

Sweeping Illinois Pension Reform Legislation Affects Retirement Systems and Pension Funds and their Advisers, Managers and Consultants

Sweeping pension system reforms have been adopted in Illinois this month that will have a significant effect on all Illinois state and local retirement systems and pension funds (each, an “Illinois Public Retirement System”), their investment advisers, managers and consultants, and the private investment funds in which these entities invest.

Public Act 096-0006 (the “Act”) became effective on April 3, 2009 (the “Effective Date”).¹ The Act makes significant changes to the operations of Illinois retirement systems, pension funds and investment boards by amending the Illinois Pension Code, 40 ILCS 5/1-101 et seq. (the “Pension Code”), the Illinois Governmental Ethics Act, 5 ILCS 420/1-101 et seq., the State Officials and Employees Ethics Act, 5 ILCS 430/1-1 et seq., (the “State Ethics Act”) and the State Treasurer Act, 15 ILCS 505/0.01 et seq.

The provisions generally impose increased oversight and accountability requirements on the boards of trustees, fiduciaries and investment advisers, managers and consultants. Many of these provisions apply to virtually all pension systems in Illinois, not only at the state level, but at the local level, including pension systems of the City of Chicago and other local governments.²

The following is a summary of the Act.

Requirements for Qualification of Consultants and Investment Advisers or Managers (Pension Code, new § 1-113.14(b))

- The Act sets forth new requirements for outside consultants, advisers and investment managers to Illinois Public Retirement Systems. Under new

Section 1-113.14(b) all outside consultants, advisers and managers must be either (i) registered as an investment adviser under the federal Investment Advisers Act of 1940 (the “Investment Advisers Act”) or (ii) a bank, as defined in the Investment Advisers Act.

- Prior to the Act, there were no qualification requirements applicable to consultants. The qualifications of advisers and investment managers were set forth in Section 1-101.4 of the Pension Code, which provides that an investment adviser or manager with respect to an Illinois Public Retirement System must be (i) registered as an investment adviser under the Investment Advisers Act, (ii) a bank, as defined in the Investment Advisers Act, (iii) registered as an investment adviser under the Illinois Securities Law of 1953 or (iv) an insurance company authorized to transact business in Illinois. Section 1-113.14(b) appears to narrow the qualification so that Illinois state registered advisers and insurance companies described in clauses (iii) and (iv) above may no longer act as consultants, advisers or managers for Illinois Public Retirement Systems.

Establishment of a Procurement Process for Investment Services; Possible Effect on Registration Requirements and Political Contribution Prohibitions Imposed by Public Act 95-971 (Pension Code, new §§ 1-113.14(a)-(d), (f) and (g))

- Under new Section 1-113.14(b), Illinois Public Retirement Systems must adopt a competitive process that is *substantially similar* to the process

required for the procurement of professional and artistic services under Article 35 of the Illinois Procurement Code (the “Procurement Code”) for all contracts for selection of an investment adviser, manager or consultant to provide “investment services” (defined as services provided by an investment adviser or a consultant).³

