



**Office of the Attorney General  
State of Texas**

**DAN MORALES**  
ATTORNEY GENERAL

June 9, 1994

Mr. Charles D. Travis  
Executive Director  
Employees Retirement System  
of Texas  
P.O. Box 13207  
Austin, Texas 78701-3207

Letter Opinion No. 94-052

Re: Whether, under article XVI, section 67 of the Texas Constitution and section 815.103 of the Government Code, the Employees Retirement System of Texas may invest its funds in equity swap contracts (RQ-668)

Dear Mr. Travis:

You have asked whether, under article XVI, section 67 of the Texas Constitution and section 815.103 of the Government Code, the Employees Retirement System of Texas (the "ERS") may invest its funds in equity swap contracts and, more specifically, in interest rate swap contracts. You describe these transactions as follows:

An investor, such as the ERS, negotiates a contract with a broker or dealer whereby agreed upon cash flows are exchanged. For example, the investor, the ERS, wanting to gain exposure to a particular foreign stock index, might contract to exchange the cash flow of some fixed income or money market security already owned or to be purchased by the ERS in return for a percentage of the appreciation in the value of the agreed upon stock index. Alternatively, the ERS could exchange a cash flow equivalent to some published interest rate as a percentage of some agreed upon amount, known as the notional amount. The cash flow is paid by the investor periodically throughout the term of the contract, while the percentage of the stock market appreciation value due to the investor is paid at the end of the term of the contract. The advantage to the investor is an opportunity for equity exposure with the potential of returns greater than from the underlying fixed income security. While the principal remains safe, the anticipated income stream is invested in a manner that provides for diversity of the investments. If the stock index declines, all that has been risked is

the income stream from the fixed income security; and the principal amount of the original investment is still received at maturity.<sup>1</sup>

Article XVI, section 67(a)(1) of the Texas Constitution authorizes the legislature to enact general laws establishing retirement systems for public employees and officers. Such a benefit system holds its assets in trust for the benefits of members. The board of trustees of a statewide benefit system must "invest the funds of the system in such securities as the board may consider prudent investments. . . . The legislature by law may

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<sup>1</sup>The federal Securities and Exchange Commission (the "SEC") categorizes swap contracts as "derivative products." See 58 Fed. Reg. 27,486, 27,487 (1993). Broadly defined, a "derivative product" is "a financial instrument that derives its value from the performance of other assets," such as securities, rates, or indexes. *Id.* According to the SEC, a swap contract "includes any of a growing number of contractual agreements providing for the exchange of cash flows between two parties." See *id.* at 27,490. The SEC asserts that the parties to the swap contract determine the terms of each agreement, but it notes that, in general, most parties adopt the terms and conditions that standard swap agreements, which industry groups have prepared, set forth. *Id.* at 27,490 & n.35.

Generally, in an interest rate swap one party

has a financing or debt position, which it desires to change. Although it may not be able to change the terms of its financing or debt position, it may change the corresponding or related interest rate exposure by entering into an interest rate swap with a third party. . . .

A typical interest rate swap (i.e., a "plain vanilla" swap) involves the net exchange of a fixed rate of interest for a short term floating rate. The parties agree on an amount (i.e., the notional amount), which is not exchanged, but instead is used to calculate the payments made under the interest rate swap. At the time when the interest payments are due, the parties will usually exchange a single amount representing the net settlement obligation.

*Id.* at 27,490; see also *id.* (describing variations from plain vanilla swap); *id.* n.37 (characterizing basic fixed-for-float rate swap as "par value" swap).

The SEC also has discussed equity swaps:

Equity swaps allow the parties to exchange the rate of return (or a component thereof) on an equity investment (e.g., a group of equity securities or an index) for the rate of return on another non-equity or equity investment. Typically, an investor will swap either fixed or floating rate interest payments for payments indexed to the performance of a broad-based stock index in a domestic or foreign market.

*Id.* at 27,490.

further restrict the investment discretion of a board." *Id.* § 67(a)(3) (emphasis added). Article XVI, section 67(b)(2) requires the legislature to establish the ERS "to provide benefits for officers and employees of the state and such state-compensated officers and employees of appellate courts and judicial districts as may be included under the system by law." *See generally* 2 D. BRADEN, THE CONSTITUTION OF THE STATE OF TEXAS: AN ANNOTATED AND COMPARATIVE ANALYSIS 814-21 (1977) (discussing article XVI, section 67).

In chapter 815 of the Government Code the legislature has provided for the administration of the ERS. Section 815.103(a) designates the ERS's board of trustees as the trustee of the ERS's assets. *See also* Gov't Code § 815.310(a) (establishing trust fund for ERS with state treasurer). Section 815.103(b) authorizes the board of trustees to "acquire, hold, manage, purchase, sell, assign, trade, transfer, and dispose of any security, evidence of debt, or other investment in which the retirement system's assets may be invested."<sup>2</sup> (Emphasis added.) *See* Gov't Code § 815.307 (prescribing duty of care). Unfortunately, neither article XVI, section 67 of the constitution nor chapter 815 of the Government Code defines "security" or "securities."

