluded his presentation by stating that several of the audit recommendations were in process or staff was developing procedures to implement. Mr. Robben also addressed the audit finding related to KRS monitoring investment managers. He clarified that the current investment policy requires annual onsite visits, which is not possible with a staff of four and 110 managers, 15 of which are located overseas. He stated that staff does monitor and meet with managers, generally quarterly, via telephone or conference, and that the board was in the process of making changes to the investment policy to conform to industry practices.

In response to a question from Senator Higdon, Mr. Eager stated that KRS is in the process of sending out demand letters to the delinquent agencies.

Mr. Barnes opened his presentation by stating that while TRS respectfully disagreed with the audit findings, TRS did appreciate their work and commended staff. Mr. Barnes noted two primary findings that he planned to address, which included transparency of investment contracts and reporting of carried interest.

First, Mr. Barnes discussed the audit finding related to greater transparency of investment contracts and stated that TRS did believe in transparency and operates in such a manner. A list of every investment manager could be found in the systems financial report, along with the amount of each investment and quarterly performance reports. Every dollar that is paid out of the TRS trust funds in the form of fees are reported in their financial statements.

Mr. Barnes then referenced legislation passed during the 2008 session that increased reporting requirements and noted that statutory language was added to protect TRS from having to disclose anything deemed proprietary, which is the same exception exemption provided by the Kentucky Open Records Act under which every other state agency operates. These protections are still in place and do not require TRS to disclose anything that would compromise their ability to invest.

Mr. Barnes pointed out that the majority of contracts that are not posted online are related to general partnership contracts. He agreed that, technically speaking, the Auditor's report that 81 percent of the system's contracts were missing from the website was correct, but stated those contracts only represented 11 percent of assets under management. If TRS were to post all contracts, they would expose \$20 billion of assets to litigation risk.

In response to a question from Senator Higdon regarding who had access to unredacted contracts, Mr. Barnes stated that all contracts are available unredacted for review by the Government Contract Review Committee, the Auditor, and other Executive Branch offices.

Mr. Barnes continued and referenced contracts that were online, but redacted, and the auditor's finding that staff was redacting language above and beyond what the underlying manager requested. The finding was accurate, and staff had redacted any information that was deemed proprietary or compromised their ability to invest, which includes the method by which TRS calculates fees.

Additionally, Mr. Barnes discussed the audit finding related to the system not disclosing contact information for fund of fund managers as required by SB 2. TRS does disclose the fund of fund managers, but stated that the managers did not want competitors to know the underlying funds or investment strategy, so, staff did not report that information. He referenced the statutory protection language again as staff's reasoning for not reporting.

Next, Mr. Barnes began to address the audit reports finding with regards to TRS not reporting carried interest. Mr. Barnes provided a short description of what carried interest was and provided a scenario that served as an example. TRS does not consider carried interest a fee, because TRS, never had a right to the percentage of profit assigned to the general partner. Again, he invoked statutory protection language as the reason for not reporting.

Senator Higdon commented that the intent of SB 2 was to have each of the systems all reporting on a similar basis and that he would like to see the systems work together, along with legislators, so that the Auditor's next report shows full compliance.

In response to a question from Senator Higdon regarding if TRS had lost investment operations, Mr. Barnes stated that TRS had four investment managers that decided to decline opportunities due to SB 2, however with the passage of HB 489, TRS was able to reconnect with two of those managers.

In response to a question from Senator Higdon regarding some fee cap language included in TRS contracts, Mr. Barnes stated that fees are limited to an amount based on a



percentage, for example, of assets under management. He stated that if TRS receives bills that may perhaps exceed the agreed upon limit, they can withhold payments until they are sure they can come in line with what the actual fees agree to and not get over billed for a particular investment.

In response to a follow up question regarding if TRS and KRS had common investments and reporting of fees, Mr. Barnes stated that he believes they may have one common investment. He stated that TRS does not report this investment as the manager has informed them it is proprietary.

Senator Higdon noted much of the public perception regarding plan underfunding had been directed at the General Assembly and lack of funding. He referenced a study provided by actuary Flick Fornia that reported underfunding had accounted for about 20 percent and asked Mr. Barnes to comment. Mr. Barnes stated that the report had been conducted some time ago and he could not remember the timeframe nor the other factors. Mr. Eager stated that KRS staff had performed a similar calculation and stated that if KRS had received the full ARC for all periods and invested that money, the KERS would be about 32 percent funded.