- Each board of trustees must adopt a procurement policy that complies with the new requirements within 60 days of the Effective Date (by June 2, 2009) and must post the policy on its web site and file it with the Illinois Procurement Policy Board.
- Under Article 35 of the Procurement Code:
 - » contracts for service are awarded under a competitive request for proposal process that requires use of standard solicitation forms made available through the Illinois Procurement Bulletin and distributed to any list of prequalified vendors;
 - » completed responses are then evaluated, ranked and the winning bidder is selected; and
 - » for all contracts with annualized values exceeding \$25,000, evaluation and ranking by price are required; however, an offeror other than the lowest bidder by price may be selected so long as notice of the lowest bidder and a written explanation for selecting a higher bidder are published along with the contract.
- The requirement that Illinois Public Retirement Systems adopt procurement processes substantially similar to the Procurement Code means that entities seeking to provide investment services may be subject to Public Act 95-971, which we summarized in our January 30, 2009, Client Alert, “New Illinois Campaign Contribution and Registration Requirements May Affect Investment Funds and Managers,” available at <http://www.mayerbrown.com/privateinvestmentfund/article.asp?id=6086&nid=288>. Public Act 95-971 requires entities that bid on and enter into contracts with state agencies that are let or awarded pursuant to the Procurement Code to complete a detailed registration form to be submitted to the Illinois State Board of Elections and comply with political contribution prohibition requirements related to certain state executive branch officials.
- New Sections 1-113.14(c), (d), (f) and (g) of the Pension Code impose additional requirements on this contracting process:
 - » Contracts with investment advisers, managers or consultants providing investments services must contain certain required provisions. For example, the contract must be in writing; the adviser, manager or consultant must acknowledge his or her role as a fiduciary; all fees, penalties or other compensation, including reimbursement for expenses, that may be paid by or on behalf of a consultant in connection with the provisions of service must be fully disclosed; the adviser, manager or consultant must submit quarterly reports; and owners of a controlling interest and subcontractors must be disclosed (see Section 1-113.14(c) for a complete list of required contract provisions).⁴
 - » There is a five-year limit for any consultant contract, and no contract may be renewed or extended; however, the consultant may immediately compete for a new contract pursuant to the procurement process.
 - » Each Illinois Public Retirement System must also develop uniform documents for the solicitation, review and acceptance of all investment services, which shall include the required contract terms, and must post these forms on its web site along with a description of every current contract for investment services detailing the total contract amount, fees, the awardee’s name and a description of the factors that contributed to the awardee’s selection.

Fee Disclosures (Pension Code, new §1-113.14(e))

- In addition to requiring disclosure of fees, penalties and other compensation paid by or on behalf of consultants, as required under the new procurement and contract process described above, new Section 1-113.14(e) requires similar disclosure from current investment advisers, managers and consultants for Illinois Public Retirement Systems.
- Specifically, within 60 days of the Effective Date (by June 2, 2009) all investment advisers, managers or consultants currently providing services, or subject to an existing contract, must disclose in

writing all direct and indirect fees, commissions, penalties and other compensation paid by or on behalf of the investment adviser, manager or consultant in connection with provision of services to the board of trustees.

- This disclosure must include the date and amount of each payment made by or on behalf of the investment adviser, manager or consultant and the name and address of the recipient.
- Such disclosures must be updated after any modification of payments or for additional payments.

Expanded Definitions—Consultant (Pension Code, new § 1-101.5) and Fiduciary (Pension Code, amended § 1-101.2)

- Definitions in the Pension Code have been added and amended so that consultants are now covered under the new procurement process requirements, certain applications of fiduciary standards of conduct and other applicable provisions.
- To accomplish this, a definition for “consultant” was added under new Section 1-101.5 and the definition of “fiduciary” under Section 1-101.2 was expanded.
- Under the revised Pension Code, “consultant” means any person or entity retained or employed by the board of a retirement system, pension fund or investment board to make recommendations in developing an investment strategy, assist with finding appropriate investment advisers or monitor the board’s investments.⁵
- Additionally, the definition of fiduciary with respect to a pension fund or retirement system under the Pension Code was expanded to include a person who “renders advice on the selection of fiduciaries.”

Expanded Use of Emerging Investment Managers (Pension Code, amended § 1-109.1)

- The definition of “emerging investment manager” (EIM) was expanded to include businesses owned by a person with a disability and by increasing the maximum portfolio amount for an EIM to \$10 billion up from \$2 billion.
- Additionally, state policy encouraging the use of EIMs was expanded beyond the retirement systems to include pension funds and investment boards.

- Moreover, if an EIM meets the criteria established by a board for a specific search, and meets the criteria established by a consultant for that search, the EIM must be invited to present the firm for final consideration of a contract.

Required Policies Encouraging Increased Use of Businesses owned by Minorities, Women and Persons with Disabilities (Pension Code, new § 1-109.1)

