

Key Points of Report

A Follow-Up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities

January 2001

Overall Conclusion

Overseen by the Legislature, the six investing entities covered by our follow-up audit manage \$61 billion in investments as of August 31, 2000. The Legislature and the investing entities generally strengthened controls over investment practices but still have opportunities to improve them further. However, we are concerned that a decline in the State Board of Education's (SBOE) controls over its oversight of the \$22 billion Permanent School Fund (PSF) has impaired its decision-making process.

The six entities substantially implemented our most significant prior recommendations to strengthen controls. We generally assessed their controls as adequate in our 1996 and 1997 reports. The Legislature also strengthened the State's investment practices controls but has additional opportunities to enhance the ability of the major investing entities to manage state investments and increase the amount of useful information the Legislature receives about investment management.

Since the previous audit, SBOE's ability to make prudent contracting and policy decisions in its oversight of PSF has declined. Members of SBOE, an elected body, normally rely on others for impartial technical investment advice, but they have not had access to a functioning investment advisory committee. Some SBOE members began to deeply mistrust the PSF staff and some outside PSF consultants; they began to rely on at least one informal advisor, often privately. This advisor's undisclosed financial relationships represented a conflict of interest.

Key Facts and Findings

- A 1999 amendment to the Texas Constitution permitted The University of Texas Board of Regents to increase the Permanent University Fund's (PUF) distributions by \$108 million in the current biennium. The amendment should also help achieve better management of future PUF distributions, a higher expected rate of return on PUF investments, and maintenance of the highest possible credit rating on bonds guaranteed by the PUF.
- The passage of similar constitutional amendments for the Permanent School Fund and Higher Education Fund could produce comparable benefits.
- Most governing boards that oversee the largest investment funds are not required to have a majority of members with substantial investment expertise. Establishing a requirement for some resident expertise on these boards might make problems with the oversight and decision-making process, such as those at SBOE, less likely to occur.

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This audit was conducted in accordance with Government Code, Sections 321.0131 and 321.0132.

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Executive Summary

Overseen by the Legislature, the six investing entities covered by our follow-up audit manage \$61 billion in investments as of August 31, 2000.

The Legislature and the investing entities generally strengthened controls over investment practices but still have opportunities to improve them further. However, we are concerned that a decline in the State Board of Education's (SBOE) controls over its oversight of the \$22 billion Permanent School Fund (PSF) has impaired its decision-making process.

The six entities covered substantially implemented our most significant recommendations to strengthen controls. We generally assessed their controls as adequate in our 1996 and 1997 reports.

A Constitutional Change Resulted in Financial Benefits and Improved Investment Practices

In 1999, an amendment to the Texas Constitution permitted The University of Texas System (UT System) Board of Regents to apply "total return" concepts in managing the Permanent University Fund (PUF). As a result, the Board of Regents will distribute \$108 million more to the Available University Fund (AUF) during the current biennium than the estimated distributions under the prior constitutional provisions.

The change also permits the University of Texas Investment Management Company (UTIMCO) to manage the PUF the way it manages the other UT System endowments. In addition to promoting operational efficiency, the total return concept should allow investment strategies that would be likely to increase the PUF's long-term

investment return and permit continued growth in the annual distributions to the AUF.

The former constitutional restrictions made it difficult to maximize investment return and annual distributions simultaneously. High total investment return (interest, dividends, and gains) did not automatically ensure that annual distributions, based only on interest and dividends, would increase.

Further Constitutional and Statutory Changes Could Provide Additional Benefits

The Legislature may wish to consider making further improvements to the State's investment practices.

Eliminate constitutional restrictions on distributions from PSF and the Higher Education Fund (HEF). These limitations, like those removed from the PUF, prevent PSF and the HEF from adopting total return spending and investing strategies. Eliminating these restrictions should provide benefits for these funds comparable to those obtained by the PUF.

Require that the major investing entities have oversight boards that possess substantial investment expertise. Only the Teacher Retirement System (TRS) Board must include a majority of members who have substantial investment expertise. The Employees Retirement System (ERS) and SBOE have no such requirement, and they typically have not had a majority of board members with investment backgrounds. UTIMCO's board has consistently been comprised of a majority of members with such expertise, although

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this expertise is not explicitly required by statute.

