Information Memorandum 96-11*

INVESTMENT BOARD LEGISLATION (1995 WISCONSIN ACT 274)

A. INTRODUCTION

This Information Memorandum describes the provisions of 1995 Wisconsin Act 274 ("Act 274"), relating to legislative oversight of the Investment Board, structure and composition of the Investment Board, regulation of certain investments by the Investment Board, granting rule-making authority and making an appropriation. The legislation which became Act 274 was developed by the Joint Legislative Audit Committee and was based on recommendations contained in Legislative Audit Bureau Report 95-16, *An Evaluation of Investment Practices of the State of Wisconsin Investment Board*, dated July 1995. The Joint Audit Committee had requested an audit of the investment practices of the Investment Board following the Board's disclosure, in March 1995, that the State Investment Fund had incurred a $95 million loss as a result of investments in derivatives. Act 274 took effect on May 7, 1996.

Copies of the Act referred to in this Information Memorandum may be obtained from the Documents Room, Lower Level, One East Main Street, Madison, Wisconsin 53702; telephone: (608) 266-2400.

B. DESCRIPTION OF ACT 274

Act 274 contains provisions on the following subjects: (1) composition of the Investment Board ("Board") and minutes of Board meetings; (2) creation of new staff positions; (3) restrictions on certain types of investments; (4) requirements for reporting to local governments and the State Legislature; (5) contracting with outside investment advisors; and (6) requirements for audits by the Legislative Audit Bureau.

1. Composition of Board and Minutes of Board Meetings

Prior to enactment of Act 274, the Board consisted of the following eight members: the Secretary of Administration or the Secretary's designee; five members appointed by the Governor for six-year terms, four of whom must have at least 10 years' experience in making investments; and two participants in the Wisconsin Retirement System, one of whom is a teacher

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appointed by Teachers Retirement Board for a six-year term and one of whom is a nonteacher appointed by the Wisconsin Retirement Board for a six-year term.

Act 274 increases the Board's membership to nine members by requiring the Governor to appoint a member who is a representative of local government to the Board for a six-year term. The person must represent a local government that participates in the local government pooled-investment fund (which is a part of the State Investment Fund) under s. 25.50, Stats. The person must be employed by the local government in a finance position and have had at least 10 years of financial experience, but may not be an elected official, an employe of a county with a population greater than 450,000 or an employe of a city, town or village with a population greater than 150,000. If the person loses the status on which the appointment was based, he or she would cease to be a Board member.

The Act also requires the Board to keep full minutes of its proceedings.

Under current law, the chairperson and vice-chairperson of the Board are designated biennially by the Governor. As passed by the Legislature, the bill which became Act 274 provided that the Board must elect its chairperson and vice-chairperson biennially from among the members appointed by the Governor who have had at least 10 years' experience in making investments. The bill also provided that the Secretary of Administration could not be the Board chairperson. However, the Governor vetoed these provisions.

2. Creation of New Staff Positions

Act 274 creates the following new staff positions at the Investment Board:

a. Internal Auditor

The Act creates an internal audit subunit of the Investment Board, under the supervision of an internal auditor. The internal auditor is appointed by the Board, reports directly to the Board and is authorized to appoint his or her staff. The internal auditor and staff serve outside of the classified service and participate in the Board's bonus compensation program. The internal auditor is required to file an annual statement of economic interests with the State Ethics Board.

The internal auditor is authorized to review any activity, information or investment of the Board and have access to the records of the Board and any external party under contract with the Board. In addition, the internal auditor is required to do all of the following:

(1) Plan and conduct audit activities, risk assessments, research projects and management reviews under the direction of the Board and in accordance with policies, principles and directives determined by the Board.

(2) Coordinate and assist with external audits and reviews of the Board.

(3) Monitor for compliance with applicable legal requirements and with the Board's contractual agreements any bank, savings and loan association, savings bank or credit union with which the Board has entered into a custodial agreement, any investment advisors with which the Board has contracted to manage and control Board assets and any other external parties with which the Board has contracted to provide investment services to the Board.

To fund the activities of the internal audit subunit, the Act increases the dollar amount for the appropriation to the Investment Board by $72,000 for fiscal year 1995-96 and by $210,900 for fiscal year 1996-97 to increase the authorized full-time equivalent (FTE) positions for the Investment Board by 3.0 PR (program revenue) positions (for an internal auditor and two staff auditors) on April 1, 1996, for the performance of the functions of the internal auditor.

b. Chief Investment Officer

The Act requires that the executive director of the Investment Board appoint a chief investment officer and that the Board participate in the selection of that person. The chief investment officer serves outside of the classified service and participates in the Board's bonus compensation program and is required to file an annual statement of economic interests with the State Ethics Board.

