University of Kentucky | Office of Legal Counsel

Opinion of General Counsel
Opinion # 2016-02

Use of Alternative Competitive Negotiation Approach for the Selection of Investment Managers

INTRODUCTION

The University uses external investment managers for investment of the University's Endowment funds across multiple investment classes. The University previously attempted to hire these investment managers through the Purchasing Division's formal Request for Proposal process. The University's senior financial leadership has proposed that the University select future investment managers utilizing an alternative competitive negotiation process to obtain the most advantageous opportunities providing best value to the University by utilizing the manager research capabilities of the University's investment consultant. Some members of the Board of Trustees' Investment Committee have expressed a concern that use of the alternative competitive negotiation process may violate state law. In response, the University's senior financial leadership has requested a formal Opinion of the General Counsel on the question.

QUESTION PRESENTED: Does Kentucky law allow the University to utilize this new competitive negotiation approach outside of the traditional formal RFP processes?

SUMMARY ANSWER: Yes. As described in further detail below, because the University has determined that it is not feasible to bid external investment manager services through the formal RFP process, the University may legally shift to this alternative selection process as the method most advantageous to the University's ability to fulfill its mission. The new process will still utilize most key competitive negotiation objectives promoted by the Model Procurement Code, including cost, transparency, avoidance of conflicts of interest, and the overriding principle to achieve the best value.

I. BACKGROUND

A. The University Endowment and Role of Investment Managers

The University Endowment is an aggregation of funds comprised of gifts from donors and grants from the Commonwealth of Kentucky with the requirement they be invested in perpetuity to generate a reliable and steadily growing income stream, to support the mission of the University now and in the future. The revenue stream or total return spending distributions, supports scholarships, chairs, professorships, basic research, as well as academic and public service programs, as defined by the individual endowment agreements. The Endowment is expected to provide fiscal stability since the principal is invested for long-term growth and total return spending distributions are generated year after year. The Endowment also includes other funds set aside by the Board of Trustees with the expectation that the Board will invest the funds on a long-term basis.

The University has a fiduciary responsibility to prudently manage and preserve the long-term purchasing power of the Endowment, as well as the individual endowment funds, in order to support present and future beneficiaries. This fiduciary responsibility constitutes both a legal and moral obligation to donors and the Commonwealth of Kentucky who intend that their gifts and grants provide support for the University in perpetuity.

The Board of Trustees has established the Investment Committee with members appointed annually by the Chair of the Board of Trustees to be responsible for the review and oversight of the Endowment. Governing Regulation II.E(2)(e)[1] of the University of Kentucky sets forth the specific responsibilities of the Investment Committee, including "(a) formulating and reviewing investment policies; (b) appointing, monitoring and evaluating investment managers and consultants; and (c) reviewing and approving plans for the general management of the endowment funds of the University."

In compliance with its duties, the Investment Committee has set forth the investment policies in an Endowment Investment Policy, last amended June 18, 2015 ("Policy").[2] That Policy provides for the selection of investment managers by University senior financial management under the following guidelines:

> In collaboration with the Consultant, the Staff will appoint, monitor, and evaluate external investment managers for the investment asset allocation and strategies approved by the Committee. The Staff and Consultant will provide updates to the Committee on manager

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[1] http://www.uky.edu/regs/files/gr/gr2.pdf

[2] https://www.uky.edu/EVPFA/Controller/files/endow/POLICY.pdf

> appointments, terminations, and the ongoing monitoring and evaluation of existing managers, at each meeting and at other times as requested by the Committee.
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> Each individual investment manager will exercise discretion over the securities or assets in accordance with specified investment guidelines.
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> Investment managers that utilize separate accounts to manage Endowment assets will adhere to specific investment manager guidelines established by Staff with the assistance of the Consultant. Each investment manager using a separate account is required to summarize its holdings and transactions on a monthly basis.
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> Investment managers that utilize a mutual fund investment structure, a commingled trust fund structure or a limited partnership structure will have discretion to manage the assets in accordance with the policies and guidelines outlined in the respective mutual fund's prospectus; the commingled trust fund's offering memorandum or limited partnership's private placement memorandum.