- State policy now encourages Illinois Public Retirement Systems to (i) use EIMs in managing their assets, encompassing all asset classes, (ii) increase the racial, ethnic and gender diversity of their fiduciaries and (iii) take affirmative steps to remove any barriers to the full participation in available investment opportunities.
- On or before January 1, 2010, each Illinois Public Retirement System must adopt policies establishing goals, which are to be reviewed annually and included in an annual report to the Governor and the General Assembly due January 1 of each year, for the following:
 - » A separate goal each for utilization of EIMs, which must include quantifiable goals for the management of assets in specific asset classes, for (i) minority-owned businesses, (ii) female-owned businesses and (iii) businesses owned by a person with a disability—all to be based on the percentage of total dollar amount of investment service contracts let to such businesses;
 - » Increasing the racial, ethnic and gender diversity of its fiduciaries, including its consultants and senior staff (except there is no January 1, 2010, adoption deadline for this policy);
 - » Utilization of businesses owned by minorities, females and persons with disabilities for all contracts and services, to be based on the percentage of total dollar amount of all contracts let to such businesses; and
 - » Increasing the utilization of minority broker-dealers, meaning a qualified broker-dealer meeting the definition of a minority-owned business, a female-owned business and a business owned by a person with a disability.

Heightened Penalties for Certain Prohibited Transactions, Placement Fees, Improper Dealings and Fraud (Pension Code, amended § 1-110 and new §§ 1-145, 1-130 and 1-135)

- **Prohibition on Contingent Fees and Placement Fees:** The Act adds a new provision to the Pension Code that makes it a business offense for any person or entity to retain a person or entity to attempt to influence the outcome of an investment decision of, or the procurement of investment advice or services of, an Illinois Public Retirement System for compensation contingent in whole or in part upon the decision or procurement. Any violation of this provision is punishable by a fine of up to \$10,000 and a three-year prohibition from doing business with an Illinois Public Retirement System. This provision has the potential to impose a significant restriction on the use of placement agents to attract Illinois Public Retirement System investors in that all contingent fee arrangements are prohibited in relation to actions of placement agents that influence investment decisions or procurement activities. The word “influence” is not defined in the Act or the Pension Code and the legislative debates related to the Act have not yet been released. Until further judicial or legislative clarification is issued, under a conservative reading, this provision could apply to any action of a placement agent related to an Illinois Public Retirement System. This could have a substantial impact on typical fee arrangements related to placement agents.
- **Prohibition on Personal Interests in Transactions:**
 - » It is now a Class 4 felony, punishable by imprisonment of one to four years, for a board member, employee or consultant of an Illinois Public Retirement System to knowingly cause or advise the Illinois Public Retirement System to engage in certain transactions with an investment adviser where a board member, employee or consultant or his or her spouse has a direct interest in the gains of the investment adviser, or where there is a relationship with the adviser that would result in a pecuniary benefit to a board member, employee or consultant or their spouse. (“Consultant” for this section

includes an employee or agent of a consulting firm who has greater than 7.5 percent ownership of the consulting firm.) (Pension Code, amended, Section 1-110).

- » It is now a Class 3 felony, punishable by imprisonment of two to five years, for any board member or employee (or his or her spouse) of an Illinois Public Retirement System to (i) knowingly have any direct monetary gain in connection with any investments of the system, fund or board, or (ii) become an endorser or surety, or an obligor for money loaned or borrowed from any Illinois Public Retirement System. (Pension Code, new Section 1-130)
- **Penalties for Fraudulent Activities:** It is now a Class 3 felony, punishable by imprisonment of two to five years, for any person to knowingly make a false statement or falsify, or permit to be falsified, any record of a retirement system, pension fund or investment board in an attempt to defraud such retirement system, pension fund or investment board. (Pension Code, new Section 1-135)

Expansion of Prohibition on Gifts (Pension Code, amended § 1-125 and new § 1-150)

- It is now unambiguous that the prohibition on intentional solicitation or acceptance of gifts from any prohibited source as described in Article 10 of the State Ethics Act covers all Illinois Public Retirement Systems.
- The prohibition now clearly applies to solicitation or acceptance of gifts by employees as well as trustees.
- The revised Pension Code also tightens certain gift ban restrictions related to Illinois Public Retirement Systems. Prior exceptions under the gift ban that permitted prohibited sources to provide educational missions and travel expenses for a meeting to discuss state business no longer apply to any Illinois Public Retirement System subject to the Pension Code. In addition, under new Section 1-150 of the Pension Code, any expenses for travel or educational missions of a board member of Illinois Public Retirement Systems must be approved in advance by a majority of the board.