The chief investment officer, under the supervision of the executive director, is required to do all of the following:

(1) Monitor activities of the investment directors for compliance with the Board's investment policies and guidelines and approve unusual transactions, as defined by the Board.

(2) Develop and implement operating procedures that are intended to ensure that the investment policies and guidelines of the Board are followed.

(3) Ensure that investments are completely and accurately reported on all management and financial reports and that any information requested by the Board is provided to it on a timely basis.

The Act increases the dollar amount for the appropriation to the Investment Board by $42,500 for fiscal year 1995-96 and by $144,100 for fiscal year 1996-97 to increase the authorized FTE positions for the Investment Board by 1.0 PR position on April 1, 1996, for the performance of the functions of the chief investment officer.

c. Investment Operations

The Act increases the dollar amount for the appropriation to the Investment Board by $42,600 for fiscal year 1995-96 and by $118,600 for fiscal year 1996-97 to increase the authorized FTE positions for the Investment Board by 2.0 PR positions (two CPA-level accountants) on April 1, 1996, for the performance of investment operations relating to the processing, accounting and monitoring of trading activities.

d. Investment Technology

The Act increases the dollar amount for the appropriation to the Investment Board by $21,300 for fiscal year 1995-96 and by $59,300 for fiscal year 1996-97 to increase the authorized FTE positions for the Investment Board by 1.0 PR position (an investment information technology specialist) on April 1, 1996, for the development of a comprehensive strategic information systems plan.

3. Restrictions on Certain Types of Investments

Act 274 limits the ability of the Board to make certain types of investments:

a. Derivatives

The Act prohibits the Board from purchasing or acquiring any derivative investment for the State Investment Fund after the effective date of the Act (May 7, 1996), except in accordance with rules promulgated by the Board. These rules must restrict the purchase or acquisition of derivatives to certain specified types of transactions made for the purpose of reducing the risk of price changes or of interest rate or currency exchange rate fluctuations. Under the Act, these limitations would not apply with respect to any derivative investments involving funds in the fixed or variable retirement investment trusts or the assets of other separate funds under management.

The Act defines "derivative" to mean any financial contract or other instrument that derives its value from the value or performance of any security, currency exchange rate or interest rate or of any index or group of any securities, currency exchange rates or interest rates. However, a derivative instrument does ***not*** include any of the following types of investment instruments and these types of investments may be made on behalf of the State Investment Fund:

(1) Securities that are traded on a national securities exchange or on an automated interdealer quotation system sponsored by a registered securities association.

(2) Forward contracts with a maturity of less than 270 days at the time of issuance.

(3) Contracts for the sale of a commodity for future delivery or any option on such a contract, traded or executed on a designated contract market subject to federal regulation.

(4) Securities of a registered open-end management investment company or investment trust.

(5) Deposits held by a financial institution.

(6) Investments that the Board is specifically authorized to make under s. 25.17 (3) (b) and (ba), Stats. [That is, direct obligations of the United States and certain specified foreign entities where the obligations mature within 10 years; securities maturing within 10 years that are guaranteed by the full faith and credit of the United States; unsecured financial and industrial

issuer notes maturing within five years and generally having one of the two highest investment ratings; certificates of deposit of financial institutions in the United States; bankers acceptances from banks within the United States; certain direct obligations of the Canadian government; certificates of deposit of at least $100,000 issued by solvent Wisconsin financial institutions; bonds issued by Wisconsin exposition districts; and loans on certain direct obligations of the United States.]

(7) Collateralized mortgage obligations and other asset-backed securities having one of the two highest investment ratings or having backing by insured instruments, guarantees or pledges of the United States or the State of Wisconsin or of an agency of the federal government or of this state.

(8) Certain types of exchange transactions ("swaps"), if the counterparty meets certain creditworthiness requirements, if the transaction is used only for specified hedging or interest rate risk reduction purposes and if the Board's payment obligations are fully backed by distinctly identified assets held in the State Investment Fund.

(9) Financial contracts or instruments that the Board determines, by rule, are not derivatives.

b. Reverse Repurchase Agreements

The Act prohibits the Board from entering into a reverse repurchase agreement after the effective date of the Act, unless the repurchase of securities under the agreement is required to occur no later than the next business day. The Act defines "reverse repurchase agreement" to mean an agreement for the sale of securities by the Board under which the Board will repurchase those securities on or before a specified date and for a specified amount.

