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# *Analysis*

## **Am. Sub. H.B. 227 - Rep. Schneider**

*As Passed by the House*

**November 19, 2003**

## **ORSC Position**

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Am. Sub. H.B. 227 is an omnibus pension reform bill that generally seeks to improve accountability, oversight and ethical standards with respect to the governance of the five state retirement systems in Ohio: the Public Employees Retirement System (PERS); the State Teachers Retirement System (STRS); the School Employees Retirement System (SERS); the Ohio Police & Fire Pension Fund (OP&F); and the Highway Patrol Retirement System (HPRS). The bill also makes significant changes in the investment authority of the five retirement systems and the authority of the retirement boards with respect to the executive director of each retirement system.

As introduced, H.B. 227 would have replaced one active teacher member position with an additional retired teacher member position to the STRS board.

A description of the numerous changes follows:

**Financial Disclosure Statements Filed with Ohio Ethics Commission**

- Requires the board members and employees of the five state retirement systems whose positions involve substantial and material exercise of discretion in the investment of retirement funds to file a financial disclosure statement with the Ohio Ethics Commission. The financial disclosure statements would be considered public records because they are required to be filed pursuant to statute rather than administrative rule. (R.C. §102.02)

Currently, the chief executive officer of each system is required by statute to file a financial disclosure statement; board members of each system are required by administrative rule to file financial disclosure statements with the Ohio Ethics Commission and, therefore, such statements are considered confidential under current law.

(S.B. 105, S.B. 133, H.B. 242 and H.B. 283 include a similar requirement.)

**Campaign Financial Disclosure Statements Filed with Secretary of State**

- Requires each candidate or campaign committee that receives contributions or in-kind contributions totaling \$1,000 or more or makes expenditures totaling \$1,000 or more in connection with the candidate's efforts to be nominated for election or elected to the retirement boards of the state retirement systems to file with the Secretary of State two complete, accurate and itemized statements setting forth in detail the contributions, in-kind contributions and expenditures relative to the board nomination or election. The Secretary of State is required to prescribe the form for the campaign financial disclosure statements and to accept such forms from candidates filing them. The first statement shall be filed no later than twelve days before election day, and shall reflect contributions and in-kind contributions received and expenditures made to the close of business on the twentieth day before the election. The second statement shall be filed no sooner than eight days after the election and no later than 38 days after the election, and shall reflect contributions and in-kind contributions received and expenditures made during the period beginning on the nineteenth day before the election and ending on the close of business on the seventh day after the election. (R.C. §§111.30, 145.052, 742.042, 3307.072, 3309.071, 5505.041)

“Contribution” is defined to mean a loan, gift, deposit, forgiveness of indebtedness, donation, advance, payment, transfer of funds, or transfer of anything of value, including

the transfer of funds from an inter vivos or testamentary trust or decedent's estate, and the payment by any person other than the person to whom the services are rendered for personal services to another person, which contribution is made, received or used for the purpose of getting an individual nominated for election to a retirement board or influencing the results of a board election. "Contribution" does not include services provided without compensation by individuals volunteering a portion or all of their time on behalf of a person; ordinary home hospitality; and the personal expenses of a volunteer paid for by that volunteer campaign worker.

"In-kind Contribution" is defined to mean anything of value other than money that is used to get an individual nominated for election to a retirement board or influence the results of a board election or is transferred to or used in support of or in opposition to a candidate and that is made with the consent of, in coordination, cooperation or consultation with, or at the request or suggestion of the benefitted candidate. The financing of the dissemination, distribution, or republication, in whole or in part, of any broadcast or of any written, graphic or other form of campaign materials prepared by the candidate, the candidate's campaign committee, or their authorized agents is an in-kind contribution.

"Expenditure" is defined to mean the disbursement or use of a contribution for the purpose of getting an individual nominated for election to a retirement board or influencing the results of a board election.

- No person shall knowingly fail to file a complete and accurate campaign financial disclosure statement. Whoever violates this provision shall be subject to a fine of not more than \$100 per each day of the violation. Any fines imposed shall be paid into the Ohio Ethics Commission fund. (R.C. §§145.053, 145.99, 742.043, 742.99, 3307.073, 3307.99, 3309.072, 3309.99, 5505.042, 5505.99)
- Authorizes the Secretary of State or any person with personal knowledge and subject to the penalties of perjury to file a complaint with the Ohio Elections Commission alleging a violation of the campaign financial disclosure requirements. Upon receipt of the complaint, the Ohio Elections Commission shall hold a public hearing to determine whether the alleged violation has occurred. The Commission may administer oaths and issue subpoenas to any person in the state compelling the attendance of witnesses and the production of documents. Upon refusal to obey a subpoena or to be sworn and answer as a witness, the Commission may apply to the court of common pleas of Franklin County to obtain compliance. The Commission shall provide the person accused of the violation at least seven days prior notice of the time, date and place of the hearing. The accused may be represented by an attorney and shall have an opportunity to present evidence, call witnesses and cross-examine witnesses. If the Commission determines that a violation has occurred, the Commission shall either impose a fine as authorized above or enter a finding that good cause has been shown not to impose the fine. (R.C. §§145.054, 742.044, 3307.074, 3309.073, 5505.043)

(S.B. 133 includes a similar requirement.)