In Attorney General Opinion MW-152 (1980) this office considered the authority of the Teacher Retirement System to invest in real estate or mortgage certificates secured by real property. Article XVI, section 67(a)(3) requires the Teacher Retirement System, like the ERS, to invest the system's funds only in those securities that the system's board of trustees considers prudent investments. Attorney General Opinion MW-152 (1980) at 1 (quoting Tex. Const. art. XVI, § 67). To determine whether the proposed investments were securities for purposes of article XVI, section 67 of the constitution, the opinion relied on the definition of "securities" that article 581-4, V.T.C.S., articulates, as well as judicial interpretations of the term under both state and federal law. *See id.* at 2. In our opinion, Attorney General Opinion MW-152 correctly defined the word "securities" in article XVI, section 67(a)(3) of the Texas Constitution by applying the definition in article 581-4, V.T.C.S. We also believe the same definition properly may be applied to define the word "security" in section 815.103(b) of the Government Code.

Article 581-4(A), a part of the Securities Act, V.T.C.S. title 19, currently defines the terms "security" or "securities" to include, with certain exceptions irrelevant here,

any limited partner interest in a limited partnership, share, stock, treasury stock, stock certificate under a voting trust agreement,

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<sup>2</sup>Of course, section 815.013(b) cannot authorize the ERS to invest in instruments that article XVI, section 67(a)(3) of the constitution does not authorize.

collateral trust certificate, equipment trust certificate, preorganization certificate or receipt, subscription or reorganization certificate, note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title, or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not.

We note that the definition of "security" or "securities" in article 581-4(A) is substantially similar to the definitions of "security" in the federal Securities Act of 1933, 15 U.S.C. § 77b(1),<sup>3</sup> and the federal Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10).<sup>4</sup> See *Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637, 639 (Tex. 1977) (stating that definition of "security" in Texas Securities Act is almost identical to definition in federal Securities Act of 1933); *Clayton Brokerage Co. v. Mauer*, 520 S.W.2d 802, 806 n.3 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.) (same). State courts, including the Texas Supreme Court, have interpreted the definition of "security" in article 581-4(A), V.T.C.S.,

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<sup>3</sup>Section 77b of title 15 of the United States Code defines "security" as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

<sup>4</sup>Section 78c(10) of title 15 of the United States Code defines "security" as, with certain specified exclusions, "any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing."

in accordance with constructions of the federal definitions of "security." *See generally Searsy*, 560 S.W.2d 637; *Clayton Brokerage Co.*, 520 S.W.2d 802. We believe, therefore, that the State Securities Board is likely to rely upon decisions of federal courts and the federal Securities and Exchange Commission in determining whether a particular instrument is a security for purposes of article 581-4(A). In our opinion, assuming the ERS board has determined that investing its funds in equity swap contracts or interest rate swap contracts is a prudent investment, the ERS may invest its funds in such contracts if the contracts are securities under either federal or state securities laws.<sup>5</sup>

The federal Securities and Exchange Commission has yet to determine whether a swap contract is a security for purposes of the federal securities laws. *See* 58 Fed. Reg. 27,487 n.4 (1993). We are advised that, likewise, the State Securities Board has yet to determine whether a swap contract is a security for purposes of the state securities laws.<sup>6</sup> We will defer to the judgment of these expert bodies as to whether a swap contract is a "security." Until the Securities and Exchange Commission or the State Securities Board makes such a determination, we advise you to invest ERS funds only in those "securities [that the ERS] board may consider prudent investments." *See* Tex. Const. art. XVI, § 67(a)(3).

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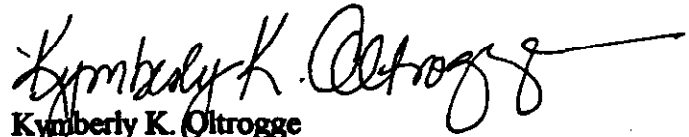
<sup>5</sup>We do not consider here whether an instrument is a security in which the ERS may invest if the federal Securities and Exchange Commission considers such an instrument a security for purposes of federal law, but the State Securities Board does not consider the instrument a security for purposes of state law.

<sup>6</sup>Indeed, we have been unable to identify any state that has determined whether a swap contract is a security for purposes of that state's securities laws.

**S U M M A R Y**

The Employees Retirement System of Texas may invest its funds in an equity swap contract or an interest rate swap contract if the particular transaction constitutes a "security" under the definition of "security" in article 581-4(A) of the Texas Securities Act, V.T.C.S. tit. 19, or under the definitions of "security" in the federal securities laws, 15 U.S.C. §§ 77b(1), 78c(a)(10).

Very truly yours,



Kimberly K. Oltrogge  
Assistant Attorney General  
Opinion Committee