



New Mexico State Senate

State Capitol
Santa Fe

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COMMITTEES:

- MEMBER:
- Committees' Committee
 - Corporations & Transportation
 - Education

INTERIM:

- MEMBER:
- Revenue Stabilization & Tax Policy Committee
 - Economic & Rural Development Committee

ADVISORY MEMBER:

- New Mexico Finance Authority Oversight Committee

DESIGNEE:

- Legislative Finance Committee

MEMO

Date: 6/1/09

To: Chairman John A. Heaton and Investments Oversight Committee Members

From: Senator Tim Keller

CC: Governor Bill Richardson, President Pro Tempore Timothy Z. Jennings, Speaker Ben Lujan

RE: Considerations for structural investment fund reform in the interim

Part of our goal this interim is to investigate the performance and effectiveness of the state's various investment funds. While this might be very familiar territory for many members, it might also be new and/or complex to some. For me, this is a rare occurrence of overlap between my professional experiences and our legislative mandate. I believe many of the challenges to our state funds go far beyond third-party marketers and speak to a need for several structural changes that will bring both more accountability and better performance.

Working with numerous individuals in the investment field in and out of our state, I have consolidated ideas to consider as we begin to dive into each investment fund. I am by no means proclaiming these as "the" solutions, nor am I personally endorsing them, but I am merely putting them forth to consider as we listen to various expert testimonies. It is my hope to further the committee's efforts by introducing some ideas that we can refine, dismiss or improve rather than waiting until the fall to raise possible solutions.

In general, most of these ideas fall under a general work plan category of "investment fund governance, process and policies". Topics for interim consideration for the audit team, executive and legislative policymakers include the following.

Governance

- Several reasonable measures can be implemented that will reduce conflicts of interest and improve oversight, effectiveness and accountability. Similar to private-sector governance under Sarbanes Oxley in the post-Enron environment, our investment-related entities (PERA, ERB, SIC) should have:

- ✓ staggered terms;
 - ✓ specified fiduciary responsibility;
 - ✓ dedicated board seats for “outsiders”, i.e., individuals with no ties to the political or investment community;
 - ✓ balance experts and stakeholder board seats for “experts”, i.e., individuals with specific alternative investment credentials (Series 7, CFA, MBA, Qualified Investor, etc.) and directly relevant experience (private equity, structured products, investment banking, etc.);
 - ✓ balanced appointment origination between the executive and legislative branches and the treasurer’s office;
 - ✓ board committee structure based on asset class and expertise and a performance committee based on data-driven evaluation. Committees should contain a mix of board members, staff and outside experts;
 - ✓ recommendations of all investments by the relevant committee to the full board; and
 - ✓ application of the agency theory to the relationship between staff, funds and advisors (advisors work for the board, not the CIO).
- A public fund “prospectus” similar to other funds that outlines allocations, goals and processes each year should be required.
 - The right balance of diversification of advisors (i.e., having a different advisor and fund partners for each fund vs. consolidating advisors into one primary relationship with large financial institution) should be determined.
 - Clear delegation of authority (approval requirements) levels for staff and advisors based on investment size, liquidation preference and other risk factors should be specified to create clear lines of accountability for any investments.
 - Tracking , not just of benchmarks, but of allocation and performance comparables for a basket of “peer” funds (endowments, etc.), should be required.

Portfolio Process Adjustments

- Consider refining the practices around investing variable rate and structured products. Using these products greatly affects return volatility and risk exposure.
- Consider writing down private equity investments based on implied market value to ensure “real value” of the funds for expected returns and planning purposes (see SIC funding allocations).
- Consider refinancing variable bonds/swaps to provide long-term predictability.
- Clearly define “prudent investor” rule in the context of public investments; SIC rations do not look, in terms of allocation and diversity, like other endowments or our other funds.

Consultant and Advisor Processes and Policies

- Clarify the recent decision to disconnect campaign contributions from advisors and fund managers and other contractor relationships and state office holders; carry over bond issuers rule to advisors and consultants.
- Clarify the recent ban on third-party marketers in terms of other types of consultants and advisors.
- Determine the level to which New Mexico wants to invest vs. hiring experts to invest for us.
- Discontinue the practice of allowing individuals and entities from playing the role of advisors and fund managers, including across funds, to reduce conflict of interest and reduce risk.
- Specify an “arm’s length” for all transactions, i.e., allowing the market to determine all related fees and associated advisors (e.g., third-party fees at b/t 1-2%) and ensuring that all relationships be disclosed in advance of any decision.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Tim", with a long horizontal flourish extending to the right.

Senator Tim Keller