**Retirement Board Composition**

- Changes the composition of each retirement board as follows:

In the case of the PERS Board, the bill would eliminate the Attorney General, the Auditor of State and the Director of Administrative Services as statutory board members and replace them with the Treasurer of State, a gubernatorial appointee with no less than five years of experience in the management, analysis, supervision or investment of assets, and another retired member. The current PERS Board consists of the Attorney General, the Auditor of State, the Director of Administrative Services, five employee members elected by their respective members (one representing state employees, one representing county employees, one representing municipal employees, one representing college and university employees, and one representing all other miscellaneous employees) and *one* retired member elected by service and disability benefit recipients. Under the bill, the Governor shall request the Director of Administrative Services, with the organizations representing county commissioners, municipal corporations and townships, to submit the names and qualifications of three nominees, and the Governor shall appoint to the PERS Board one of the persons so nominated. (R.C. §145.04)

In the case of the OP&F Board, the bill would eliminate the Attorney General and the Auditor of State as statutory members and replace them with the Treasurer of State and a gubernatorial appointee with no less than five years of experience in the management, analysis, supervision or investment of assets. The current OP&F Board consists of the Attorney General, the Auditor of State, the fiscal officer of a municipal corporation appointed by the Governor, four employee members elected by their respective members (two representing police officers and two representing firefighters), and two retired members elected by their respective counterparts (one representing retired and disabled police officers and their survivors, and one representing retired and disabled firefighters and their survivors). Under the bill, the Governor shall request the Director of Administrative Services, with the organizations representing county commissioners, municipal corporations and townships, to submit the names and qualifications of three nominees, and the Governor shall appoint to the OP&F Board one of the persons so nominated. (R.C. §742.03)

In the case of the STRS Board, the bill would eliminate the Attorney General and the Auditor of State as statutory members and replace them with the Treasurer of State and another retired teacher member. At the option of the Governor, either the Superintendent of Public Instruction or an individual appointed by the Governor with no less than five years of experience in the management, analysis, supervision or investment of assets would serve as a statutory member. With respect to the proposed gubernatorial appointee, the Governor shall request that the organization representing school boards submit the name and qualifications of three nominees, and the Governor shall appoint one of the persons so nominated. The current STRS Board consists of the Attorney General, the Auditor of State, the Superintendent of Public Instruction, five teacher members elected by active, inactive and disabled teachers, and one retired teacher member elected by service benefit recipients. (R.C. §3307.05)

In the case of the SERS Board, the bill would eliminate the Attorney General and the Auditor of State as statutory members and replace them with the Treasurer of State and another retired member. The current SERS Board consists of the Attorney General, the Auditor of State, four employee members elected by active and inactive members, and one retired member elected by service and disability benefit recipients. (R.C. §3309.05)

In the case of the HPRS Board, the bill would eliminate the Auditor of State and Superintendent of the State Highway Patrol as statutory members and replace them with the Treasurer of State and another retired member. The current HPRS Board consists of the Auditor of State, the Superintendent of the State Highway Patrol, four employee members elected by contributing members, one retired member elected by service and disability benefit recipients. (R.C. §5505.04)

The attached pension profile provides the current composition of each retirement board.

(S.B. 133 also makes changes to the composition of the retirement boards; H.B. 283 (125th G.A.) would remove the Attorney General and the Auditor of State from the retirement boards.)

- Provides that the initial election of the additional retired member to the PERS, STRS, SERS and HPRS boards shall be held at the first election that occurs later than 90 days after the effective date of the bill, and every four years thereafter.

The initial gubernatorial appointment to the PERS, OP&F, and STRS boards shall be made within 90 days after the effective date of the bill. The term of office for such appointee shall be four years commencing on the first day of January (fourth day of June in OP&F; first day of September in STRS) following appointment or, if the Governor makes the appointment after the first day of January (first day of September in STRS), the term shall commence on the day of appointment. The member shall continue in office subsequent to the expiration date of the member's term until the member's successor takes office or until a period of 60 days has elapsed, whichever comes first. A member appointed by the Governor to fill a vacancy occurring prior to the expiration of the predecessor's term shall hold office for the remainder of that term.

In the case of the PERS Board, the Auditor of State and Director of Administrative Services shall remain members of the board until the new member has been appointed by the Governor and the additional retired member has been elected. In the case of the OP&F Board, the Auditor of State shall remain on the board until the new member has been appointed by the Governor. In the case of the STRS Board, the Auditor of State shall remain on the board until the additional retired member has been elected, and the Superintendent of Public Instruction shall remain on the board until the new member has been appointed by the Governor should the Governor opt to replace the Superintendent. In the case of the SERS Board, the Auditor of State and the Attorney General shall remain on the board until the additional retired member has been elected. In the case of the HPRS Board, the Superintendent of the State Highway Patrol shall remain on the board until the additional retired member has been elected. (R.C. §§145.05, 742.03, 3307.06, 3309.06, 5505.04)

- Makes a member of the retirement systems who has been convicted of or pleaded guilty to a felony in this state or any other jurisdiction ineligible for election to the retirement boards. The bill also provides that the office of a member of the retirement boards who is convicted of or pleads guilty to a felony shall be deemed vacant. (R.C. §§145.05, 145.055, 742.03, 742.045, 3307.061, 3307.07, 3309.062, 3309.07, 5505.04, 5505.044)

(S.B. 133 includes a similar prohibition.)

