

SUBJECT: Permanent School Fund investment and management oversight

COMMITTEE: Public Education — committee substitute recommended

VOTE: 7 ayes — Sadler, Dutton, Dunnam, Hardcastle, Hochberg, Olivo, Smith
0 nays
2 absent — Grusendorf, Oliveira

SENATE VOTE: On final passage, April 30 — voice vote

WITNESSES: For — None
Against — Merry Lynn Gerstenschlager, Texas Eagle Forum; Grace Shore

BACKGROUND: The Permanent School Fund (PSF), primarily comprising stocks, bonds, and oil and gas royalties from state-owned lands, was established as a constitutional fund in 1854. Today, the PSF is worth more than \$20 billion. Interest and dividend income from PSF generate nearly \$700 million per year, and PSF land sale and lease proceeds generate another \$300 million for a total annual distribution to all school districts of about \$1 billion through the Available School Fund (ASF). The ASF also receives dedicated revenue from one-quarter of state-levied motor fuel taxes. The ASF is a constitutional fund that distributes funds to all school districts for textbook purchases, the technology allotment, and a per-student distribution regardless of district wealth or size. The PSF also is available to insure voter-approved, long-term bonds issued by accredited schools.

The State Board of Education (SBOE) invests and manages the PSF, under Texas Constitution, Art. 7, sec. 8. Before 1995, the SBOE managed the fund exclusively through staff hired by the Texas Education Agency (TEA). In 1995, SBOE decided to allow private portfolio managers to manage part of the PSF. SBOE authorized three firms to begin managing PSF assets on September 1, 1995, and increased the number of managing firms to 12 in 1997. Private firms now manage roughly one-third, or about \$7 billion, of the PSF and receive nearly \$18 million annually for their services. In

addition to the portfolio managers, SBOE also contracts with independent investment firms to provide advice on fund management and economic forecasting. Another firm is employed independently to evaluate the fund's long-term investment strategy and performance.

For additional background information on the SBOE's management of the PSF, see House Research Organization Focus Report Number 76-19, *State Board of Education: Controversy and Change*, January 3, 2000.

DIGEST: CSSB 512 would make a number of changes regarding the management and investment of the Permanent School Fund (PSF), including:

- ! providing for state auditor investigations of malfeasance;
- ! applying conflicts of interest and ethics policies to interested persons;
- ! allowing an administrative law judge to hear cases and ban certain parties from contracting with the SBOE for PSF management;
- ! creating a nine-member PSF advisory committee;
- ! reporting of any expenditure over \$50 on behalf of the SBOE; and
- ! providing for regular management and performance audits.

Investigations. CSSB 512 would amend the Education Code to require the SBOE to contract with the state auditor for an investigation of any written allegation of misfeasance or malfeasance submitted to the SBOE regarding PSF investment or management. This would include allegations about:

- ! noncompliance with constitutional investment standards;
- ! violations of the ethics policy;
- ! conflicts of interest, including those affecting SBOE's decisions relating to consultant and money manager selection, asset allocation, and broker-dealer eligibility requirements; and
- ! the effect of an informal advisor on SBOE decisions on managing and investing PSF.

Interested persons. The bill would define "interested person" to mean a person who applied for or received anything of value as a result, direct or indirect, of PSF investments. The bill would require SBOE to maintain a website listing of interested persons and to update it quarterly. SBOE would have to post this website by March 1, 2002.

Hearings. The commissioner and the chief administrative law judge (ALJ) of the State Office of Administrative Hearings (SOAH) would have to adopt a memorandum of understanding not later than March 1, 2002, for SOAH to conduct hearings. An interested person found at an SOAH hearing to have violated the ethics policy or conflict of interest restrictions could be barred from contracting with SBOE or with another interested person to provide PSF management or investment services. If the ALJ determined that an interested person should be barred, the ALJ would enter a final decision in the case, concerning the period for which the person was barred, based on:

- ! previous violations of the ethics policy or conflict of interest restrictions, if any;
- ! the seriousness of the violation; and
- ! damage to PSF interests.

The bill would provide for judicial review of an ALJ's decision, as provided by Government Code, chapter 2001.

