COMMITTEE ON LEGISLATIVE RESEARCH
OVERSIGHT DIVISION

FISCAL NOTE

L.R. No.: 2865H.01I
Bill No.: HB 1700
Subject: Retirement Systems and Benefits - General; Retirement - State; Retirement - Schools; Retirement - Local Government
Type: Original
Date: February 12, 2024

Bill Summary: This proposal modifies provisions relating to the fiduciary duty and proxy voting activities of public retirement systems.

FISCAL SUMMARY

ESTIMATED NET EFFECT ON GENERAL REVENUE FUND			
FUND AFFECTED	FY 2025	FY 2026	FY 2027
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 2025	FY 2026	FY 2027
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 Other 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 2025	FY 2026	FY 2027
Federal Funds	$0	(Unknown, could be substantial)	(Unknown, could be substantial)
Total Estimated Net Effect on All Federal Funds	**$0**	**(Unknown, could be substantial)**	**(Unknown, could be substantial)**

ESTIMATED NET EFFECT ON FULL TIME EQUIVALENT (FTE)			
FUND AFFECTED	FY 2025	FY 2026	FY 2027
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 2025	FY 2026	FY 2027
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 JCPER. The JCPER's review of this legislation indicates it will not affect retirement plan benefits as defined in Section 105.660(10).

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 addition of the definition of "fiduciary" in section 105.687(2) 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).

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 the proposed new subdivision (4) of § 105.687 RSMo, range from greenhouse gas emissions to firearms and ammunition. The proposal introduces a new definition of "fiduciary" which includes any person acting on behalf of a public retirement system as an investment manager or proxy advisor. 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.

This act also provides 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.

<u>Existing Statutes in Proposal</u>

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.

<u>Changes in Proposal: Summary of Provisions and Application</u>

<u>Section 105.687</u>
This proposal adds and defines "fiduciary" to include any persons acting on behalf of a public retirement system, specifically investment managers and proxy advisors.

The legislation also 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 clearcut situations when 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 subdivision (10) of subsection 2 of § 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 that 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.

Officials from the **University of Missouri System** state the bill could have a significant fiscal impact by limiting the University's investment options, however, an estimate of the potential impact has not been determined at this time.

Officials from the **City of Kansas City**, **Kansas City Supplemental Retirement Plan**, **Kansas City Employees' Retirement System** 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 certain mandates for its investment fiduciaries, as defined in the act, which may impact LAGERS' ability to invest system assets in a manner that provides the best risk-adjusted returns for the system and its membership. At this time, an estimated fiscal impact cannot be known.

Officials from the **County Employees' Retirement Fund (CERF)** state this proposal may have an unknown fiscal impact to the County Employees' Retirement Fund. This proposal would alter provisions relating to fiduciary duties relating to public retirement plan investments. It may impact how CERF's investment managers make investment decisions. 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 investment 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 this legislation provides an expanded definition of fiduciary duties in Sections 105.687 and 105.688, RSMo. The expanded definition would govern the Systems outside investment managers and partners and appears to extend to their relationship with all clients, including those outside the State of Missouri. The Systems' current Investment Policies appear to be in compliance with the proposed legislation. However, the legislation appears to modify how their investment partners can interact and contract with their other clients. This change appears to significantly alter the Systems' ability to set a prudent asset allocation. The proposed legislation, in its current form, could prohibit PSRS/PEERS from working with top-tier investment managers in all asset classes.

Per the System's actuary firm, Pricewaterhouse Coopers (PWC), this proposal provides an expanded definition of fiduciary duties in Sections 105.687 and 105.688, RSMo. The expanded definition would govern the Systems' outside investment managers and partners and appears to extend to their relationship with all clients, including those outside the State of Missouri. The Systems' current Investment Policies appear to be in compliance with the proposed legislation. However, the legislation appears to modify how their investment partners can interact and contract with their other clients. This change appears to significantly alter the Systems' ability to set a prudent asset allocation. The proposed legislation, in its current form, could prohibit PSRS/PEERS from working with top tier investment managers in all asset classes.