**Travel Policy**

- Requires each retirement board to adopt rules establishing a policy for the reimbursement of travel expenses incurred by employees of the retirement system. Currently, this statutory requirement is limited to the reimbursement of travel expenses incurred by members of the retirement boards.

(S.B. 133 includes a similar requirement.)

The bill further prohibits board members and employees of the retirement systems from accepting payment or reimbursement for meals and other food and beverages provided from any source other than the retirement system's expense fund. Currently, meals and other food and beverages provided are exempted from this prohibition. (R.C. §§145.08, 742.08, 3307.10, 3309.10, 5505.05)

**Ethics Policy**

- Requires each retirement board to adopt rules establishing an ethics policy to govern members of the board and employees of the retirement system in the performance of their duties. (R.C. §§145.09, 742.102, 3307.041, 3309.041, 5505.051)

**Board Training Program**

- Requires each retirement board to provide periodic training to members of the board and employees of the retirement system, including the requirements and prohibitions under the Ohio's ethics laws, the board's ethics policy, the board's travel policy, the board's policy on employee compensation and bonuses, and any other training the board deems to be appropriate. (R.C. §§145.093, 742.103, 3307.042, 3309.042, 5505.052)

(S.B. 133 includes a similar requirement.)

**Internal Audit Committee**

- Requires each retirement board to appoint a committee to oversee the selection of an internal auditor and to employ such person(s) selected. The committee shall consist of the following board members: one retired member, one employee member, and one ex officio member. The committee shall annually prepare a report of its actions during the preceding year and submit it to the ORSC. (R.C. §§145.094, 742.104, 3007.032, 3309.032, 5505.111)

(In testimony before the Joint Legislative Committee to Study Ohio's Public Retirement Plans in 1996, the Auditor of State recommended that the legislature require the five retirement systems to adopt an internal control structure, including the employment of an internal auditor, and file an annual internal control audit report with the ORSC and the standing committees of both houses with primary responsibility for retirement issues. All of the retirement systems, except HPRS, has employed an internal auditor since then.)

**Treasurer of State**

- Grants the Treasurer of State sole authority to appoint the executive director of each retirement system upon the advice and consent of the other board members. The board shall advise and consent regarding the appointment no later than 60 days following the appointment. The executive director shall serve at the pleasure of the Treasurer of State.

The bill provides that the initial executive directors appointed by the Treasurer of State shall commence service immediately upon appointment. Each board shall advise and consent providing the appointment not later than 60 days after it is made. (R.C. §§ 145.09, 742.10, 3307.11, 3309.11, 5505.07)

Currently, the executive director of each retirement system is appointed by the entire board.

- Requires the Treasurer of State to deposit all domestic assets of the retirement systems with a bank that is eligible to become a public depository and is subject to corporate franchise tax in this state. “Domestic asset” is defined to mean United States government securities, securities issues by a federal agency, corporate bonds and notes of companies incorporated in the United States, domestic equities, and any other asset considered a domestic asset by the Treasurer of State. (R.C. §113.052)

**Investment Operations**

- Requires each retirement board to execute not less than 70% of all equity and fixed-income trades in any given year through approved agents (i.e., licensed dealers) designated by the board and, *as a board goal*, not less than an additional 10% of all equity and fixed income trades through approved agents that are minority business enterprises (i.e., owned and controlled by Ohio residents who are Black, American Indian, Hispanic, or Oriental). The board shall designate an agent as an approved agent if the following requirements are met:
  - the agent submits to the board all required information concerning the agent’s history, personnel with substantial responsibilities regarding equity investments, support personnel, clients, fees, and any other related matter specified by the board;
  - the agent has practiced, or each of its principals has practiced, as an agent in Ohio for at least three years prior to designation;
  - the agent is subject to Ohio taxation;
  - the agent employs at least five Ohio residents;
  - the agent has demonstrated professional and administrative ability; and
  - the agent has no outstanding legal judgments or past judgments that reflect negatively on the agent or the retirement system.

The percentage of equity trades shall be measured by the dollar value of commissions paid; the percentage of fixed-income trades shall be measured by the face value of the securities traded. The board shall annually compile and make available upon request a list of

approved agents. (R.C. §§145.11, 145.114, 742.11, 742.114, 3307.15, 3307.152, 3309.15, 3309.157, 5505.06, 5505.062)

- Requires each retirement system to disclose annually to the Division of Securities of the Department of Commerce and the Ohio Ethics Commission the following information:
  - any money received by the retirement system from an agent and any money spent by an agent for any expense of the system; and
  - the name of any employee of the retirement system with authority over the investment of funds or any board member of the system who deals with such agent.

