

State Board of Education

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JUL 13 2004

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July 13, 2004

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OPINION COMMITTEE

FILE # ML-43828-04

I.D. # 43828

The Honorable Greg Abbott
Texas Attorney General
Price Daniel Building
Post Office Box 12548
Austin, Texas 78711-2548

Attention: Opinion Committee

RQ-0249-GA

Dear General Abbott:

I am writing to ask your opinion regarding the effect of a recent amendment to Article VII, Section 5, of the Texas Constitution¹.

Prior to the amendment, Article VII, Section 5, distinguished the corpus of the Texas Permanent School Fund ("PSF") from income generated by that fund, which constituted a part of the Available School Fund ("ASF")². The corpus could not be appropriated for any purpose, while all of the income was required to be "applied annually" to the support of education³. The amendment reorganized the funds under a "total return" concept that eliminated the distinction between corpus and current income, bringing both within the ambit of the PSF. The PSF now will transfer a percentage of its "average market value"⁴ to the ASF for distribution⁵.

¹ H.J.R. 68, Acts 2003, 78th Reg. Leg. Sess.. Implementing legislation was also enacted, contingent upon adoption of the constitutional amendment. Acts 2003, 78th Reg. Leg. Sess. Ch. 328 (SB206). The amendment was adopted by the voters in September 2003.

² The ASF additionally contains one-quarter of revenues from state occupation and motor fuels taxes. See Section 43.001, Texas Education Code. Note that a part of the Permanent School Fund is managed by the General Land Office under Article VII, Section 4 of the Texas Constitution.

³ See also Attorney General's Opinion DM-316 (1995). Note that Subsection (d) allows the PSF to be pledged to secure school district bonds for the purchase of school facilities and certain state bonds used to support the same purpose. Most school district bonds are guaranteed by the PSF. No state bonds have ever been issued under this subsection. The school district bond guarantee program is administered pursuant to Subchapter C, Chapter 45, Texas Education Code. No payment has ever been made from the PSF under this subsection.

⁴ Under Article VII, Section 5(a), the percentage transferred is set by a two-thirds vote of the State Board of Education prior to each regular legislative session or, if no such vote takes place, by the legislature, all within an allowable range and subject to a limit designed to prevent the PSF from transferring more than its average total return over a ten-year period.

⁵ Real property managed by the General Land Office is excluded from the "market value" described in Section 5(a)(1). We assume that the market value exclusive of real property described in Section 5(a)(1) is the same as "investment assets" as that term is used in Subsections 5(a) and 5(a)(2).

The State Board of Education (the "Board") is granted broad authority over the PSF under Article VII, Section 5(f), of the Texas Constitution⁶. That subsection provides as follows:

(f) Notwithstanding any other provision of this constitution, in managing the assets of the permanent school fund, the State Board of Education may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment, including investments in the Texas growth fund created by Article XVI, Section 70, of this constitution, that persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, acquire or retain for their own account in the management of their affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

Prior to the constitutional amendment, Section 5(c) of Article VII read as follows:

(c) The legislature may appropriate part of the available school fund for administration of the permanent school fund or of a bond guarantee program established under this section.

Prior Subsection (c) was amended to retain the ability of the Legislature to appropriate from the AS for administration of the bond guarantee program⁷, but eliminated the reference to administrative expenses of the PSF. A new Subsection 5(b) now provides:

(b) The expenses of managing permanent school fund land and investments shall be paid by appropriation from the permanent school fund.

Several questions have arisen regarding the Board's authority to manage the fund after the constitutional amendment. In particular, the Board's ability to contract and pay for external investment managers and make certain types of investments has been discussed in light of Section 5(b). My questions are:

1. Is the amount the Board may spend on PSF management expenses, including external investment managers, limited to amounts specifically appropriated by the Texas Legislature?

Since 1995, the Board has been authorized to "contract for the investment of the permanent school fund to the same extent as the governing board of an institution of higher education with respect to an institutional fund under Chapter 163, Property Code⁸." Beginning in 1996, the Board has contracted with external investment managers to invest specific assets of the PSF⁹. Payment for those services has been made pursuant to specific appropriations riders authorizing payment from the ASF¹⁰.

⁶ See, e.g., Attorney General's Opinions DM-175 (1992), DM-316 (1995), and GA-16 (2003).

⁷ Prior Subsection 5(c) of Article VII was redesignated Subsection 5(e) as part of the amendment.