Current Texas statutes prevent SBOE from appointing any outside trustees, who might be investment experts, if it were to create a nonprofit PSF investment management corporation. Also, the Comptroller of Public Accounts does not have a governing board to oversee some of its investment portfolios.

Considering the huge sums involved, the complexities of modern investing, and the opportunities for decisions to produce financial gain or harm, Texas' largest funds could benefit from more oversight by investment experts.

Provide explicit statutory authority that permits TRS and ERS to delegate investment decisions to external managers. TRS and ERS could further diversify their investment portfolios if they could use outside managers to gain access to additional investment types or strategies. Most government investing entities in Texas have this delegation authority.

Although external management is viewed as more expensive than managing in-house, the agencies may not be able to manage many of these new investment types internally. Further diversification could help both agencies increase their long-term investment returns and/or reduce their overall portfolio risks.

A 1996 independent investment review of TRS conducted for the Legislative Audit Committee recommended such increased diversification and suggested external management to achieve it.

Require periodic external investment reviews at major

investing entities. Periodic independent reviews of the major investing entities' investment practices and performance, like the reviews required for TRS, could provide the Legislature with useful information about the management of those funds.

The State Board of Education Has Not Provided Effective Oversight of PSF

Controls related to SBOE's oversight of the \$22 billion PSF have weakened significantly since our prior audit. A number of factors contributed to major weaknesses in SBOE's ability to make sound contracting and policy decisions for PSF.

Certain SBOE members relied on advice from one or more outside parties who lack fiduciary responsibility to PSF. This reliance may have resulted, in part, from SBOE members' lack of substantial investment expertise. Because much of this advice was provided privately, the Legislature, the public, and other SBOE members did not see how some important decisions were made and who was involved in making them.

SBOE lacks a functioning investment advisory committee (IAC). An effective IAC could help compensate for the lack of resident investment expertise on SBOE and might deter SBOE members from seeking advice from individuals who are not accountable to PSF.

SBOE did not take appropriate actions regarding certain individuals or firms on whom some SBOE members relied for advice. Some SBOE members did not ensure disclosure of business or personal relationships among an unpaid advisor, his business partner, and a consultant to SBOE that represented potential

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impairments to their independence of judgment. Also, SBOE adopted an ethics policy that does not prohibit consultants from requesting favors from money managers whose performance they evaluate.

SBOE's decision-making process permitted SBOE members to introduce significant assertions that affected important SBOE votes without determining the reliability of those assertions. One unsupported allegation by an SBOE member changed two important contract decisions, but evidence obtained much later suggests the claim was incorrect.

SBOE's relationship with, and reliance on, the PSF investment staff and other paid service providers has declined in recent years. Some SBOE members directed numerous allegations at, and lost trust in, the PSF staff and some outside PSF contractors.

Some SBOE members appear willing to spend more of PSF's money than necessary to achieve a state-mandated economic development goal. Certain SBOE members have insisted that PSF should pay full-service commission rates to certain brokers who provide a reduced level of brokerage services that is ordinarily available at a discount.

Summary of Responses

Responses to our Legislative Issues recommendations were mixed:

TEA management agreed with the total return concept for PSF. Several SBOE members disagreed, and another was willing to consider the issue further.

TRS management agreed that requiring some governing board

members to have investment expertise enhances the investment function. ERS management and all SBOE respondents disagreed. The Comptroller of Public Accounts agreed with the concept of an advisory board.

TRS management supported and ERS management did not object to receiving authority to fully delegate investment decisions to outside parties.

TRS and TEA management and two SBOE members agreed that periodic external investment reviews would be worthwhile. ERS management disagreed.

We have included three State Auditor follow-up comments after those Legislative Issues responses.

Most of the ten SBOE members who responded disagreed with the conditions, results, and conclusions of our report. However, none of the responses introduced accurate new information that caused us to change any of our conclusions and recommendations.

Selected responses from SBOE members to the TEA section of the report are summarized separately on page 5 along with our follow-up comments.