The bill also requires each agent who receives a commission from a retirement system to disclose to the Division of Securities of the Department of Commerce and the Ohio Ethics Commission the following information:

- any money paid by the agent to the retirement system and any money spent by an agent for any expense of the system; and
- the name of any employee of the retirement system with authority over the investment of funds or any board member of the system who deals with such agent.

The disclosures shall be made semiannually, not later than the thirtieth day of June and the thirty-first day of December of each year. (R.C. §§145.115, 742.115, 1707.49, 3307.153, 3309.158, 5505.063)

- Requires each retirement system that contracts with external investment managers to award not less than 50% of the assets externally managed to investment managers that meet the following criteria and, *as a board goal*, not less than an additional 10% of such assets to minority business enterprises:
  - the investment manager must have at least one significant contract as determined by the board with another state or federal governmental entity; and
  - the investment manager must have its headquarters in Ohio *or* have at least three operating locations in Ohio and employ at least 15 individuals at each location *or* employ at least 500 individuals in Ohio.

The bill would also require each retirement system, *as a board goal*, to award an additional 3% of its assets to one or more emerging investment managers. Each board shall adopt a policy not later than six months after the effective date of the bill that does both of the following:

- establish criteria that an investment manager must meet to be designated an emerging investment manager which shall include at least the following two requirements: (1) manage not more than \$500 million worth of investments; and (2) have at least one contract deemed significant by the board with another state or federal level government entity.

- provide preferential treatment to emerging investment managers that meet all of the following requirements: (1) has its corporate headquarters in Ohio; (2) employs at least five individuals in Ohio; and (3) has other investment operations within Ohio that utilize agents determined to be significant by the board.

All external investment managers shall meet all of the following requirements:

- shall be a bank, an insurance company, an investment company, or an investment adviser;
  - provide to the board the manager's investment strategies and objectives and satisfactory evidence of successful employment of such strategies and objectives;
  - demonstrate to the board's satisfaction that the investment management has achieved performance measures calculated on a time-weighted basis and based on a composite of fully discretionary accounts with a similar investment style and has net and gross fees that are comparable to other investment managers with similar investment strategies and objectives;
  - provide to the board an investment performance evaluation prepared by an objective third party that illustrates the investment manager's risk and return profile relative to other investment managers with similar investment strategies and objectives;
  - provide all information required by the board concerning the investment manager's history, personnel with substantial responsibilities regarding investment strategies and objectives, support personnel, clients, fees, and any other related matters; and
  - shall not have any judgments that may, in the board's opinion, reflect negatively on the investment manager or the retirement system. (R.C. §§145.11, 145.116, 742.11, 742.116, 3307.15, 3307.154, 3309.15, 3309.159, 5505.06, 5505.064)
- Requires external investment managers to do all of the following:
    - comply with the board's investment policies and objectives and the laws governing the investment of retirement funds;
    - at the board's direction, vote by proxy for the board in a manner consistent with the long-term interests of the retirement system and the board's investment policies and objectives;
    - keep detailed records of any votes by proxy;
    - on at least a quarterly basis, report to the board on the status of the retirement system's investments under management, including the gains and losses on such investments for the reporting period; and
    - meet with officers and employees of the retirement system at least twice per year to report the economic outlook of the retirement system's investments under management and compliance with the board's investment policies and objectives.

(R.C. §§145.117, 742.117, 3307.155, 3309.1510, 5505.065)

- Requires each retirement board to supervise and control the execution of the equity and fixed-income trades made by external investment managers to ensure compliance with the mandated percentages described above for Ohio-based licensed dealers and minority business enterprises. (R.C. §§145.118, 742.118, 3307.156, 3309.1511, 5505.066)
- Requires each retirement board to submit a quarterly report to the ORSC, including all of the following information:
  - the name of each approved agent designated by the board;
  - the percent of equity and fixed-income trades executed by approved agents;
  - the percent of equity and fixed-income trades executed by minority business enterprises;
  - the name of each investment manager contracted with by the board;
  - the percent of assets managed by each investment manager and the status of those assets;
  - the percent of assets managed by minority business enterprises and the status of those assets;
  - the percent of assets managed by emerging investment managers and the status of those assets;
  - a summary of the investment managers' compliance with the legislative mandates relative to trade execution. (R.C. §§145.119, 742.119, 3307.157, 3309.1512, 5505.067)

**Fiduciary Performance Audits**

- Requires the ORSC to have conducted an independent fiduciary performance audit of each retirement system at least once every ten years. The cost of such audit shall be paid by the retirement system audited. (R.C. §171.04)

(S.B. 133 includes a similar requirement as well as H.B. 283.)