⁸ Section 43.006(a), Texas Education Code. Although this statute was enacted in 1995, the broad grant of constitutional authority in Article VII, Section 5(f), would seem to also allow contracts for such services since its adoption in 1988. See Attorney General's Opinion DM-175 (1992).

⁹ Various aspects of PSF administration can be found at Chapter 33, Title 19, Texas Administrative Code.

¹⁰ Appropriations for management of the PSF are made to the Texas Education Agency under the direction of the commissioner of education. See Attorney General's Opinion GA-16 (2003).

Although the Board has in the past been allowed to pay investment managers without a specific limit¹¹, the Texas Education Agency appropriation for the 2004-2005 state fiscal biennium sets a limit of \$7 million for external investment managers¹².

The amendatory language of H.J.R. 68 was originally introduced as S.J.R. 13 during the 2003 regular session of the Texas Legislature. As introduced, S.J.R. 13 provided that the expenses of managing the PSF "be paid by the permanent school fund" with no mention of the appropriations process. That language appears to have been patterned on the 1999 total return amendment to Article VII, Section 18 of the Texas Constitution involving the Permanent University Fund¹³. A floor amendment in the Senate added the phrase "by appropriation"¹⁴ to the provision dealing with payment of PSF expenses. The operative language of the engrossed version of S.J.R. 13 was later added as an amendment to H.J.R. 68.

The Legislature may have added the phrase "by appropriation" to clarify that only a specific legislative appropriation would authorize payment of PSF expenses. On the other hand, Section 163.004 of the Texas Property Code authorizes a "governing board" to "appropriate for expenditure" the "net appreciation" over a fund's historic value¹⁵. The provisions of Article VIII, Section 6, of the Texas Constitution¹⁶ may also be relevant.

2. May the Board invest in assets that deduct a management fee from the assets invested?

Among the investment options potentially available to the Board are assets structured like the "mutual funds" or "investment trusts" commonly utilized by individual investors. Such an investment typically deducts a management fee from the assets under management rather than charging a separate fee paid by the investor. While it appears clear that a mutual fund would be within the scope of permissible investments under the Board's "prudent person" standard in Article VII, Section 5(f), the potential deduction of management fees raises a question of whether that arrangement would violate the "by appropriation" language of Article VII, Section 5(b), or Article VIII, Section 6.

While predating the constitutional amendment under consideration, two prior attorney general's opinions appear to offer some guidance with regard to investment expenses. Both opinions address

¹¹ Each biennium since 1996-97, the Board was allowed to spend amounts from the ASF on external managers in its discretion after first meeting certain income requirements. See, e.g., the discussion in Attorney General's Opinion GA-16 (2003).

¹² See, Rider 34 to the Texas Education Agency appropriation, Acts 2003, 78th Leg., R.S. (H.B. 1) Article III (III-12). Note that a contingency rider changes the source of the appropriation to reflect the constitutional amendment. Acts 78th Leg., R.S., H.B. 1, Article IX, Section 11.34 (IX-84). Additional amounts are appropriated to the agency to fund internal staff operations and certain other expenses paid to external third parties such as custody services in support of the Board in managing the PSF.

¹³ Acts 1999, 76th Leg., H.J.R. 58.

¹⁴ Floor Amendment Number 1 to C.S.S.J. 13, Senate Session of May 9, 2003 at approximately 1:23, available at <http://www.senate.state.tx.us/75r/Senate/AVarch.htm#May>.

¹⁵ It appears unclear whether the provisions of Article VII, Section 5(a)(2), are more or less restrictive than the limit in Section 163.004 of the Property Code. Note that the Property Code provision was enacted in 1989 and would not appear to be compatible with the corpus/income distinction under Article VII, Section 5(a), as it existed prior to the 2003 constitutional amendment.

¹⁶ "No money shall be drawn from the Treasury but in pursuance of specific appropriations made by law...". We are unaware of the extent, if any, to which the Permanent School Fund is considered to be within the Treasury. Note that Attorney General's Opinion WW-69 (1957), discussed in the second question, refers to the Permanent University Fund as "retained in the Treasury of the State". See also Attorney General's Opinion GA-75 (2003). Current practice is to hold most of the PSF assets managed by the Board with a commercial bank acting as a securities custodian, although some cash and other short-term investments remain with the State Treasury.

the Permanent University Fund but would logically apply to the PSF, as well. Opinion WW-69 (1957) dealt with the payment of "documentary stamp taxes, transfer taxes and fees, and commissions" on investments made by the Permanent University Fund. The opinion determined that "costs of acquiring the securities...must be paid from the Permanent University Fund." The opinion expressly distinguished those "items of expense" from "premiums, discounts, accrued interest, investment counsel fees and administrative expenses", which were not considered by the opinion.