Summary of Objective and Scope

The primary objective of this audit was to follow up on the implementation of our most significant recommendations from two prior reviews of controls over investment practices. The six entities covered by our follow-up procedures are:

Executive Summary

Texas Education Agency/PSF
UT System/UTIMCO
Employees Retirement System
Texas A&M University System
General Land Office/Veterans
Land Board
Department of Housing and
Community Affairs

Although TRS is mentioned in this report, we did not perform additional

procedures in this review due to a lack of significant prior issues. The Comptroller of Public Accounts is mentioned where legislative issues apply to them. Other State Auditor's Office projects addressed prior recommendations at the Comptroller of Public Accounts' Treasury Operations and at Texas Tech University. The status of those recommendations will be, or has been, addressed in separate reports.

State Auditor's Office Summary of State Board of Education Members' Responses and Auditor's Follow-Up Comments

Several SBOE members responded individually. One response, referred to here as the Group Response, was signed by five current members and one former member. Some individual responses concurred with some of our recommendations, but strongly disputed others. One response found our factual descriptions fairly accurate but disagreed with our recommendations. Other individual responses and the Group Response disagreed with almost all of the conditions, results, and conclusions of our report. None of the responses introduced accurate new information that caused us to change our conclusions and recommendations.

The full responses begin on page 72 (see Texas Education Agency, Section 6). Due to the length of some responses, we have summarized selected issues, raised by one or more members, and provided our follow-up comments on an issue-by-issue basis rather than following up member by member. We have chosen not to include additional comments later in this report, following each detailed response. Our evidence contradicts many statements in those responses, in addition to those specifically addressed in these follow-up comments.

Most SBOE Responses Failed to Acknowledge Any Problem With the Use of an Informal Advisor, the Advisor's Undisclosed Business Interests, and With a Paid Performance Consultant's Involvement With the Advisor and the Brokerage Business

Selected SBOE Responses Summarized: The Group Response (from five current members and one former member) asserts that "[w]hen the House Investigating Committee studied these same issues, with the Auditor's assistance, no findings, indictments, charges or referrals were made."

State Auditor's Follow-Up Comment: To the contrary, we believe the House Committee on General Investigating found serious problems with the decision-making process and the appearance of undisclosed conflicts of interest, for which it recommended specific remedies. *The House Committee on General Investigating, Interim Report to the 77th Legislature* concludes on page 2.13 states that "the actions of several SBOE members, the Evaluation Consultant [the paid Performance Consultant] and the two advisors [the informal advisor and another party] have eroded public trust in this major state investing entity." The House Committee report further recommends amending the Constitution to create a separate PSF Investment Board so that SBOE no longer oversees these investments.

Selected SBOE Responses Summarized: The Group Response characterizes members' involvement with the informal advisor as nothing more than elected officials seeking and receiving the informal input of a constituent. Furthermore, the informal advisor's involvement in the brokerage business is of no concern because SBOE does not decide which brokers get PSF business, and brokers are not under contract with SBOE.

State Auditor's Follow-Up Comment: As documented throughout the report, the informal advisor (Advisor) performed duties for a few SBOE members that went far beyond "informal input" from a constituent. We find it imprudent for fiduciaries of any investment fund to give a private citizen, who lacks a contractual fiduciary obligation to the fund, such extensive access to a fund's confidential business. These few SBOE members compounded this risk by their failure to inquire about (and the Advisor's failure to disclose) the Advisor's 49 percent ownership of a brokerage firm. The Advisor's firm benefited financially after his undisclosed business partner, who misrepresented his business affiliation, successfully lobbied SBOE to change its brokerage policy.

Selected SBOE Responses Summarized: *The Group Response asserts that the performance measurement consultant does nothing more than calculate and reconcile investment returns and compare those returns with an external benchmark, and cannot purposely favor any manager. The Group Response and one of the individual responses assert that SBOE has the strongest ethics policy of any state fund or board.*

State Auditor's Follow-Up Comment: The Group Response fails to recognize that a performance measurement consultant's evaluation of performance contains subjective aspects. This appears to have convinced six SBOE members that a lack of

A Performance Measurement Consultant's Independence Is Important

Many business officers rely on a consultant for performance measurement. The value added in this area is not in the calculation of the numbers, but in the presentation of the data and interpretation of the results for the trustees. A consultant is often able to prevent a hasty manager termination by providing trustees with a complete and balanced description of the investment climate Regardless of whether consultants or brokers are used [to provide consulting services], they should be chosen with great care, and any potential conflicts should be understood by all parties.