4. Requirements for Reporting to Local Governments and the State Legislature

a. Reports to Local Governments

Act 274 requires the Board to provide more information to local governments investing in the local government pooled-investment fund ("the fund"). Currently, the Board is required to formulate policies for the investment and reinvestment of moneys in the fund and the acquisition, retention, management and disposition of such investments. The Act expands this requirement to also require that the Board provide a copy of the investment policies, together with any guidelines adopted by the Board to direct staff investment activity, to each local government having an investment in the fund. These policies and guidelines must be provided upon the local government's request and at least annually to all investors. The policies must include information about prohibited investments, asset allocation requirements, credit standards for private companies in which the fund may invest and dollar or percentage limits on investments in a single company or bank. At least annually, the Board must distribute performance information on the fund for the preceding one-year, five-year and 10-year periods, compared with appropriate indices or benchmarks in the private sector.

The Act also requires the Board, in cooperation with the Department of Administration, to provide information necessary for the State Treasurer to provide a monthly report to each local government having an investment in the fund. The Board is required to use all reasonable efforts to provide the information to the State Treasurer in time to allow the Treasurer to mail or electronically transmit the report to the local government not more than six business days after the end of the month covered by the report. The report must include information on the fund's monthly earnings with comparison to appropriate indices or benchmarks in the private sector. Upon request of a local government having an investment in the fund, the Board is also required to provide a summary of securities held by the fund including, for each type of security, its cost, current value and, in the case of debt instruments, the average maturity. The Board must provide this information as soon as practicable after receiving the request.

b. Reports to the Legislature

Act 274 provides that annually, by January 1, the Board must submit to the Joint Legislative Audit Committee, the Joint Committee on Finance and the chief clerks of each house for distribution to appropriate legislative standing committees, a report of the Board's annual investment goals and long-term investment strategies. The report must specify any change in the goals and strategies from those in the previous year. For 1996, the report is due by July 1, 1996.

In addition, the Board must submit annually, by March 31 (for the report for 1995, by July 1, 1996), to those entities a report which includes all of the following:

(1) An assessment of the Board's progress in meeting its annual investment goals.

(2) Information on the types of investments held by the Board, including the market values of the investments and the degree of risk associated with the investments, the Board's use of derivatives, any ventures into new markets, any use of new investment instruments and a comparison of the investment performance of the Board to that achieved by a peer group of public and private entities that invest similar-sized funds.

(3) A discussion of the amounts and categories of investments made within the State of Wisconsin.

The Act also requires that the Board, upon adopting any change in its investment policies or guidelines, submit to those entities a report summarizing the change in the investment policies or guidelines.

In addition, the Act requires the Board to report to the Joint Legislative Audit Committee and the Joint Committee on Finance on alternative insurance arrangements for the local government pooled-investment fund. The report is due by July 1, 1996.

Finally, the Act requires that the chairperson of the Investment Board appear at least annually before the Senate committee whose jurisdiction includes financial institutions, if the committee so requests.

5. Contracting With Outside Investment Advisors

Prior to enactment of Act 274, the Board was authorized to contract with investment advisors for the management and control of not more than 10% of the total assets of the fixed retirement investment trust or 10% of the total assets of the variable retirement investment trust. These assets may be invested in real estate, mortgages, equities, debt of foreign governments and debt of corporations not organized under the laws of this state. Responsibility for management and control of the balance of the assets of these trusts rests directly with the Board's employes. When retained, investment advisors are paid from the income that would otherwise accrue to the trust. The Act permits the Board to contract with investment advisors for the management and control of not more than 15% of the total assets of the fixed retirement investment trust or 15% of the total assets of the variable retirement investment trust.

6. Requirements for Audits by the Legislative Audit Bureau

Prior to enactment of Act 274, the Legislative Audit Bureau was required to perform an annual financial audit of the Investment Board, including financial statements and an evaluation of accounting controls and accounting records of the Board. The Act slightly modifies the wording of that requirement to require an assessment of the fair presentation of the financial statements and an evaluation of the internal control structure of the Board. Also, as part of the financial audit, the Act adds a requirement that the Audit Bureau identify certain statutes and certain policies and guidelines adopted by the Board and determine the extent of compliance by the Board with those statutes, policies and guidelines. Also, the Act newly requires that the Audit Bureau biennially conduct a performance evaluation audit of the Investment Board that includes an audit of the Board's policies and management practices. The Audit Bureau is required to charge the Investment Board for the costs of these audits and the Board is required to reimburse the Audit Bureau for those costs.

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