PERA
Public Employees
Retirement Association
of New Mexico

INVESTED IN TOMORROW.

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January 23, 2017

Legislative Finance Committee
325 Don Gaspar Street Suite 101
Santa Fe, NM 87501

Re: Proposed $12.5 million "Sweep" from the Legislative Retirement Fund

Per your request, the Public Employees Retirement Association ("PERA") provides this legal analysis of the proposal to "sweep" $12.5 million from the Legislative Retirement Fund into the General Fund. As explained below, any legislation to "sweep" funds (regardless of the amount) from the Legislative Retirement Fund into the General Fund is an unconstitutional taking contrary to NM Const., Art. XX, Section 22, potentially jeopardizes PERA's status as a qualified governmental plan under the Internal Revenue Code, and would violate the fiduciary duties of the PERA Board and principles of trust law that apply to PERA because trust fund monies must be used only for the exclusive benefit of members.

Background

The Legislative Retirement Plans are created within the PERA Act as a retirement coverage plan applicable to legislators and the lieutenant governor. The State contributes the amount sufficient to finance the benefits provided to legislators under Plan 2 on an actuarial reserve basis. The PERA Act obligates the State to contribute funds sufficient to finance legislative retirement benefits.[1] The funding distribution to the Legislative Retirement Fund is found in the Tax Administration Act. [2]

Historically, the Legislature transferred $2.4 million annually, which applied to both the normal costs associated with State Legislator Member Coverage Plans 1 and 2 and their respective unfunded actuarial accrued liability ("UAAL"). See, NMSA 1978, Section 10-11-43. During the 2016 Special Session, the Legislature reduced the distribution to the Legislative Retirement Fund from $200,000 per month to $75,000 per month, resulting in a $900,000 annual distribution for the remainder of the 2016 fiscal year and fiscal years thereafter. This reduction in funding of the Legislative Retirement Fund was in response to the State's budget shortfall and solely for budget solvency purposes.

[1] NMSA Sections 10-11-43 and 10-11-43.5 state: "the State shall contribute amounts sufficient to finance the membership of members under state legislator coverage plans 1 and 2 on an actuarial reserve basis."

[2] Section 7-1-6.43 requires a monthly distribution to the legislative retirement fund in an amount equal to seventy-five thousand dollars ($75,000) or, if larger, one-twelfth of the amount necessary to pay out the retirement benefits due under state legislator member coverage plan 2 and Paragraph (2) of Subsection C of Section 10-11-42 NMSA 1978 for the calendar year.

Unconstitutional Taking

In 1998, the Legislature passed Senate Joint Resolution 6, which proposed a constitutional amendment to prohibit the encumbrance of trust funds created under the public employees retirement systems for any other purpose except for the sole and exclusive benefit of the trust beneficiaries. The Constitutional Amendment, which passed in the November 1998 general election, states in pertinent part:

> "All funds, proceeds, income, contributions, gifts and payments ***from any source whatsoever*** paid into or held by a public employees retirement system or an educational retirement system created by the laws of this state shall be held by the respective retirement system in a trust fund to be administered and invested by each respective system ***for the sole and exclusive benefit of the members, retirees and other beneficiaries of that system***. Expenditures from a system trust fund shall only be for the benefit of the trust beneficiaries and for expenses of administering the system. ***A system trust fund shall never be used, diverted, loaned, assigned, pledged, invested, encumbered or appropriated for any other purpose***." (emphasis added).

Accordingly, the plain language of Art, XX, Section 22 (A) of the New Mexico Constitution unambiguously prohibits the proposed "sweeping" of funds from the Legislative Retirement Fund.

Jeopardizing PERA's Tax Qualification Status

As a retirement plan governed by the New Mexico Public Employees Retirement Act, Sections 10-11-1, *et. seq.*, NMSA 1978 (PERA Act"), PERA qualifies and has been recognized as a qualified governmental defined benefit plan under 401(a) of the Internal Revenue Code. As a qualified plan, PERA must follow the PERA Act and the applicable provisions of the Internal Revenue Code and accompanying Treasury Regulations. Among the most fundamental qualified plan requirements are the obligation to administer a plan in accordance with its terms (Treas. Reg. Section 1.401-1(a) (2)) and the exclusive benefit rule (Internal Revenue Code Section 401(a) (2); Treas. Reg. Section 1.401-2(a) (1)). Under these requirements, a pension plan fails to administer the plan in accordance with its terms if it pays amounts in violation of the terms of the plan. The PERA Act does not authorize transfer of funds from the trust fund to the State of New Mexico general fund for any reason. In addition, the exclusive benefit rule states that in order to be tax qualified, a plan must make it "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries . . . for any of the corpus or income to be … used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries…".[3] Accordingly, paying amounts that are not payable under the terms of the plan (e.g. a transfer to the general fund) is not paying a liability covered by the terms of the plan (e.g. paying benefits), and also reduces the plan assets available to pay all members and beneficiaries the benefits to which they are entitled to under the terms of the plan.