Spitz, William T., *Selecting and Evaluating an Investment Manager*, pps.31 and 33, National Association of College and University Business Officers, 1992.

independence by the consultant could never be a concern (see text box at left). This might explain these members' lack of concern that their performance measurement consultant (Performance Consultant) did not disclose that he not only knew about, but also made loans that helped finance, the Advisor's plans to enter the brokerage business.

Thus, not only the Advisor, but also the Performance Consultant, already in the brokerage business throughout the period of his contract, can benefit financially if they receive business from the money managers the consultant evaluates. We believe this creates at least the possibility that the consultant might look favorably on certain managers based on brokerage relationships.

SBOE significantly strengthened its ethics policy, as the 76th Legislature required. However, the policy does not prohibit a consultant from requesting favors, such as increased brokerage commissions, from the money managers the consultant evaluates. Despite knowing the consultant was in the brokerage business when it entered into the current contract with him, SBOE did not add this control, either initially or when it adopted its new ethics policy two months later. Because many SBOE members see no problem with these relationships, disclosed or undisclosed, the problems we cite may go unaddressed.

Strong PSF Investment Performance Does Not Prove That Controls Are Effective

Selected SBOE Responses Summarized: Most SBOE responses noted that PSF's investment performance has been good, with several calling PSF the "best performing" fund in Texas. The Group Response suggests this performance is evidence that there is no problem with SBOE's decision-making processes.

State Auditor's Follow-Up Comment: While PSF's most recent five-year total return was the highest among the major State investment funds, in fiscal year 2000, PSF reportedly underperformed all three large endowments managed by UTIMCO. However, the "bottom line" is not the only factor to consider in the operations of state entities, including large investment funds. The focus of our follow-up audit was on controls over investment practices, not on the fund's performance. We recommended improvements to SBOE's decision-making controls, which had deteriorated since our 1996 review. Poor controls do not guarantee an undesirable outcome; however, they increase the chance of its occurrence. For example, leaving the cash drawer unlocked does not ensure that theft has occurred or will occur, but it increases the risk of that outcome.

The Benefit of Investment Expertise on Investment Boards Does Not Equate to a Need for Special Expertise at the Legislative Level

Selected SBOE Responses Summarized: SBOE responses disagreed with our suggestion that SBOE might be more likely to make better informed investment decisions if some SBOE members had substantial investment expertise. Some responses suggested that this recommendation criticizes the Legislature whose members, for example, are not required to possess specific financial expertise but must make decisions on the State's multi-billion dollar biennial budget.

State Auditor's Follow-Up Comment: We agree that boards without specialized investment expertise can and do successfully manage large investment funds. However, when the size of the funds increase and the board only has a few primary functions, the potential benefit of having such expertise grows. The citizen Legislature makes policy and spending decisions for our entire state. Though many members are experts in various subjects, it is neither necessary nor practical for legislators to be subject-matter experts. Executive branch agencies and boards overseeing them, however, have a much narrower focus. Thus, investment expertise at the board level is more practical for an executive branch entity such as SBOE, for which investing is among its major functions.

Two Responses Misrepresent SBOE's Decision-Making Process by Introducing New Criteria Not Considered in the Original Decision and Not Supported by the Information Available to SBOE at That Time

Selected SBOE Responses Summarized: The Group Response and one of the individual responses assert that SBOE voted to take \$300 million from only one external stock manager's holdings because that manager was the only one who used a particular investment style ("large-cap growth"). The responses assert that this style was then exposed to a greater risk of declines in value, rendering its action prudent

despite contradicting the PSF staff's recommendation to allocate the reduction among several stock managers.

State Auditor's Follow-Up Comment: Instead of addressing the decision-making process deficiency we reported, the two responses now introduce a new reason to support a 1999 SBOE decision. This newly offered reason for the decision is contradicted by the 1999 meeting tapes, which clearly reflect that the "growth style" was never offered as a rationale for decision when SBOE discussed and approved this action.

