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Instituting Competency Based Pay Systems For Public Funds Investment Staff

**Public & Private Pension Investing & Administration:
Issuing in a New Era of Fund Governance**

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OVERVIEW

- Are the investment staff employees of the public pension fund or the plan sponsor?
- Are there different investment objectives for a public pension fund's investment staff as compared to corporate/private portfolio managers?
- Does the investment staff monitor external managers or does the staff manage the portfolio internally?
- What are some options for establishing merit, performance or incentive based pay systems for public pension plans investment staff?

THE EMPLOYER OF THE INVESTMENT STAFF IS CRITICAL

- If members of the investment staff are employees of the plan sponsor (i.e., state, city or county) then those same members are subject to the pay system of the plan sponsor.
 - *Connell v. CalPERS*. State Comptroller refused to process salary increases for CalPERS portfolio managers because the State’s Department of Personnel Administration refused to approve the salary increases. CalPERS argued that in order to meet its fiduciary responsibilities, it must be able to determine salary increases, in particular to attract the best portfolio manager. The California Superior Court ruled on October 30, 2001 in favor of the State Comptroller. This case is on appeal.
 - Employees of county retirement boards in Massachusetts are subject by statute to “the general personnel guidelines and pay scales adopted for county personnel” (Mass. Gen. Laws c. 32 § 20 (3)(d)).
 - Elected public officials who are ex-officio trustees of public funds have pre-determined salaries.

III.

- Plan sponsor may decide to delegate compensation issues to plan trustees by statute, regulation or ordinance.
 - “The [Pension Reserve Investment Management] Board shall select an Executive Director who shall serve at the pleasure of the Board ... and such Executive Director shall, with the approval of the Board ... employee professional staff ... “ (Mass. Gen. Laws. c. 32 § 23(2A)(f and g).
 - Statutorily created state supervisor or constitutional officers may review pay scales established by plan trustees (e.g., Public Employee Retirement Administration Commission [Massachusetts], Auditor General of Pennsylvania).
- To implement incentive based pay system requires express authority from plan sponsor unless the public pension plan is an independent entity.

PUBLIC PENSION FUNDS' INVESTMENT STAFF HAVE DIFFERENT INVESTMENT OBJECTIVES THAN CORPORATE/PRIVATE PORTFOLIO MANAGERS

- Public plan trustees and investment staff owe fiduciary duties of prudence and loyalty to the beneficiaries of the plan, not necessarily to the plan sponsor or the taxpayer.
- Elected officials focus on their constituents.
- Corporate/Private portfolio managers owe prudence and loyalty to shareholders and investors.
- Public pension plan trustees and investment staff have duty to preserve capital and diversify so as to increase value (“modern portfolio theory”).
- Investment recommendations by investment staff must reflect compliance with these duties, not simply performance based returns since such a goal might encourage riskier investments.
- Investment decisions by public plans are generally made by public plan trustees and investment staff in “open meetings”.

IV.

ESTABLISHING MERIT, PERFORMANCE OR INCENTIVE BASED PAY SYSTEMS FOR PUBLIC PENSION PLAN INVESTMENT STAFFS WHERE PERMITTED

- Public plan trustees must establish investment objectives.
- Internal portfolio managers must recognize unique fiduciary duties, ethical standards as public employees, potential or actual conflicts of interest and corporate governance. Performance standards for investment staff which monitors external managers must consider similar issues, but not necessarily day-to-day investment decisions.
- Pay may reflect work environment and nature of opportunities.
- Pay incentive may also reflect size of plan assets and risk to Board (political and legal) to Board trustees if assets are managed in-house, as well as number of staff which need to be supervised.
- Incentives may be tied to similarly sized public pension funds as well as performance benchmarks such as S&P 500, and other stock and bond indices.
- “You get what you pay for.”