**Removal of Elected Board Members**

- Provides that any elective board member of the retirement systems who willfully and flagrantly exercises authority or power not authorized by law, refuses or willfully neglects to enforce the law or to perform any duty imposed by law, or is guilty of gross neglect of duty, gross immorality, drunkenness, misfeasance, malfeasance, or nonfeasance is guilty of misconduct in office. Upon a complaint and hearing as provided below, the board member shall have judgment of forfeiture of the office, creating a vacancy in the office to be filled as provided by existing law.

Proceedings for the removal of such board member shall be commenced by filing with the court of appeals of the district in which the board member resides a written complaint specifically setting forth the charge. The complaint shall be accepted if signed by the Governor or signed by eligible members or retirees constituting at least 10 percent of the number of votes cast in the election for such board member position with at least 20 signatures in at least five different counties (or if no election, the most recent election held for such board member position). The clerk of court shall submit the signatures to the board, which shall verify the validity of the signatures and report its finding to the court.

The clerk of court shall cause a copy of the complaint to be served on the board member at least ten days before the hearing. The court shall hold a public hearing not later than 30 days after the filing of the complaint. The court may subpoena witnesses and compel their attendance in the same manner as in civil cases. Process shall be served by the sheriff of the county in which the witness resides. Witness fees and other fees in connection with the proceedings shall be the same as in civil cases. The court may suspend the board member pending the hearing.

If the court finds that one or more of the charges in the complaint are true, it shall make a finding for removal of the board member. The court's finding shall include a full detailed statement of the reasons for the removal, and shall be filed with the clerk of court and be made a matter of public record. The board member has the right of review or appeal to the supreme court on leave first obtained. The supreme court shall hear the case in not more than 30 court days after granting leave. In all other respects, the hearing shall follow the regular procedure in appealable cases that originate in the court of appeals. No person who has been removed from the board pursuant to the above procedure shall be eligible for future board membership. (R.C. §§171.50, 171.51, 171.52)

This provision is modeled after existing law governing the removal of public officers under R.C. §3.07, et al.

**Staff Comments** - In this section of our analysis, we will focus on those provisions of the bill that raise significant public policy issues or depart from well-established legislative principles and past precedents that have guided the operations of the retirement systems over the years.

- **Retirement Board Provisions**

One of the most significant public policy issues raised by the bill is the actual composition of the retirement boards. A survey of other state retirement boards throughout the 50 states indicates that board composition varies widely. (See attachment) Some boards are primarily made up of governmental officials, while others are made up of more pension plan participants than representatives of the public. Some boards provide for the election of members by the plan participants, while others provide for the appointment of such members by the governor or some other governing authority. Some require representation of citizens who are not members of the retirement system and individuals with experience in special fields, such as actuarial science, banking, insurance, and investments; others require no such representation. Some boards include legislators, while others do not. Some boards require retiree representation; others have no such representation. Some have

as few as one trustee, while other have as many as 18 trustees, with an average of 9 trustees.

In Ohio the composition of the state retirement boards share the following characteristics:

- The majority of the board members are elected by the members of the system, including contributing members and non-contributing members with accounts on deposit with the system;
- Each board includes at least one elected retired member (two retired members in OP&F);
- Each board has an odd number of trustees to prevent voting deadlocks; and
- Each board includes statutory members to represent the general public, such as the Auditor of State, the Attorney General or other public officials.

Generally, the bill would provide *less* public representation on the retirement boards at a time when *more* public accountability for board decision-making is sought. The number of statewide public office holders on four of the five retirement boards (PERS, STRS, SERS, and OP&F) would be reduced from two (the Attorney General and Auditor of State) to one (the Treasurer of State). Also, the number of overall public representatives on four of the five retirement boards would be reduced from three (the Attorney General, Auditor of State and the Director of Administrative Services) to two (the Treasurer of State and a gubernatorial appointee with investment experience) in PERS; in STRS, from three (the Attorney General, Auditor of State and the Superintendent of Public Instruction) to two (the Treasurer of State and *either* the Superintendent of Public Instruction *or* a gubernatorial appointee with investment experience at the option of the Governor); from two (the Attorney General and Auditor of State) to one (the Treasurer of State) in SERS; and in HPRS, from two (Auditor of State and Superintendent of State Highway Patrol) to one (the Treasurer of State).

Since the creation of the retirement systems beginning in 1919, the Attorney General as well as the Auditor of State have served as statutory members of the retirement boards, with the exception of the HPRS board on which only the Auditor of State has served. Both the Attorney General and the Auditor of State are statewide public office holders directly accountable to the citizens of all 88 counties in Ohio. The proposed replacement of at least one of these statewide public officers with a gubernatorial appointee in PERS and OP&F, a local school board member in STRS, and no one in SERS and HPRS would seem to provide more limited accountability and representation to the general public, particularly given the statewide nature of these retirement systems. *Therefore, we would recommend that at least two statewide public office holders remain statutory members of the PERS, STRS, SERS and OP&F retirement boards and that an additional statewide public office holder be added to the HPRS board to provide consistency with the other four retirement boards as well as greater public accountability. This could be accomplished within the current framework of the bill by retaining the Auditor of State on all five retirement boards.*