Additionally, two sources of evidence contradict the new assertion that there was only one "growth style" manager. Meeting tapes reveal that the Performance Consultant told SBOE before this vote that PSF had four such "large cap growth" managers, not one, as six SBOE members now state. Further, quarterly investment style analysis reports submitted by the departing performance measurement consultant also noted more than one such manager in each quarter of 1999.

As a result, there is no evidence that the growth style issue affected SBOE's decision, as that issue was not discussed before the vote and was, at the time, contradicted by information from SBOE's own experts on the subject. Our original conclusion, that SBOE made a \$300 million decision without assuring itself of the technical accuracy of the reasons for its vote, is unchanged by the two responses' new assertion.

We Adhered to Standards of Independence in Conducting This Audit and Gave SBOE Members a Reasonable Opportunity to Respond to Our Report

Selected SBOE Responses Summarized: *The Group Response suggests that our audit work was deficient because a "prior relationship" caused us to be biased against a private citizen who figured prominently in our report. Another response suggests that*

we might have had a "personal vendetta" and also asserts that our belief in the benefits of investment expertise on governing boards of investment funds affected our objectivity.

The SAO Conducted This Audit According to Auditing Standards

We performed this audit in accordance with generally accepted government auditing standards. Those standards require that the auditors assigned to the project be free from personal impairments to their independence, that we obtain sufficient, competent, and relevant evidence to support our conclusions, and that we apply an internal quality control review to our audits.

State Auditor's Follow-Up Comment: We conducted this audit in accordance with auditing standards, which require us to be independent and have compelling evidence for all of the factual statements made in the report (see text box at left). This "prior relationship" refers to a previous audit during which this individual made allegations, some of which we

could not substantiate and did not include in our published report. An earlier letter from an SBOE member raised this same issue of bias. In response, State Auditor's Office management thoroughly reviewed and monitored the conduct of the audit to assure adherence to standards.

Our conclusion on the benefits of investment expertise on governing boards is not dependent on the problems we found with SBOE's decision-making process and the behavior of certain SBOE members. Our 1996 report, which reported no such problems at SBOE, included a similar recommendation for legislative consideration.

Our recommendation was then, and still is, applicable to the boards of other major investing entities regardless of whether we found significant problems with board oversight.

Selected SBOE Responses Summarized: The Group Response and one of the individual responses criticized our unwillingness to delay issuance of the report until SBOE could deliberate and agree on a collective response to our draft report in a public meeting.

State Auditor's Follow-Up Comment: The State Auditor's Office followed a response process to which the SBOE Chair and our Office had agreed before we distributed our draft report. After discussing the possibility that the Chair could compile SBOE members' responses into a single response, the Chair suggested that it would be better to permit each of the 15 elected SBOE members to speak for him- or herself.

We asked SBOE members to respond within three weeks, although we customarily request responses from agency management within two weeks. We later extended the deadline an additional 10 days after some members requested more time, and we accepted any responses submitted after the second deadline. We did not agree to the last-minute request to wait for a collective response developed in a board meeting for three reasons: the possible lengthy delay, the possibility that SBOE members would not reach a consensus, and our concern that public debate of our draft report prior to its availability to the Legislature and the public would diminish oversight of SBOE's decision-making process.

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Legislative Issues

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Overall Summary

The Legislature has further strengthened controls over investment practices at major state investing entities by implementing several recommendations from our 1996 report. The Legislature has additional opportunities to enhance the ability of the major investing entities to manage state investments and increase the amount of useful information the Legislature receives about investment management.

The Legislature's Adoption of Our Prior Recommendations Had Significant Impacts on State Finances

Passage of the Permanent University Fund (PUF) constitutional amendment to improve the method used to determine the PUF's annual distributions resulted in an increase in distributions over the estimates under the old method. The University of Texas System Board of Regents increased the fiscal year 2000 distribution by \$45.3 million (almost 18 percent) and the fiscal year 2001 distribution by \$63.1 million (almost 25 percent) over the amounts they would have been required to distribute under the old constitutional provisions.

Additionally, some sources estimated an annual increase in lending revenues of between \$1.6 and \$2.6 million as a result of eliminating a statutory restriction on the ERS securities lending program.