The asset allocation shifts that would be required by this legislation would greatly diminish the Systems' returns and are described in greater detail in the attached responses. A 1.0% decrease in the Systems' assumed rate of return, increases PSRS' unfunded liability by $7.2 billion and increases the actuarially determined contribution rate (ADC) to 40.10% from 28.78%. The impact for PEERS is an increase in the unfunded liability of $0.9 billion and the ADC would increase to 18.04% from 13.67%.

However, System staff have communicated to them their concern that, while the fiduciary duty provisions for investing and proxy voting in HB 1700 are similar to the Systems' current investment and proxy policies in certain respects, the definition of "fiduciary" and "financial", along with the addition of section 105.688(2) and (3), could subject their investment managers to the same fiduciary duties under Missouri law as the Board of Trustees and staff of the Systems. In the absence of clarifying language, this could require that their investment managers consider Missouri law as paramount to the policies and requirements of other fund sources and increases the possibility that those investment managers would choose not to do business with the Systems.

This proposal in its current form is therefore expected to have a fiscal impact on the Systems. PWC understand that the Systems' asset allocation and overall performance could be directly impacted by the inability to invest in the broadest available opportunity set in the world economy, as the bill would diminish the Systems' opportunity set, impacting all asset classes, including private market assets, and other business partners. The impact of the diminished opportunity set is currently unknown. To illustrate the sensitivity of the potential fiscal impact, the following pages present a detailed estimate of the fiscal impact for both PSRS and PEERS of a 1.0% decrease in the overall return on assets in the Systems' portfolio. The Systems have acknowledged that the impact may vary from this level of decrease in returns, and could be a more substantial decrease; however, the 1.0% sensitivity is consistent with the sensitivity analysis required by Government Accounting Standards Board Statement No. 67, Financial Reporting for Pension Plans. Due to the unknown impact on future returns, theye have also included a chart summarizing the estimated fiscal impact for both PSRS and PEERS for a reduction in the assumed rate of return in increments of 0.10% from the current 7.3% assumption down to 6.3%.

The Systems have communicated that their investment returns for the 10-year time period ended June 30, 2023, exceeded the return of a passive portfolio of 60% global stocks and 40% bonds by 2.2% per year, resulting in added value above a traditional portfolio of $11.9 billion, while internal investment staff and external investment managers added value above the policy benchmark of almost $7.0 billion over the same time period. This outperformance was due to portfolio construction as well as active management on the part of external managers, which they understand the Systems would be impaired going forward if this proposal were enacted.

The information is intended to illustrate the potential fiscal impact of that impairment. To the extent that the proposed changes would reduce the expected investment returns of PSRS and PEERS, the expected return on assets assumption used as the discount rate in the valuation of the benefit liabilities and determination of the Actuarially Determined Contribution Rate of PSRS and PEERS would also need to be lowered. This would also result in the existing Unfunded Actuarial Accrued Liability amortization bases needing to be updated to amortize the remaining balance using the lower discount rate. As requested by System staff, the estimated fiscal impact of a 1% reduction in the expected return on assets assumption for both PSRS and PEERS is provided herein to illustrate the potential fiscal impact to PSRS and PEERS.

The asset allocation shifts that would be required by this legislation would greatly diminish the Systems' returns. A 1.0% decrease in the Systems' assumed rate of return, increases PSRS' unfunded liability by $7.2 billion and increases the actuarially determined contribution rate (ADC) to 40.10% from 28.78%.

The impact for PEERS is an increase in the unfunded liability of $0.9 billion and the ADC would increase to 18.04% from 13.67%.