The proposed addition of a gubernatorial appointee with experience in investments to the PERS, OP&F and STRS Boards has considerable merit, and is very common among other

retirement boards throughout the country. Given the importance of investments in the actuarial funding of the retirement systems (funding up to 75% of benefit costs), such individual could provide invaluable knowledge and experience to perhaps the single most important responsibility of the board - managing the assets of the fund. Therefore, it is questionable why the bill, as currently drafted, would provide for the appointment of such individual to only three of the five retirement boards (PERS, OP&F, STRS), and *not* SERS and HPRS as well. It should also be noted that SERS is the only retirement board without a public representative under the authority of the Governor; with the proposed removal of the Superintendent of the State Highway Patrol, HPRS would become the second retirement board without a public representative under the authority of the Governor. Currently, PERS, OP&F, STRS and HPRS boards include the Director of Administrative Services, a fiscal officer of a municipal corporation appointed by the Governor, the Superintendent of Public Instruction, and the Superintendent of the State Highway Patrol, respectively. In the case of the STRS board, the bill would provide, at the option of the Governor, for *either* the Superintendent of Public Instruction remaining on the board *or* being replaced by an individual with experience in investments. *Accordingly, we would recommend that the Governor be given the same option either to retain his current public representative on the PERS, OP&F and HPRS boards or appoint an individual with investment experience in place thereof. We would further recommend that the SERS board include, at the option of the Governor, either a school board member or an individual with investment experience appointed by the Governor to provide the same level of public representation and accountability as the other four retirement boards.*

The bill had provided for a public employer representative on the STRS and SERS Boards, namely, a school board member, *prior to* a standing committee amendment which removed the proposed school board member from the STRS and SERS Boards in order to retain the current number of employee representatives on those boards. This type of representation has considerable merit given the significant contributions made by public employers to the retirement systems, and is rather common among other state retirement boards. *Therefore, we would recommend that consideration be given to adding a public employer representative to the PERS Board as well, such as a county commissioner or the chief executive officer of a municipal corporation, and restoring the proposed school board member to the STRS and SERS Boards.* These recommended changes, along with the other recommended changes described above, would deny absolute voting control of the board decision-making process to any single group of board members, thereby ensuring that all voices are heard and considered.

The bill would apparently change the manner in which current “teacher members” to the STRS board are elected by limiting voting to “contributing members”, though that term is *not* defined under the bill or under existing STRS law. Therefore, it is not clear, for example, whether “reemployed retirants” who are receiving a service retirement allowance from the system while contributing to the system would be eligible to vote for such “contributing member,” though they are not otherwise deemed to be “members” pursuant to existing STRS law. Similarly, it is not clear whether disability benefit recipients, who are *not* contributing to the system but are otherwise considered “members” under existing STRS law, would become disenfranchised under the proposed change. “Teacher members” are currently elected by the members of STRS, which includes *not only* members who are currently contributing to the retirement system *but also* members who are not currently contributing but who have accounts on deposit with the retirement system which may

include teachers on temporary professional, maternity, disability or military leave. In addition, disability benefit recipients are considered “members” and, therefore, are eligible to vote for the “teacher member.” The proposed change would seem to limit voting rights to only members who are currently contributing to STRS which is inconsistent with the laws governing the other two non-uniformed employee retirement systems, PERS and SERS. The proposed change would seem to disenfranchise large segments of the current STRS membership who continue to have vested, financial interests in the proper management and operation of their retirement system. *Therefore, we would recommend that this proposed change be removed from the bill so that members of PERS, STRS and SERS continue to be treated fairly and consistently with respect to their voting rights. We would further recommend that STRS law be amended to conform with the laws of the other four retirement systems which provide that the retired board member shall be elected by both the service and disability benefit recipients. STRS is the only retirement system in which disability benefit recipients vote for the “employee board member” as opposed to the “retired board member.”*

The attached table shows the composition of each retirement board if the recommendations described above were adopted.

- **Investment Provisions**

The proposed changes to the five state retirement systems’ investment authority mark a significant departure from well-established legislative principles and past precedents that have guided the investment operations of the retirement systems over the decades. The proposed mandates on the retirement systems’ use of Ohio-based brokerage firms, investment managers, minority business enterprises and emerging investment managers generally are contrary to the principles underlying the adoption of the “prudent person” standard established by the legislature in 1997 as the sole criteria to be used in managing the retirement systems’ investments. The proposed mandates also run counter to the legislature’s consistent and steadfast opposition to various and sundry proposed mandates over the years on the retirement boards’ exercise of their investment authority and fiduciary responsibilities with respect to the management of the system’s assets. Moreover, the proposed mandates could jeopardize the qualified plan status of the retirement systems under Section 401(a) of the Internal Revenue Code which, in addition to state statutes, applies to governmental plans, and thus adversely impact the favorable tax treatment currently accorded to the plan participants. The retirement boards could also become subject to various causes of action filed by the plan participants for breach of fiduciary duty as a result of the proposed mandates.