The Legislature Could Further Strengthen Controls and Improve Finances

The Permanent School Fund (PSF) continues to operate under constitutional restrictions on annual distributions that were removed from the PUF. Likewise, the Higher Education Fund (HEF) will face similar constitutional restrictions when it becomes sufficiently funded to begin making annual distributions.

Other recommendations that the Legislature may wish to consider are as follows:

- Require most board members of major investing entities to possess professional investment expertise.
- Clarify the authority of TRS and ERS to delegate investment decisions to outside managers.
- Require periodic external investment practice reviews, possibly to include compensation studies, of all major investing entities.

Changes to Constitutional and Statutory Requirements at Major Investing Entities Could Improve Their Ability to Optimize Management of State Funds

The following issues would require legislative action to implement our proposed changes.

Section 1-A:

Total Return Strategies for Two Funds Would Focus Investment Policy on Maximizing Returns and Stabilizing Distributions

Some Benefits of a Total Return Strategy for the PUF

Changing the PUF to a total return strategy allowed The UT System Board of Regents to do the following:

- Initially increase the current biennium's annual payout to the Available University Fund by \$108 million above the prior level without jeopardizing the long-term purchasing power of the PUF.
- Better manage the annual payout so that it keeps pace with inflation.
- Increase the PUF's allocation to stock-type investments, resulting in an expectation of higher long-term total investment return.
- Manage the PUF as it manages all other endowment funds it controls.
- Maintain the highest possible credit rating on the bonds guaranteed by the PUF, as evidenced by a major rating agency's favorable response to the amendment.

A constitutional change permitting PSF and the HEF to manage their investment and distribution policies on a total return basis, like most endowment funds, would provide several important benefits (see text box at left). The funds could make distributions from total returns (interest, dividends, and gains) instead of just from current income (interest and dividends), as is now required. Under total return strategies, fund managers could base investment decisions almost entirely on the long-term investment benefits they expect those decisions to provide.

The proposed constitutional change for PSF and HEF would be similar to the 1999 constitutional amendment for the PUF. That amendment changed

the way The UT System Board of Regents determines the annual distributions from PUF.

Existing spending restrictions for PSF and HEF may prevent these funds from taking full advantage of opportunities in the investment market to maximize long-term investment benefits (see text box at right). The funds may achieve high long-term total return, but fund managers may not be

Basing Endowment Spending Solely on Income Can Have Negative Consequences

In a 1999 study, only 4 percent of the 473 participating North American endowment funds reported basing their annual distributions on the amount of their current income (interest and dividends).

Endowment fund literature warns that basing endowment spending solely on current income can have negative long-term consequences. This policy can cause undesired swings in the level of distributions or allocation decisions that sacrifice total return to preserve current income. We have observed examples of both undesired outcomes at PSF and PUF (before the amendment).

able to consistently grow the annual distributions from these funds. This can occur because investing more in stocks and less in bonds usually results in higher overall gains and higher total return but lower current income. Both PSF and PUF have experienced periods recently in which investment performance (measured by total return) was excellent but annual distributions sometimes declined.

Existing restrictions may also cause fund managers to sacrifice higher long-term

“Spend All Income” Restrictions Affect Investment Decisions

At its March 3, 2000, meeting, at least one SBOE member was reluctant to reallocate PSF investments out of some potentially overvalued stocks and into some attractively priced bonds, despite a strong recommendation to do so from its outside investment counsel. This rebalancing, which SBOE finally approved, also resulted in an increase in annual distributions to the Available School Fund under existing restrictions. The SBOE member’s hesitancy to heed this sound advice was in part due to a valid concern regarding future distributions under the constitutional restrictions.

The SBOE member correctly reasoned that if stock prices later fell and bond prices increased, SBOE would want to rebalance again by moving some assets out of bonds and into stocks. Both contemplated rebalancings would help SBOE accomplish the old adage of “selling high and buying low.” Unfortunately, the latter rebalancing would also result in a decline in distributions. That decline could negatively affect the State’s budget if the appropriated budget had projected a continuation of the prior, higher distribution level. Moreover, because of an appropriation rider, the failure to meet budgeted distributions could also limit SBOE’s future ability to pay certain investment management expenses.

