Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 5a

October 15, 2012

ITEM NAME: Standard Contract Terms and Conditions Modifications

PROGRAM: Operations Support Services Division

ITEM TYPE: Action

RECOMMENDATION

Approve staff's recommendation to modify three (3) of the seventy-five (75) current standard Contract Terms and Conditions: Indemnification, Unlimited Liability, and Fiduciary Responsibility based upon the completion and approval of the Risk Assessment Worksheet for contracts deemed to be low or medium risk.

EXECUTIVE SUMMARY

The CalPERS Board of Administration (Board) retains exclusive control of administration and investment of Public Employees' Retirement Fund including authority for approval of all CalPERS contracting and procurement policies.

Per Board Resolutions 92-04B and 92-04B-1 and Delegation No. EXEC-11-01, the Board of Administration delegated to the Chief Executive Officer (CEO) the administrative authority to oversee the procurement process, and to direct and monitor the performance of services from all contractors, vendors, consultants, and advisors. In addition, per Delegation No. LEG-12-01, the CEO delegates to the General Counsel authority to approve deviations from Board approved contract language.

This request permanently modifies three areas of the standard terms and conditions for systematic and efficient processing of low to medium risk contracts. Substantive modifications to the standard Contract Terms and Conditions require Board approval. High risk contracts would remain unchanged keeping the existing indemnification and unlimited liability terms and conditions unless negotiated separately with the Legal Office.

BACKGROUND

In 2011, OSSD collaborated with many areas of the enterprise in a Contract Reform Project. The project resulted in increased efficiency, accountability, ownership, and increased knowledge of the contracting process. In September 2011, Phase 2 of that project commenced, with the goal to amend three main contract terms, which we believed to be the most often requested reasons for contract negotiations or not signing and executing a contract.

The three main areas of negotiation are the provisions relating to Indemnification, Unlimited Liability, and Fiduciary Responsibility. While high risk contracts merit stringent contract terms, it may be acceptable to agree to less stringent terms in connection with lower risk contracts.

Currently, the CalPERS Terms and Conditions are the same for every type of contract regardless of risk. Staff from OSSD, Legal, Audits, Fiscal, and Human Resources worked together to develop a risk assessment tool and process to determine the risk level (low, medium or high) of contracts. Examples of low and medium risk contracts are:

Kaleidoscope:	Performed assessment surveys for the Diversity Office
BoardSource:	CalPERS Board Member Training
Veaco Group:	Board Self-Assessment
Compliance 11:	Personal Trading Platform

An example of a high risk contract would be Caremark (the Pharmacy Benefit Manager). Under this proposal, for contracts falling into the low or medium risk level, staff would be authorized to modify the indemnification language and negotiate a reduced limitation of liability.

ANALYSIS

The working group met on a bi-monthly basis with additional smaller subgroups breaking out and gathering information to bring to the larger group. Feedback was requested from vendors and contract language was requested and reviewed from other state pension programs.

A risk assessment worksheet was developed to determine low to medium risk level contracts. Risks were identified into thirteen categories including, for example, cost, political sensitivity, impact of non-performance, reputational risk, and given a specific weighted risk ranking. Contracts falling into the low to medium risk level were given a limited liability amount of two to four times the contract value, respectively.

Additionally, depending on the risk level of the contract, the indemnification language was updated. For “Indemnification” vendors routinely request the addition of the word “gross” to the negligence portion of the clause, as well as the substitution of the word “misconduct” in lieu of willful “misfeasance”. Contracts falling into the low to medium risk level will have “gross negligence” added to Indemnification.

Finally, the Legal Office did an analysis to define which contracts should include fiduciary responsibility language. The fiduciary language currently is (and will continue to be) in all contracts for investment managers, investment advisors, all investment consulting contracts including pools (AIM, Real Estate, etc.), plan custodian and plan administrators (health-related administrators, benefit and investment plan administrators). With that said, this proposal is requesting the removal of the word "fiduciary" from the standard conflict of interest clause, if the contract does not fall into one of the previously mentioned program areas.

The risk assessment worksheet will be completed by staff at the beginning stages of the solicitation phase and requires the approval of the program Division Chief, Legal and OSSD. This will be particularly helpful in low risk pool contracts, when program does not wish to enter into contract negotiations. Additionally, it will speed up the contract execution process and save time currently spent negotiating low risk contracts.

BENEFITS/RISKS

Implement and modify three areas of the standard contract terms and conditions through a risk assessment process will benefit CalPERS through:

- Less staff time spent in lengthy contract negotiations for lower risk contracts
- Ability to execute contracts faster
- Increase the number of CalPERS business partners willing to submit proposals based on modified proposed contract terms

Potential risks may include:

- Program requesting a project or additional work through a contract amendment or letter of engagement that could potentially change the risk level of the contract.
    - This risk is mitigated with contract amendments since they will go through the risk assessment process.
    - This risk is also mitigated by the new policy requiring the Board's approval on all contract activity over $1 million.

- Low dollar contracts currently have unlimited liability and stronger indemnification language. Under the new terms, a low dollar contract such as $25,000 would only be liable for $50,000 or $100,000 of liability. There is a small exposure that a low dollar contract could have reputational impacts and a small amount would be recovered.
    - This risk is mitigated by the point value assigned to contracts with reputational risks to CalPERS. A total of five points out of 50 possible points are assigned to reputational risk alone. A low risk contract can have no more than 12 points. With 13 different risk areas, it is unlikely that a contract with a high reputational risk would meet the low risk category.

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