Policy at 6. Under the Endowment Policy, the investment managers are required to act as fiduciaries of the University and must manage the transaction costs they incur on the Endowment's behalf in the best interests of the University. *Policy* at 11. These transaction costs or fees are charged to the Endowment income stream.

B. Kentucky Model Procurement Code

The General Assembly adopted Kentucky Model Procurement Code in 1978, effective January 1, 1979.[3] Codified at KRS Chapter 45A, the Model Procurement Code has the following purposes:

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[3] The legislation was based on a model procurement code authored by the American Bar Association. Kentucky was among the first states to adopt it, and kept the word "Model" in the legislation's title. *See* KRS 45A.005 (title).

> (a) To simplify, clarify, and modernize the law governing purchasing by the Commonwealth;
> (b) To permit the continued development of purchasing policies and practices;
> (c) To make as consistent as possible the purchasing laws among the various states;
> (d) To provide for increased public confidence in the procedures followed in public procurement;
> (e) To insure the fair and equitable treatment of all persons who deal with the procurement system of the Commonwealth;
> (f) To provide increased economy in state procurement activities by fostering effective competition; and
> (g) To provide safeguards for the maintenance of a procurement system of quality and integrity.

KRS 45A.010. The Model Procurement Code applies "to every expenditure of public funds by this Commonwealth under any contract or like business agreement." KRS 45A.020(1). Key facets of the Model Procurement Code include public advertisement of a request for bid or proposal for at least seven (7) days, and the following methods of soliciting contract vendors: (1) competitive sealed bidding, by which the public agency solicits bids with no negotiation and awards the contract to the lowest, responsible and responsive bidder; (2) competitive negotiation, by which the public agency solicits proposals emphasizing other factors alongside price, and negotiates with one or more responsive bidders before awarding the contract; and (3) non-competitive negotiations, by which a public agency may award a contract in a situation where there is only one known capable supplier of a commodity or service, or when competition is not feasible. *See* KRS 45A.080 (competitive sealed bidding); KRS 45A.085 (competitive negotiation); KRS 45A.095 (noncompetitive negotiation). Personal service contracts are exempt from competitive sealed bidding under KRS 45A.095(g).

The University has traditionally used competitive negotiation under KRS 45A.085 to select its investment managers. Among the requirements for this process are "adequate public notice," KRS 45A.085(2), and that the award "be made to the responsible offeror whose proposal is determined in writing to be the *most advantageous* to the [University]." KRS 45A.085(6) (emphasis added).

C. The Formal RFP Process and Its limitations

KRS 164A.630(1)(b) requires the University to follow the Model Procurement Code. University contracts are requisitioned through the University's Purchasing Division, whose procedure for solicitation is set forth in the University's Business Procedures Manual.

Currently, when the University's investment staff determines that a new investment manager is needed to implement the strategies set forth in the Investment Policy, the staff contacts the Purchasing Division. The Purchasing Division then compiles a Request for Proposal with the assistance and input from the investment staff.

In order to streamline its own processes, the Purchasing Division always incorporates the University's standard and general terms and conditions into the RFP. These general terms and conditions necessarily cover a broad range of anticipated services or contract needs. Not every standard term or condition will be germane to the service or product solicited.

The RFP is then publicly advertised on the Purchasing Division's website for three to four weeks. Potential responsive bidders are required to note any objections or exceptions to the terms and conditions of the Request (including the standard and general terms and conditions) in their responses.

Once the deadline for responses passes, the Purchasing Division includes the investment staff as part of a committee to review the responses received. The committee may choose certain respondents to come to the University to make a presentation.

Once the committee makes a recommended selection, the Purchasing Division, with input from the Office of Legal Counsel, works on completing a contract with the selected manager. In other purchasing areas, this may simply involve issuing a standard "Notice of Price Contract Award" that incorporates the Request for Proposal and the vendor's response into a final contract.

In the investment management area, however, the selected managers often have their own legal agreements that require review by the University, depending on the nature of the investment. Such agreements may include subscription agreements or partnership agreements. Many investment options involve agreements that cannot be altered due to federal securities law or other factors such as number of other investors. While many managers are open to reconciling a few discrete concerns through what is known as a "side letter," reconciling these agreements with the formal RFP document has taken considerable time and effort on the part of all University staff involved. Moreover, the time spent completing this entire process is lengthy.