Under a total return spending policy, SBOE could have accomplished both desirable rebalancings without altering the projected annual distribution amounts that had already been included in the State’s budget.

return by choosing investment allocations designed instead to satisfy the need for current income (see text box at left). Until the 1999 PUF constitutional amendment, the University of Texas Investment Management Company (UTIMCO) was not able to implement its desired allocation to stock-type investments because annual distributions would have declined.

Before adopting any proposed constitutional changes, the State should obtain favorable rulings from the Internal Revenue Service (IRS) to ensure that the tax-exempt status of any bonds supported by these funds is not affected. Tax-exempt status lowers the State’s and the participating school districts’ interest costs. Such IRS rulings could take considerable time and complex negotiations. Therefore, the sooner this process starts the greater assurance the State could have that it could adopt the constitutional changes without negative consequences.

The Legislature could draft the constitutional changes permitting these funds to be managed using total return strategies in a way that would minimize the possibility that future distributions could deplete the funds. The 1999 PUF amendment included general language and specific limitations that mandated a sound long-term distribution policy. Changes to PSF and HEF restrictions could contain similar provisions.

If legislators adopt this recommended change, they should also consider changing the standard of care imposed on the fiduciaries of the two funds. The 1999 PUF constitutional amendment replaced the “prudent person” standard of care with the “prudent investor” standard for management of the investments.

Recommendation:

The Legislature should consider adopting constitutional amendments for PSF and HEF that permit the management of the funds and their annual distributions using total return strategies. If adopted, the revision of the distribution rules and the investment standards of care should follow the model of the 1999 PUF amendment.

Furthermore, to ensure no negative tax implications result from these amendments, the State should consider beginning negotiations with the IRS as soon as possible. The appropriate parties for such negotiations may include personnel at TEA, the Office of the Comptroller of Public Accounts (which oversees the HEF), the Office of State-Federal Relations, the Attorney General, and/or outside legal counsel. These parties should consider consulting with UT System management, which may have previously addressed this issue in relation to the PUF amendment.

Comments From the Texas Education Agency:

The agency agrees that a total return-based spending policy could help the Permanent School Fund better meet its objective of growing the corpus of the PSF while generating a growing revenue stream to the Available School Fund. It would remove constraints from the investment of the PSF portfolio that are imposed by the need to manage it to meet expected biennial income targets. Removal of these constraints should improve the long-term total return of the PSF.

The agency agrees with the recommendation to obtain a favorable ruling from the Internal Revenue Service with respect to the Permanent School Fund bond guarantee program. However, we do not believe it is likely that the IRS will respond to an inquiry before the 2001 legislative session is over. Some consideration should be given to a contingency provision that defers implementation of a spending rule until a favorable response from the IRS can be obtained.

Comments From Mr. Chase Untermeyer, Chair, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

This is an ironical recommendation, considering that the report accuses SBOE of imprudence in managing the PSF. "Total return" would be a major leap backwards from the prudent, cautious, and conservative approach the Fund's creators specified in order to preserve it for untold generations of Texas schoolchildren. Especially if management of the Fund were put in the hands of appointed financial speculators, the Fund's integrity could be endangered – and move a future state auditor to issue a report lamenting the adoption of the imprudent "total return strategy."

Comments From Geraldine "Tincy" Miller, Vice-Chair, State Board of Education:

See Texas Education Agency Section 6 for full text of letter in which Ms. Miller disagrees with the recommendation for a total return strategy for the PSF.

Comments From Dr. Joe Bernal, Member, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

While I am impressed by your reference to a 1999 study that only 4 percent of the 473 of the participating endowment funds reported basing their annual distributions on the amount of their current income (interest, dividends, and gains), it seems that what we have been doing, drawing income from interest and dividends has been working quite favorably for our growing PSF fund. However, the Total Return strategy item has not been discussed in the PSF committee during the past 2 years. I would certainly want to listen to experts on the matter before I would commit to changing from what has otherwise been working quite well for the PSF up until now.

Comments From Dr. Don McLeroy, Member, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

As a citizen, I voted against the constitutional amendment to allow the Permanent University Fund to “raid” its “corpus” to keep the cash flowing into the Available University Fund. I do not believe it was a wise decision for the Permanent University Fund and especially do not believe it would be a wise decision for the Permanent School Fund. I am very surprised to see this recommendation in your report. I believe our Texas pioneers showed great wisdom in the prudent restrictions they established for the Permanent School Fund over a hundred years ago.