By way of background, the legislature has long recognized the significant role investments play in the overall funding of benefit costs in each retirement system. Of the three sources of revenue - employee contributions, employer contributions, investment earnings - the largest source of revenue for all five state retirement systems is investment earnings, funding up to 75% of their benefit costs. Thus, investment yields are very important to determining the contributions required from employees, employers and ultimately taxpayers to fund current and future benefit obligations.

Governed by outdated “legal lists” that severely restricted both the types and amounts of investments that could be made by the five state retirement systems, the ORSC

recommended that the legislature revamp the retirement systems' investment authority to enable them to respond to changing financial markets and a changing economy.<sup>1</sup> As part of a comprehensive review of the laws governing the state retirement systems, the ORSC recommended that the "legal lists" be abolished and that the retirement systems' investment authority be made subject solely to the "prudent person" standard.<sup>2</sup> This recommendation was adopted by the legislature in S.B. 82 (eff. 3/7/97), which was later amended to provide similar investment authority for the Bureau of Workers' Compensation (BWC).

Under the "prudent person" standard, the state retirement boards "shall discharge their duties with respect to the funds *solely in the interest of the participants and beneficiaries; for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the public employees retirement system;* with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims; and by diversifying the investments of the system so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." (Emphasis added) The guiding principles underlying the "prudent person" standard adopted by the legislature recognize the need for the state retirement systems to respond to changes in the economy and investment markets in a timely manner and to rely upon professional investment managers and economic advisors to guide their investment decisions, including trade execution, asset allocation, and the selection of investment managers. The proposed mandates under the bill undermine these guiding principles by reverting back to inflexible, arbitrary percentages and standards that do not allow the boards to respond to changing conditions or to rely solely on professional investment judgment to guide their decisions.

During the past two decades, the legislature has established a firm precedent of opposing any proposed mandates on the investment authority of the retirement systems. Since the early 80's, the legislature has rejected all attempts to require the systems to divest in companies with connections to South Africa, Northern Ireland, nations sponsoring acts of terrorism, tobacco and other social issues. The proposed mandates under the bill would mark a departure from this legislative precedent, and could set a precedent for future

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<sup>1</sup>A "legal list" generally spells out in varying degrees of detail the types and amounts of investments that can be made. If an investment is not specifically authorized under the legal list, then the retirement systems can not make the investment, regardless of whether it would otherwise be prudent to do so. Legal lists are in need of constant revision in order to keep current with changing financial markets and a changing economy.

<sup>2</sup>*Final Report: Findings, Staff Recommendations and JLC Action, Joint Legislative Committee to Study Ohio's Public Retirement Plans (December 11, 1996).*

mandates that would further erode the boards' investment authority and fiduciary responsibility to manage the systems' assets "solely in the interest of the participants and beneficiaries."

The proposed mandates under the bill are reportedly modeled after the current BWC investment policy. It should be noted, however, that at least two significant differences can be found. First, the statutory authority governing the BWC investments includes no similar mandates. The use of Ohio-based brokers, investment managers and minority business enterprises by BWC is done pursuant to its investment policy, which can be changed at any given time under its current statute. Therefore, the BWC retains discretionary authority under its current statutes to modify its policy as it deems appropriate and "prudent." The proposed mandates under the bill would be amended into each retirement system's investment statute, thereby providing no board discretion or flexibility with respect to the enumerated percentages or standards and requiring legislative action to change them - one of the very reasons the "legal lists" were abolished and the "prudent person" standard was adopted for both the state retirement systems and the BWC as the sole criteria for guiding investment decisions under S.B. 82.

Secondly, the BWC is a state insurance fund *not* subject to the qualification requirements under section 401(a) of the Internal Revenue Code; as qualified plans, the state retirement systems must satisfy the exclusive benefit rule of section 401(a)(2) of the Internal Revenue Code in order for the current favorable tax treatment to be accorded to their plan participants. The exclusive benefit rule provides that a trust forming part of a qualified plan must be established and maintained by an employer *for the exclusive benefit of that employer's employees and beneficiaries*. The proposed mandates under the bill could jeopardize the status of the retirement systems as qualified plans since the investment statutes, as amended by the bill, would make it possible for the assets of the retirement system to be diverted for a purpose other than the exclusive benefit of the plan participants, *should strict compliance with such mandates not otherwise be deemed prudent*. It is for this reason that the current investment statutes of all five retirement systems provide, for example, that it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens *where the investments offer quality, return, and safety comparable to other investments currently available to the board* rather than strictly mandating a specified percentage of such investments, regardless of whether all things are otherwise equal. The same type of statutory provisions apply to investments that involve minority owned and controlled firms and firms owned and controlled by women.

One of the basic principles of public pension policy adopted by the National Conference of State Legislatures in its publication Public Pensions: A Legislator's Guide, July 1995 is that pension investments should be governed by the "prudent person" rule. It further cautions against "any attempt to invest pension fund assets in ways designed primarily to perpetuate public services or to improve the business climate or tax base." The proposed mandates under the bill would seem to warrant such caution.