The University's senior financial management has identified the following key constraints of using the formal RFP process for the selection of investment managers:

> Time: Within the current formal RFP process, once the investment office decides to conduct a manager search, it typically takes three to six months to create the RFP, await responses, review proposals, and select a finalist.[4] Many investment opportunities arise and require action more quickly than is feasible in this timeline, and investment staff have determined that the University is missing out on this source of potential return. Forward-looking return forecasts across asset classes are relatively low in the current market environment, and investment staff have determined that the University needs to have an increased ability to make active, tactical investment decisions that are not possible under the University's traditional procurement process.[5]

> Constrained Universe: Based on the investment staff's experience, the formal RFP structure limits the universe of available managers, since many smaller and/or highly successful firms do not seek investors with the University's process requirement. These managers often have limited capacity for new investors and therefore do not pursue investments from clients with additional, operational requirements related to formal RFP's, though many will otherwise work with investors to address specific investor requests related to an investor's public status through the use of "side letters." While the investment staff cannot precisely quantify how large of a return opportunity the University is missing due to managers choosing not to participate in

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[4] A key portion of the delay is due to the time the RFP is publicly advertised on the University's website. Although the Model Procurement Code requires an advertisement period of only seven (7) days, the Purchasing Division typically recommends a longer posting and response period for requests that will involve complex matters or proposals. Because any exceptions to an RFP must be noted in an offeror's initial response, much of the time necessary for an investment manager to prepare a response to a formal RFP involve making exceptions to the University's general terms and conditions.

[5] The Endowment Policy tasks the University's investment staff with, among other tasks, rebalancing Endowment assets when certain asset classes hit a trigger point and with developing a rebalancing plan appropriate for existing market conditions. Time delays due to the formal RFP process could potentially disrupt this rebalancing.

the current structure, they are confident that missed opportunities exist.

Cost: The University's portfolio contains substantial exposure to alternative investment managers. The University has implemented the majority of these investments in fund of fund structures, since building a diversified portfolio of direct, alternatives managers using a RFP structure is not practical. Fund of fund structures have been used largely because they are simpler and faster to implement via formal RFP, but these vehicles are materially more expensive than a direct investment program. Higher fees result in lower net of fees performance and reduce the value of the endowment portfolio.

D. Proposed New Investment Manager Search Process

Given the challenges identified above, University senior financial management have recommended an alternative approach to selecting managers that directly engages the research capabilities of its investment consultant. Instead of the Purchasing Division issuing a formal RFP for each manager search, they propose having the University's investment consultant provide investment staff with a search document that includes detailed information on their recommended, fully-vetted and approved managers in a given asset class. Investment staff would then conduct an in-depth review of these search candidates and work with the consultant's research staff to select the most appropriate managers for finalist consideration. At this stage, the manager selection process would closely resemble the finalist review process in the current formal RFP structure, thus retaining an essential competitive negotiation feature of the formal procurement process. Investment staff would conduct additional due diligence via conference calls and/or meetings to gain more familiarity with each firm and ask targeted questions to assist in making the manager selection, including request for a best and final offer and negotiation of fee terms. The objective of the search process will be to select the firm that offers the best value for the University and whose proposal is the most advantageous to the University's ability to fulfill its mission.

At the conclusion of the search process, senior financial leadership would negotiate and execute the required contractual documents, in consultation with the Office of Legal Counsel.

This new process places enhanced emphasis on the integrity, quality, and depth of the investment consultant's research capabilities. The University recently completed a competitive, in-depth formal RFP search process to identify a new investment consultant with strong capabilities across several areas, including manager research. In reviewing responses to this RFP, the Evaluation Committee thoroughly vetted each firm and its capabilities. This included a review of the firm's manager search processes, its code of ethics and approach to mitigating potential conflicts of interest. The firm selected, Fund Evaluation Group ("FEG"), has agreed to serve as a fiduciary of the University and work in the University's best interest when conducting all business, and will do so on a <u>flat fee</u> consulting basis. The firm has deep research capabilities, particularly in alternative strategies, and they have been very transparent regarding their manager search process. FEG has also demonstrated its ability to help the University save several thousands of dollars in fees in the alternative portfolio by utilizing their research on direct funds and investing through a nondiscretionary fund-of-one legal entity FEG will form on our behalf to facilitate execution of contractual documents.