PSF advisory committee. The bill would create a nine-member PSF advisory committee, with three members appointed by the governor, the lieutenant governor, and the House speaker, respectively. The governor's appointees would not be subject to confirmation by the Senate, and appointees would serve at the will of the appointing authority. Members would have to possess substantial experience and expertise in investments. The committee would select its own presiding officer and meet at the call of the presiding officer. Members would not be compensated, but would be reimbursed for travel expenses incurred while conducting committee business, as provided by the general appropriations act. The committee would not be subject to Government Code, ch. 2110, which outlines requirements for state agency advisory committees. Initial appointments would have to be made by March 1, 2002.

PSF ethics policy and conflicts of interest. The bill would amend the current PSF ethics policy and conflicts of interest sections to make them both explicitly applicable to committee members and interested persons.

Reports of expenditures. A money manager, investment manager, or dealer would have to file an expenditure report for any expenditure of more than

\$50 on behalf of an SBOE member, a committee member, the commissioner, an interested person, or an employee of the agency or of a nonprofit corporation created for PSF investment management.

Disclosing conflicts of interest. If an interested person entered into an arrangement involving PSF management or investment, under which the interested person served as a consultant, advisor, broker, money manager, investment manager, dealer, or vendor of any of those parties, and the interested person failed to disclose a relationship subject to the conflicts of interest section, the comptroller or SBOE could void the arrangement, and the comptroller or SBOE could declare the person ineligible to contract for business relating to PSF management or investment. This only would apply to an arrangement or contract entered into on or after January 1, 2002.

Required contract provisions. As a part of each contract for services to the board relating to management or investment of the PSF, the SBOE would have to include a standard provision, adopted by the board, that would:

- ! require a contracting person to comply with all applicable statutes and rules relating to services provided to SBOE, and
- ! acknowledge that SBOE could terminate the contract or arrangement if the person failed to comply.

This only would apply to a contract entered into on or after January 1, 2002.

Investigation cooperation. The comptroller would have to provide information about investigations or disciplinary actions involving persons interested in PSF management or investment, such as:

- ! consultants, advisors, brokers, money managers, investment managers, or dealers doing business with or seeking to do business with the PSF to the United States Securities and Exchange Commission;
- ! the securities commissioner;
- ! self-regulatory organizations; and
- ! professional organizations of persons involved in management or investment of institutional funds.

The comptroller also would have to cooperate with these persons in their investigations involving consultants, brokers, or dealers doing business with or seeking to do business with the PSF.

Management and performance audit. The PSF committee would have to choose an independent firm with experience evaluating institutional investment practices and performance to evaluate PSF investment management practices and performance as often as the Legislative Audit Committee (LAC) determined necessary or advisable. LAC would have to determine specific areas to be evaluated and specify a date by which the firm would have to file an audit report with LAC. The audit would be paid for out of ASF funds. LAC also would have to select an independent firm to evaluate PSF investment management and performance by March 1, 2002.

Other provisions. The bill also would:

- ! amend the PSF investment management reporting requirements to permit SBOE to determine the frequency of reports;
- ! replace references to PSF securities with references to investments in the purchase, sale, and exchange, duties of comptroller, and use of banks section;
- ! replace references to PSF securities with references to bonds in the default;
- ! require SBOE to exercise the constitutionally prescribed standard of care in making investment decisions; and
- ! amend the section permitting SBOE to contract with a commercial bank to serve as custodian, to require the bank to execute an indemnification agreement fully indemnifying the PSF and ASF against loss due to borrower default or due to the failure of the bank to properly execute its responsibilities under the applicable securities lending agreement.

Investment section repealed. The bill would repeal Education Code, sec. 43.003, describing PSF investment by SBOE, and would make conforming amendments to reflect the changes made by this bill, effective September 1, 2001.

Except as otherwise provided, the changes set forth by CSSB 512 would take effect September 1, 2002.

SUPPORTERS
SAY:

CSSB 512 would act upon some of the recommendations of the House General Investigating Committee after its interim investigation of recent SBOE actions relating to management of the PSF and its investments as well as critical findings made by the State Auditor's Office. The interim report found "evidence suggesting, at a minimum, the appearance of a conflict of interest affects the SBOE's decisions on consultant and money manager selection, asset allocation, and broker-dealer eligibility requirements." The committee also found that financial relationships between informal advisors and SBOE's PSF committee members were not disclosed and limited the full SBOE's ability to safeguard its decisions. The committee also reported that tracing previously undisclosed financial transactions was challenging, particularly in light of the complexity of the investment arena, which can camouflage self-dealing.