The practice of the PSF has been to treat commissions as a part of the cost of the security or as a deduction from the proceeds of a sale (in effect, paid from the PSF itself) but to pay investment management services from an appropriation of the ASF under former Article VII, Section 5(c)¹⁷.

Attorney General's Opinion C-793 (1966) followed WW-69 in addressing whether "FHA insured first lien real estate mortgages" were eligible investments for the Permanent University Fund. The opinion held that the Board of Regents was authorized to "contract with mortgage bankers for servicing of their investments", but does not appear to have considered from what funds such contracts would be paid. The Board is explicitly mentioned as a state entity able to make such investments and contracts.

Article VII, Subsection 5(b), requires "expenses of managing" the PSF to be paid "by appropriation from the permanent school fund". We understand WW-69 to continue to allow commissions to be paid from the proceeds of sale or be incorporated into the cost of a purchase as a "customary business and accounting practice". However, "administrative expenses" of the fund were distinguished in that opinion and could include fees paid to investment advisors and fund managers, as well as other internal expenses. My question is thus whether WW-69 can be extended to allow management fees to be paid without appropriation as a "customary" expense of a mutual fund investment, or whether the language in Article VII, Section 5(b), or Article VIII, Section 6, requires a specific appropriation.

3. Does Article VII, Section 5(f), allow an investment in the Texas Growth Fund that would otherwise require an appropriation?

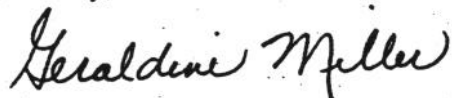
To the extent you should determine in Questions 1 or 2 above that a specific appropriation is required for payment of management fees or mutual fund-type investments, I would ask you to consider whether the specific reference to the Texas Growth Fund in Article VII, Section 5(f), allows such an investment in that fund without a specific appropriation.

¹⁷ Currently, a small number of PSF investments and contractual arrangements do appear to have management fees deducted. The PSF has invested in some publicly traded funds such as Real Estate Investment Trusts (REITs) and S&P Depository Receipts through its S&P 500 Index portfolio. Each is structured to have a management fee deducted from income prior to a return of the income for deposit to the PSF. The Fund also invests in Short Term Investment Funds at the custodian bank which deducts a management fee from the income earned. Effective June 1, 2004, the Fund will also follow the industry standard practice of bundling custody and securities lending. Under this practice, a nominal fee is charged for custody services and the custodian receives a portion of the securities lending revenue. The Fund has also in the past participated in "commission recapture" or "soft dollar" arrangements under which a portion of the commissions paid are made available to the Fund for research services (either from the broker or through a third party.) For more information on soft dollar and commission recapture arrangements, see Section 28(e) of the Securities Exchange Act of 1934 and ERISA Technical Release No. 86-1. While these practices can be funded under the terms of the previous TEA appropriation, Acts 2001, 77th Leg., R.S., S.B. 1, Art. III (Rider 38 at III-15), they may raise the same constitutional issues as the mutual fund question under the change made in Article VII, Section 5(b), to the Texas Constitution. Note that the two Attorney General's opinions discussed above also predate the 1983 addition of former Subsection (c) that allowed appropriation from the ASF. Acts 1983, 68th Leg., S.J.R. 12.

Our understanding of the Texas Growth Fund structure is that management fees are deducted directly from the assets under management. Given that such a deduction is the normal method of operation of that fund and that investment in the Texas Growth Fund is specifically authorized in the Texas Constitution, may the Board make an investment in that fund which deducts management fees or other expenses directly from the assets under management?

Thank you for your attention to this matter. Should you require any additional information, please feel free to contact me, David Anderson, General Counsel (463-9720), or Holland Timmins, PSF Executive Administrator (463-9169).

Sincerely,

A handwritten signature in cursive script that reads "Geraldine Miller".

Geraldine Miller, Chair
State Board of Education

cc: Shirley J. Neeley, Ed.D., Commissioner
Members, State Board of Education
David A. Anderson, General Counsel
Holland Timmins, PSF Executive Administrator