Working Group to Develop Uniform Standards for Selection of Investment Services (new 15 ILCS 505/16.10)

- The Treasurer is required to convene a working group to review performance of investment managers and consultants providing investment services for Illinois Public Retirement Systems.
- The group is charged with developing uniform standards for comparing the costs of investment services and making recommendations to Illinois Public Retirement Systems.
- The working group will include representatives from the Illinois Public Retirement Systems, persons that provide investment services and members of the financial industry.

Changes to Boards of Trustees of the State Employees' Retirement System (SERS), the State Universities Retirement System (SURS), the Teachers' Retirement System (TRS) and the Illinois State Board of Investment (ISBI) (Pension Code, amended §§ 14-134, 14-134.1, 15-159, 16-163, 16-164 and 22A-109)

- In the aftermath of former Illinois Governor Rod Blagojevich's impeachment and indictment, the Act makes certain immediate changes to the make-up of the boards of the state retirement systems and the investment board.
- Specifically, the term of office of each trustee appointed by then-Governor Blagojevich who was sitting on the boards of SERS, SURS, TRS and ISBI as of the Effective Date was terminated immediately. The boards of SERS and SURS are to be entirely reconstituted under new membership requirements by July 2, 2009 (within 90 days of the Effective Date), including completed elections for the new elected trustees of SERS and SURS.
- The Illinois Comptroller will now serve as the Chairperson of SERS and the Chairperson of the Board of Higher Education will serve as the Chairperson for SURS. The boards of TRS and ISBI also have new membership requirements.

- The new Governor has until June 2, 2009 (within 60 days of the Effective Date), to make nominations for appointments to the boards of SERS and SURS.
- Nominations for all of the state boards are now subject to the advice and consent of the state Senate.
- No trustee sitting on a board as of the Effective Date may hold over for more than 90 days for SERS and SURS and for more than 60 days for TRS and ISBI.
- The Illinois Governor may make temporary appointments and may nominate a trustee that held office on or before the Effective Date.

Additional Reforms Related to Illinois Public Retirement Systems

- Trustees of any Illinois Public Retirement System are now required to file a "statement of economic interests." (Amended 5 ILCS 420/4A-101, 4A-102, 4A-106 and 4A-107).
- The Act confirms that provisions of the State Ethics Act apply to any elected as well as appointed commissioner, trustee, director or board member of any Illinois Public Retirement System. (State Ethics Act, amended Section 1-5).
- The Act confirms that all boards and committees of an Illinois Public Retirement System must comply with the Illinois Open Meetings Act, that a majority of all committee members must be board members and that any non-board committee member shall be a fiduciary. (Pension Code, new Section 1-113.16).
- Each Illinois Public Retirement System must maintain an official web site with certain information including total amount of funds held, asset allocation, historic return information and a listing of investment advisers and consultants, available in a clear and conspicuous manner to be updated, at minimum, on a quarterly basis. (Pension Code, new Section 1-113.16).
- All trustees of an Illinois Public Retirement System must attend at least eight hours of ethics training per year. (Pension Code, new Section 1-113.18).

Endnotes

- ¹ Available at <http://www.ilga.gov/legislation/publicacts/96/PDF/096-0006.pdf>.
- ² In particular, a number of the provisions include exceptions or different requirements related to municipal police and fire pension systems outside of Chicago. These exceptions and different requirements are not highlighted in this summary.
- ³ Exceptions to this new procurement process include (i) sole source procurements, (ii) emergency procurements and (iii) at the discretion of the pension fund, retirement system or investment board, contracts that are nonrenewable and one year or less with a value of less than \$20,000, and provided that the exceptions granted are published on the system's, fund's or board's web site with the name of the person authorizing the procurement and an explanation of the exception.
- ⁴ "Subcontractor" does not include non-investment related professionals or professionals offering services that are not directly related to the investment of assets, such as legal counsel, actuary, proxy-voting services, services used to track compliance with legal standards and investment fund of funds where the board has no direct contractual relationship with the investment advisers or partnerships.

- ⁵ "Consultant" does not include non-investment related professionals or professionals offering services that are not directly related to the investment of assets, such as legal counsel, actuary, proxy-voting services, services used to track compliance with legal standards and investment fund of funds where the board has no direct contractual relationship with the investment advisers or partnerships.

For more information about these reforms, or any other matter raised in this Client Update, please contact one of the authors, listed below.

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