This process also requires active, ongoing oversight and participation by University investment staff, which over the past eighteen (18) months has enhanced its capabilities by hiring a Chief Investment Officer, Investment Operations Analyst, and an Investment Intern. Further expansion is expected, and plans include the addition of a full-time Investment Analyst. Given this enhanced capacity to focus on the endowment investment portfolio, the University is prepared to take a more active role in manager due diligence.

Investment staff will conduct periodic reviews of the consulting firm and its staff. This will include onsite meetings at FEG's headquarters to meet with senior research team leaders and a review of any changes to staff or processes. The investment office will also review the firm's ADV filings, particularly disclosures in Parts 2A and 2B that provide updates on any regulatory issues and material changes affecting the firm.

This new process is intended and designed to remain transparent and competitive, and the investment office will continue its existing process of providing a report on investment manager searches, hires, and terminations at each Investment Committee meeting.

III. LEGAL ANALYSIS

The analysis of whether the proposed new process is permissible under Kentucky statutes governing university procurement and financial management begins—and ends—with the statutory text. As the Supreme Court of Kentucky recently explained:

> It must be clear at the outset that the first rule of statutory interpretation is that the text of the statute is supreme. Upon review, "the words of the text are of paramount concern, and what they convey, in their context, is what the text means." In determining what the text means, words will be presumed to be understood in their ordinary meanings, unless context mandates otherwise. But most significantly, we will not construe a meaning that the text of the statute cannot bear.

Owen v. University of Kentucky, 2016 WL 2604779 at 3 (Ky. 2016). "Where a statute is plain and unambiguous on its face, we are not at liberty to construe the language otherwise, *even though such a construction may be more consistent with the statute's legislative purpose*." *Pennyrile Allied Cmty. Servs., Inc. v. Rogers*, 459 S.W.3d 339, 343 (Ky. 2015) (emphasis added). "It is not for [the courts] to rewrite the statute so that it covers only what we think is necessary to achieve what we think [the legislature] really intended." *Lewis v. City of Chicago,* 560 U.S. 205, 215 (2010). Thus, "it is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed." *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998). Consequently, the courts cannot "displace the legislature's judgment for our own." *Owen*, 2016 WL 2604779 at 5.

In determining whether the statutes—as written—allow the University to utilize the proposed process, the analysis must focus on three issues: (1) the authority of the University to manage its own Endowment; (2) the application of the Model Procurement Code to Investment Manager Contracts; and (3) assuming the Model Procurement Code does apply to Investment Manager Contracts, is the proposed process consistent with the Model Procurement Code. Each of these issues is addressed below.

A. University Has the Authority to Manage Its Own Endowment

The post-secondary institution financial self-management statutes, KRS 164A.550 through 164A.630 ("financial self-management statutes"), allow the state's universities to elect to exercise all or some of a variety of financial self-management powers granted under the legislation, including the power to "receive deposit, collect, retain, invest, disburse and account for all funds received or due from any source." KRS 164A.560(2). The University has exercised its option to exercise all powers available to it under these statutes. *See* 765 KAR 1:010.[6]

B. Application of the Model Procurement Code to the Investment Manager Contracts

Upon the University's election to exercise powers under the financial self-management statutes, KRS 164A.630(1)(b) requires the University to be bound by the Kentucky Model Procurement Code in carrying out those powers. As noted above, the Model Procurement Code applies "to every expenditure of public funds by this Commonwealth under any contract or like business agreement."[7] KRS

[6] Even if the University had not made this election, other applicable statutes grant the University control of "private funds or contributions" made to the University. *See* KRS 41.290 (requiring every state agency to remit private contributions to the State Treasury, except for "private funds or contributions made and available to the governing board of the state supported institutions of higher learning.").

[7] However, the Model Procurement Code does not automatically apply to use of state funds by localities that have not adopted the Code. *Laurel Const. Co., Inc. v. Paintsville Utility Comm'n*, 336 S.W.3d 903 (Ky. App. 2010) (holding that Model Procurement Code did not apply to Utility Commission's award of contract to build water tower using funds from a Kentucky Infrastructure Authority grant that required the Commission to perform "consistent with" KRS Chapter 45A).