PERA's tax qualified status provides favorable tax treatment for its 90,000 members—for example, for preretirement plan distributions (trustee-to-trustee transfers) and employers and employees do not pay employment taxes (federal and state income tax, FICA withholding) when contributions are made or benefits are paid. Furthermore, favorable tax treatment means that employee contributions may be "picked-up" by employers and treated as pre-tax. PERA's $14 billion trust fund also enjoys favorable tax treatment in its investment activities. As investors, governmental plans earnings and income are not taxable to the trust or its members. Further, tax recapture is available for qualified plans in treaty countries.[4]

[3] Internal Revenue Code Section 401(a)(2).
[4] PERA currently has over $4 billion invested in international markets across all asset classes.

Violation of Law Protecting Trust Assets

All assets held in the Legislative Retirement Fund are restricted trust funds. Statutorily, the PERA Board are trustees of these funds.[5] Constitutionally, the PERA Board are the named fiduciaries of the retirement funds of the association. Additionally, by Board policy, certain staff (Executive Director, Chief Investment Officer and General Counsel) are named fiduciaries. All trust assets, including the Legislative Retirement Fund, are held in trust at PERA's custody bank, Bank of New York Mellon. These funds, while segregated for accounting purposes, are commingled with PERA's total funds of $14 billion.

Public pension plans in New Mexico are governed by the common law of trusts. The legal standards applied under the common law of trusts are the highest under the law. The law requires that custodians, trustees and all other persons dealing with plan assets held in trust must *act for one purpose only*. That purpose is to provide benefits to plan participants and to defray the reasonable expenses of administering the plan. This is known as the "exclusive benefit rule" and requires undivided loyalty to the plan. In order to satisfy this rule, the trustee may not comingle plan assets with any other accounts and may not use them in a way that would favor its own or anyone else's interests.

The exclusive benefit concept is so strict that, except in certain situations involving clear mistakes, and even then, only within certain time limits, an employer cannot get back a contribution once it has been earmarked as a plan asset and contributed to the trust. Moreover, claims by creditors of a plan participant will not be honored. The inability of creditors to attach plan assets is another example of the protected status of retirement plan assets. It does not matter whether the creditor is owed money by the employee, the employer, the trustee or some other party that has dealt with the plan.

The governance of modern pension plans relies heavily on the tools of trust law and especially the trust-based fiduciary regime. Trust law subjects the trustees to strict fiduciary obligations, including the duty of prudence and the duty of loyalty. The duty of prudence requires the trustee to administer the trust "as a prudent person would, in light of the purposes, terms, and other circumstances of the trust" and with the "exercise of reasonable care, skill, and caution." The duty of loyalty demands administration solely in the interest of the beneficiary and prohibits the trustee from self-dealing with trust assets and from partaking in any conflict-of-interest transactions.

New Mexico is not alone in applying the law of trusts to public pension funds; courts in numerous jurisdictions have made the same determination. *See Petition of Barney*, 142 N.H. 798, 710 A.2d 408, 409 (1998)(holding, under common-law of trusts, the board of trustees of the New Hampshire Retirement System owe members and beneficiaries a fiduciary duty to manage the system for the benefit of the members and beneficiaries); *City of Sacramento v. Pub. Emps. Ret. Sys.*, 229 Cal.App.3d 1470, 1494, 280 Cal.Rptr. 847 (1991)(holding that, under "well-established rules of the law of trusts," the trustee 245 of the pension system owed undivided loyalty to the beneficiaries). *Hill v. Vanderbilt Capital Advisors, LLC*, 834 F. Supp. 2d 1228, 1244–45 (D.N.M. 2011).

PERA has a fiduciary duty to manage the monies in the trust fund in for the benefit of the members and beneficiaries. Any other use of the funds would constitute a breach of the PERA Board's fiduciary duty. See *State ex rel. Pub. Emps' Ret. Assoc. v. Longacre*, 131 N.M. 156, 33 P.3d 906 (Ct.App.2001) (finding that trustee of the fund is a fiduciary to the PERA members, and "following the principles of trust law," the PERA Board has a duty to collect overpayments for the trust) *reversed on other grounds by State ex rel. Pub. Emps. Ret. Assoc. v.*

[5] NMSA 1978, Section 10-11-132, "[A]ll funds created by the state retirement acts are trust funds of which the retirement board his trustee."

Longacre, 133 N.M. 20, 59 P.3d 500 (2002). Accordingly, a legislative directive to transfer trust funds to the General Fund would place the PERA Board in a position of having to evaluate the legal consequences of violating their duties as trustees or seeking a court determination regarding the constitutionality of such a legislative directive.

Thank you for the opportunity to provide this analysis.

Sincerely,

Susan Pittard
General Counsel