Mr. Jefferson commented that in the investment community today, carried interest is considered a fee. In response to a question from Mr. Jefferson regarding carried interest, Mr. Barnes confirmed TRS is not reporting their carried interest in their Comprehensive Annual Financial Report. In response to a follow up question regarding whether or not the law explicitly states carried interest should be reported, Mr. Barnes referenced the notwithstanding language in subsection 5 of KRS 161.250, which states TRS does not have to disclose information that is proprietary or, if disclosed, would compromise their ability to invest. In response to a follow up question regarding if TRS reconciles the carried interest calculations, Mr. Barnes stated that a reconciliation process is performed quarterly.

Representative Miller expressed a desire for staff to work on providing a report on these issues so that the PPOB can consider them for their annual list of recommendations to the General Assembly approved each December. For example, what changes need to be made regarding carried interest so all the state's plans can report and treat these fees exactly the same way. He asked staff to look at other states and plans, such as CalPERS, Wisconsin, South Dakota, and Tennessee and see how they are treating and handling carried interest.

In response to a question from Senator Higdon, Mr. Barnes stated that before reporting, TRS looks at state laws, administrative regulations, and strategies for implementing investment policy, which is approved by the board. TRS also looks at SB 2 for transparency requirements, and written policy.

## **Kentucky Public Employees' Deferred Compensation Authority Update on Auto Enrollment**

Chris Biddle, Executive Director, began his presentation by stating that the Kentucky Deferred Compensation (KDC) Authority is the official supplemental retirement program servicing employees of the Commonwealth, public education, and local programs and is authorized by KRS 18A.230-18A.350. He noted that KDC is self-funded, receives no general fund revenue, and costs nothing for employers. KDC operates like a non-profit and is funded by participant fees, which are waived during a participant's first year and are capped at a maximum of \$237 per year, which is generally reached when an account reaches \$125,000. KDC is administered under the direction of a seven member Board of Trustees and an Executive Director that meets quarterly.

KDC has been in existence since 1975, when it began offering a 457(b) plan and introduced a 401(k) and IRA plan in 1986. He reviewed the maximum amounts a participant could defer for each of the plans along with the tax treatment. Currently, approximately 75,000 members are participating, the assets under management total just over \$3 billion, and the average account balance is \$39,900. He noted that Nationwide Retirement Solutions provides recordkeeping, marketing, and communications services for KDC, and they are supported by a KDC administrative staff of 16.

Mr. Biddle discussed the various investment options provided and noted that participants elect their own investments from a list approved by the Board. Currently, KDC offers over 20 investment options and participants can invest by self-selection, target retirement date funds, or managed account services. He provided a chart of the investment options across each of the three structures.

Mr. Biddle discussed recent initiatives of KDC and referenced an effort to coordinate with the Kentucky Personnel Cabinet in 2016 to provide benefits to employees as one total benefits package. He noted that working in concert with other personnel agencies to utilize shared information, message coordination, and unity of purpose had increased awareness and participation.

Next, Mr. Biddle explained the auto-enroll program. In 2019, legislation was passed to automatically enroll all new state employees hired after July 1, 2019, into the KDC 401(k) plan. The based deferral is \$15 per pay or \$30 per month and the funds for the first 90 days are held in a fixed contract fund, while assets of any future contributions are invested into the Vanguard Target Retirement Fund most appropriate to a participant's age after the initial 90 day period. Mr. Biddle outlined the rights provided to new employees, which included contributing more than the initial \$30 per month, designating beneficiaries, and the option to terminate contributions at any time. Mr. Biddle noted all new enrollees had 90 days to remain in the plan or opt out.

The auto-enrollment options include claiming a retirement savings contribution credit, a choice of investment options the KDC plan offers, being able to change their

investment options any time, and choosing a ProAccount, which is a managed account service.

Mr. Biddle stated that their average enrollment goal per month is around 500. In September 2019 there were 431 participants auto enrolled. With over 1,000 auto enrollments since July 2019, there have been only six participants that have filled out the form to opt out.

In response to questions from Senator Higdon, Mr. Biddle stated in regards to their returns, within the 90 day period, the fixed contract was about 2.32 percent. In regards to year-to-date average earnings, Mr. Biddle stated in general the assets continue to trend upward.

In response to a question from Mr. Jefferson, Mr. Biddle stated that the construction of the investment process that KDC provides for their participants starts with the Board of Trustees and an investment subcommittee that meets quarterly along with outside consulting. Mr. Biddle stated that there is also an annual due diligence that KDC executes with their record keeper along with the fixed contract fund.

In response to a question from Senator Higdon, Mr. Biddle stated that KDC services are also available to the school districts and county employees, but with less participation.

With no further business, the meeting was adjourned.