*Therefore, we would recommend that the proposed mandates on the retirement boards' investment authority and fiduciary responsibility to manage the retirement systems' assets be removed from the bill for the various reasons cited above.*

- **Treasurer of State**

The proposed changes with respect to the employment of the executive directors of the five state retirement systems also mark a significant departure from well-established legislative policy. Since the creation of the state retirement systems beginning in 1919, the board has appointed the executive director who has served at the pleasure of the board. Under the bill, the Treasurer of State would have sole authority to appoint the executive director, with the advise and consent of the board, and the executive director would serve at the pleasure of the Treasurer of State.

Under the governing statutes of the retirement systems, it is the board as a collective whole, not as individual board members, that is granted statutory authority with respect to the management and administration of these retirement systems, including the investment of retirement funds. The law also provides that the board as a whole may sue and be sued, plead and be impleaded, contract and be contracted with, employ and fix the compensation of employees, and adopt rules for the proper administration and management of the fund. In exercising such authority, fiduciary responsibility and potential liability apply equally to all individual board members, which suggests that each board member should have equal authority to fulfill such responsibilities. Investing the sole authority to hire and fire the executive directors in the Treasurer of State would create an untenable situation where the remaining board members remain responsible as fiduciaries, yet are denied the authority to take appropriate and necessary action as circumstances warrant, such as the removal of an executive director against the wishes of the Treasurer. It could also place the executive directors in a compromising position with respect to their duty of undivided loyalty to the board when the Board majority and Treasurer take conflicting positions on various issues and board policies, especially given the sole authority of the Treasurer to fire the director at will. In essence, the bill creates the potential for requiring the executive directors to serve two masters in these situations.

*Therefore, we would recommend that the proposed changes with respect to the employment of the executive directors of the five state retirement systems be removed from the bill.*

**Fiscal Impact** - We are not in position at this point to determine the fiscal impact of the bill on the retirement systems, particularly with respect to the investment changes proposed under the bill. This measure could have an actuarial impact upon the retirement systems to the extent that their investment costs increased and thus their investment returns decreased. Further information and analysis is required.

**ORSC Position** - At its meeting of November 13, 2003, the Ohio Retirement Study Council voted to recommend that the 125th Ohio General Assembly approve Sub. H.B. 227 upon the adoption of the following amendments:

- *that at least two statewide public office holders remain statutory members of the PERS, STRS, SERS and OP&F retirement boards and that an additional statewide public office holder be added to the HPRS board to provide consistency with the other four retirement boards as well as greater public accountability. This could be accomplished within the current framework of the bill by retaining the Auditor of State on all five retirement boards.*

- *that the Governor be given the same option either to retain his current public representative on the PERS, OP&F and HPRS boards or appoint an individual with investment experience in place thereof. In addition, we recommend that the SERS board include, at the option of the Governor, either a school board member or an individual with investment experience appointed by the Governor to provide the same level of public representation and accountability as the other four retirement boards.*
- *that consideration be given to adding a public employer representative to the PERS Board as well, such as a county commissioner or the chief executive officer of a municipal corporation, and restoring the proposed school board member to the STRS and SERS Boards..*
- *that the proposed change that “contributing” members rather than “teacher” members be removed from the bill so that members of PERS, STRS and SERS continue to be treated fairly and consistently with respect to their voting rights. We would further recommend that STRS law be amended to conform with the laws of the other four retirement systems which provide that the retired board member shall be elected by both the service and disability benefit recipients. STRS is the only retirement system in which disability benefit recipients vote for the “employee board member” as opposed to the “retired board member.”*
- *that the proposed mandates on the retirement boards’ investment authority and fiduciary responsibility to manage the retirement systems’ assets be removed from the bill for the various reasons cited in the staff comments.*
- *that AM4733-125, which was adopted by the House Banking, Pension, and Securities Committee yesterday and expands eligibility in the alternative retirement plans (ARP) offered by PERS, STRS, and SERS, to any full-time employee of a public institution of higher education with less than five years of service be removed until an actuarial analysis can be completed, as required by statute. (This recommendation was adopted on the House floor)*
- *that AM4709-125, which provides for the transition of the new board members, be harmonized with language added by AM 4731-125, which removes the school board member from the SERS and STRS boards (This recommendation was adopted on the House floor)*
- *that AM4729, which provides that the retirement systems shall have as a goal that one or more emerging investment managers manage not less than 3% of the assets of the retirement system, be clarified to mean not less than 3% of the assets of the retirement system that are managed externally to reflect the intent of the bill, which retains the retirement boards’ existing discretionary authority to decide the appropriate use of internal versus external management of their assets. In addition, the goal of having 10% of the investment managers be minority business enterprises should also be clarified to*

*mean not less than 10% of the assets of the retirement system that are managed externally for the same reason. (This recommendation was adopted on the House floor)*

- *that 125HB227-4748/BGE, which provides that the Treasurer of State shall appoint to each board, with the advice and consent of the board, an executive director who serves at the pleasure of the Treasurer of State and requires the board to advise and consent within sixty days following the appointment, be removed from the bill.*