Officials from the **Kansas City Police Employees' Retirement System** and the **Civilian Employees of the Kansas City Police Employees' Retirement System** state the fiscal impact is unknown. The Police Retirement System of Kansas City and the Civilian Employees' Retirement System of the Police Department of Kansas City are too small not to 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 will replicate the equity holdings of an appropriate index fund at a very low cost. 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 HB 1700, could prevent the Retirement Board from investing in funds that could add value to the plans.

The proxy voting provisions of HB 1700 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 manager's fees would increase due to the potential liability implied in 105.688.10. RSMo.

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 this proposal 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 this proposal would require either additional KCPSRS staff or hiring a firm specifically for proxy voting. There would be additional costs for either option, the costs 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.

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 **Metro St. Louis Sewer District Employees Pension Plan (MSD)** state this proposal could have an impact on MSD and its ratepayers. The MSD Employees' Pension plan does not consider investments or fiduciary partners based on ESG characteristics, however the MSD is concerned that targeting these characteristics for exclusion may limit a fiduciary's ability to discharge his or her duties in the best interest of the participants in the system and their beneficiaries. As written, the legislation might not restrict a fiduciary's ability to invest and appropriately diversify but the addition of specific language to target certain characteristics for political reasons causes confusion that may prevent rational investment decisions that could otherwise enhance risk management and/or returns and creates concern that certain investment managers may become targets for offering products with ESG characteristics even if those products are not being used by the Plan.

Officials from the **Employees Retirement System of the City of St. Louis** state, the money managers hired by the Board also vote proxies on the System's behalf. The System's only requirement for voting the proxies is that the vote be in the best interests of the System and its participants. By requiring or prohibiting certain considerations which could be viewed by the money managers as in the best interests of the System and its participants or creating economic value, you restrict the money manager's ability to vote the proxies in a manner that may enhance shareholder value. It is speculative to put a dollar amount on such considerations, but it will cost more to administer such considerations as money managers may be unwilling to accept the risk associated with voting the proxies. This would require the System to hire a proxy voting company and pay additional fees.

The representatives of Marquette Associates expressed their belief that requiring consideration of such matters may prevent some investment managers from managing assets of Missouri public pension plans and severely limit opportunities offered by commingled investment vehicles (which are much more cost effective for smaller public pension plans like the System). Proposed pieces of legislation which impose financial penalties on investment fiduciaries who take these matters into consideration may have a chilling effect on the number of money managers willing to provide services to Missouri public pension plans. The money managers may decide not to take on risk when public pension plans in other states don't have financial penalties.

Officials from the **Attorney General's Office**, **Office of Administration**, **Rock Community Fire Protection District Retirement Plan**, **Northwest Missouri State University**, **University of Central Missouri**, **City of Springfield**, and the **City of Ulrich** 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 organizations.

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.

FISCAL IMPACT – State Government	FY 2025 (10 Mo.)	FY 2026	FY 2027
GENERAL REVENUE			
Costs – 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			
Costs – 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)**
VARIOUS OTHER STATE FUNDS			
Costs – increase in employer contribution rates	$0	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON VARIOUS OTHER STATE FUNDS	**$0**	**(Unknown, could be substantial)**	**(Unknown, could be substantial)**
FEDERAL FUNDS			
Costs – increase in employer contribution rates	$0	(Unknown, could be substantial)	(Unknown, could be substantial)
ESTIMATED NET EFFECT ON FEDERAL FUNDS	**$0**	**(Unknown, could be substantial)**	**(Unknown, could be substantial)**

FISCAL IMPACT – Local Government	FY 2025 (10 Mo.)	FY 2026	FY 2027
LOCAL POLITICAL SUBDIVISIONS			
Costs – increase in employer contribution rates	$0	(Unknown, could be substantial)	(Unknown, could be substantial)

ESTIMATED NET EFFECT ON LOCAL POLITICAL SUBDIVISIONS	**$0**	**(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.

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
Attorney General's Office
Office of Administration
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
City of Ulrich
University of Missouri System

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Northwest Missouri State University

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