45A.020(1). Though there is some ambiguity as to whether the Model Procurement Code would apply to an endowment made up entirely of privately donated funds,[8] the Model Procurement Code applies to expenditures of Endowment funds used to pay investment managers because the Endowment includes "public funds."

C. The Model Procurement Allows Exemption from Formal RFP Requirements When "Not Feasible"

As discussed above, the University has traditionally used the formal RFP competitive negotiation process to select investment managers. KRS 45A.095, however, allows the University to utilize noncompetitive negotiation outside the formal RFP process under one of three circumstances: (1) for sole source purchases; (2) when "competition is not feasible," as determined by the purchasing officer in writing prior to award, or (3) when emergency conditions exist. KRS 45A.095(1).[9]

The Kentucky Courts have not addressed what constitutes a situation when "competition is not feasible." Some guidance can be gleaned from the circumstances

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[8] *See* KRS 164A.615 ("Nothing contained in KRS 164A.555 to 164A.630 shall be construed to prevent an institution or an affiliated corporation from enforcing or carrying out the bona fide terms of any gift, grant, conveyance, devise or bequest from any private person, corporation, foundation, estate or entity contributing funds or any other thing of value to the institution or affiliated corporation."); Ky. AG Op. 82-520 (1982) (S. Beshear, A.G.) ("KRS Chapters 45 and 45A concern public funds of the Commonwealth such that these provisions are not applicable to the private funds and contributions [of state supported institutions of higher learning] covered in KRS 41.290.")

[9] *See also* Ky. AG Op. 92-40 (1992) (Gorman, A.G.) ("The emergency conditions exception is only one of three exceptions to the competitive bidding requirement, the other two being sole source purchases and situations when competition is not feasible.")

in which sole source is allowed, specified in 45A.095(1) as a "situation in which there is only one (1) known capable supplier of a commodity or service, occasioned by the unique nature of the requirement, the supplier, or market conditions." However, the text of the statute does not limit the "not feasible" requirement to a "unique" situation, but rather defers to a determination made by the purchasing officer.

There are two reasons why the present circumstances are a "unique" situation. First, the University's senior financial staff has demonstrated that the formal RFP process is not feasible for selecting investment managers. Second, the proposed process furthers the broad purposes of the model procurement code. Each of these reasons is addressed below.

1. Senior Financial Management Staff Have Demonstrated That the Formal RFP Process Is "Not Feasible" for Selecting Investment Managers.

The constraints and limitations of the current formal RFP process detailed above justify a determination that formal competitive negotiation conducted strictly under KRS 45A.085 is not a feasible method for selecting investment managers that would provide services most advantageous to the University. This infeasibility results from the University's need to anticipate or react to ever changing market conditions in a deliberate but timely manner. The time and market constraints inherent in the formal RFP process do not allow the University to meet this need, and generally increases the costs to the University in the form of both higher fees and lost opportunities. Therefore, sufficient evidence exists to allow the University's purchasing officer to determine that the use of the formal RFP process to select investment managers is "not feasible."

2. The Proposed New Selection Process Furthers the Purposes of the Model Procurement Code by Retaining Key Competitive Negotiation Elements

Although the formal RFP process has proven "not feasible" for selecting investment managers, the University should still strive to meet as many of the purposes and policies of the Model Procurement Code as possible. The new selection process proposed by the University's investment staff complies with these purposes and policies by retaining many of the key facets of competitive negotiation listed in KRS 45A.085. The new process will utilize solicitation of offers through its fiduciary investment consultant, and University officials will actively review the offers along with the consultant. University officials will engage with offerors to perform additional due diligence, and will negotiate with offerors regarding fees and other terms. Therefore, the new process has been clearly defined and designed to select the firm that offers the best value for the University and whose proposal is the most advantageous to the University's ability to fulfill its mission. Moreover, University officials will report on searches conducted under the new process to the Investment Committee, thus safeguarding the quality and integrity of, and maintaining public confidence in, the process.

CONCLUSION

For the reasons detailed above, the University may adopt the new alternative competitive negotiation process to select external investment managers for the Endowment as described above.

August 4, 2016

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