The bill is needed to address the committee conclusions that private rewards were received for public influence in SBOE's management of the PSF. The PSF should be safeguarded by establishing an independently appointed advisory committee of experienced investment managers, setting clear ethical guidelines concerning conflicts of interest, and setting up investigatory and disciplinary mechanisms to oversee those involved in investing the PSF. SBOE members are elected officials who do not have the investment expertise or experience necessary to manage the PSF without the advice of a qualified advisory committee.

Most voters do not understand what SBOE does or that it manages PSF, and they do not query candidates on their financial background. SBOE members rely on financial experts to make investment decisions. This lack of expertise makes it more difficult for SBOE members to manage the PSF prudently, and avoid conflicts of interest regarding advice from outside investment consultants. SBOE is too inexperienced to be managing PSF without reliable expert advice in an increasingly complex and volatile market. Nevertheless, the bill would not restrict or dilute SBOE's basic investment authority, only provide for additional investment expertise and oversight.

The actions of SBOE members and advisors have eroded public trust, and CSSB 512 is aimed at restoring that trust. The interim committee concluded that SBOE members shared confidential information with an informal adviser and allowed him to participate in interviewing bidders, improperly giving a

person with no fiduciary relationship to the PSF apparent authority to speak and act on behalf of PSF. SBOE members have made many decisions about PSF recklessly, based on unreliable and unsubstantiated information. SBOE ignored ethical breaches by a key hired consultant, as well as an unpaid adviser. Some SBOE members also have stated they do not trust TEA personnel assigned to advise them on financial matters. SBOE chose, for example, to hire two financial institutions to oversee the fund, despite TEA's recommendation to hire only one. An investment firm refused to accept a contract to review PSF strategies, citing the lack of a positive working relationship between SBOE and TEA staff. While it is arguable whether these problems have harmed PSF value, that is not the issue. As trustees of public funds, SBOE members must avoid even the appearance of impropriety.

OPPONENTS
SAY:

This bill is an unnecessary response to a problem that does not exist. There have been no allegations of wrongdoing by SBOE members in investing the PSF. All of the allegations in the House General Investigating Committee report and the State Auditor's Office reports concerned informal advisors and their failure to disclose economic interests.

No one ever has alleged that PSF investments were made improperly or that even one dollar was improperly invested. There has been no showing that the current management model will not continue to work. SBOE is capable of managing the PSF without an advisory committee. The PSF has performed at or above the market in many aspects and is growing at a respectable rate under SBOE management. An advisory committee is unnecessary. Use of TEA staff and outside financial advisors provides SBOE with the expertise necessary to manage the fund properly. Personal financial knowledge is not a prerequisite to sound financial management. Many members of the Legislature have no financial or investment experience, and yet they determine the budget for the State of Texas — a budget far larger than the assets of the PSF. It is doubtful that anyone would argue to reduce the budgetary authority of the Legislature in order to give more power to an advisory committee.

OTHER
OPPONENTS
SAY:

The complicated provisions of this bill would not restore public trust or ensure competent PSF investment and management. It would make more sense to remove PSF investment from SBOE's enumerated duties and place

PSF investment and management with an appointed body, similar to the committee created by this bill, with extensive financial knowledge and the authority to make final decisions concerning PSF investment.

NOTES:

The committee substitute modified the committee membership and added that members would serve at the will of the appointing authority. The committee substitute removed provisions in the Senate-passed bill relating to committee member terms and removal for good cause.

The committee substitute amended the ethics policy of SBOE, conflict of interest provisions, and reports of expenditures to include interested persons, and removed provisions that would have prohibited the employment or compensation of a lobbyist. It required SBOE to meet and act as a body corporate on investment decisions.

The committee substitute also added provisions regarding:

- ! failure to disclose conflicts of interest;
- ! posting a list of interested persons on a website;
- ! required contract provisions;
- ! investigations of interested persons;
- ! barring persons from contracting to provide services related to PSF investment and management;
- ! SOAH hearings; and
- ! management and performance audits.

The committee substitute repealed provisions governing the investments of the PSF in certain types of securities. The substitute would authorize SBOE to determine the frequency of reports filed by a nonprofit corporation investing funds under contract with SBOE.

A related measure, HJR 74 by Keel, et al., would have removed PSF investment authority from SBOE and created an appointed PSF investment board. HJR 74 was reported favorably by the Public Education Committee, placed on the Constitutional Amendment Calendar, and laid on the table subject to call on May 10. HB 2414, the enabling legislation for HJR 74,

was reported favorably by the Public Education Committee and sent to Calendars on April 26.