State Auditor’s Follow-Up Comment:

The total return concept for endowment funds has been widely recognized in authoritative literature for more than 30 years. Some proponents of this concept include the Ford Foundation, the National Conference of Commissioners on Uniform State Laws (NCCUSL), a committee of the American Institute of Certified Public Accountants, and the legislatures of 46 states, including Texas. The concept, typically codified in some version of the NCCUSL’s Uniform Management of Institutional Funds Act (UMIFA), acknowledges that trust law concepts, which distinguish between current income and capital gains, hinder the investment and management of endowment funds. We have not encountered any authoritative literature that rejects the total return concept or that advocates the benefits of the current constitutional restrictions on PSF and HEF.

In 1989, the Texas Legislature adopted its version of UMIFA and in 1993 made the statute applicable to endowment funds of institutions of higher education such as The UT System’s \$3.1 billion Long Term Fund (LTF). The statute includes standards of prudence and overall expectations for endowment funds that, if adhered to, should not permit the oversight boards to jeopardize the future purchasing power of the underlying investments. The statute also acknowledges that, far from jeopardizing the future success of an endowment fund’s investment and spending policies, UMIFA was designed to help make such success possible.

Although several SBOE members commented on the strong growth of PSF in recent years, none commented that this growth was achieved at a price of temporarily decreased annual distributions from the fund. In fiscal year 1995, when SBOE

decided to move PSF into a much higher allocation to stocks instead of the fund's emphasis on bonds, it knew that the expected increase in total return and PSF principal growth would be accompanied by a temporary decline in annual distributions but determined that to be a prudent long-term action nevertheless.

The fiscal year 1999 annual PSF report documents that annual distributions had declined every fiscal year since 1993 except for an increase in fiscal year 1996 due to a one-time statutory accounting change. That decline, from \$739 million to \$662 million, represented a 10 percent decrease in actual dollars paid out at the end of the six-year period. More recent investment reallocations by SBOE caused the declining trend to reverse beginning in fiscal year 2000¹.

A common goal of an endowment fund is to increase annual payout to keep pace with inflation. Thus, if the fiscal year 1999 payout was adjusted for an average inflation rate of 2.5 percent over the six-year period, PSF distributions declined by almost 23 percent. If the distributions had kept pace with inflation, the 1999 distribution would have been \$857 million instead of \$662 million.

Although SBOE's underlying approach to increasing the long-term health of PSF was reasonable, its inability to make distributions from PSF's cumulative total return resulted in strong principal growth but a temporary decline in the actual purchasing power of the fund's distributions. Because the student population also increased during the six-year period, the per capita distributions declined further compared to the combination of price inflation and population growth.

In contrast to the experience of PSF, The UT System was able to change its investment strategies for its LTF endowment fund to a higher equity allocation without major disruptions to the LTF's income beneficiaries. Because UMIFA permitted the LTF to operate using total return investing and spending policies, The UT System was able to freeze the dollar payout rate during fiscal years 1993 through 1997 while simultaneously increasing the LTF's allocation to equities. The capital markets' ensuing performance was so robust that the payout rate increased in fiscal year 1998 by 11.4 percent, including a one-time "bonus," by another 7.7 percent in fiscal year 1999, and by another 16.7 percent in fiscal year 2000. As a result, while PSF's payout declined by 10 percent during the six-year period ending August 31, 1999, the LTF's payout rate increased by 20 percent (outpacing overall inflation) in this same period, and increased by 40 percent in the seven fiscal years ending August 31, 2000.

The total return concept has not resulted in imprudent distribution decisions at The UT System. As intended, when the Legislature allowed the use of this concept in 1993 by

¹ The rapid growth in stock prices caused the PSF's percentage of stock holdings to exceed the desired level established by SBOE investment policy. This resulted in "rebalancings" during fiscal year 2000 in which the PSF sold excess stock holdings and purchased bonds with the proceeds. These rebalancings caused annual distributions to begin increasing again, much sooner than expected by the 1995 SBOE when it began the shift to a higher stock allocation. The PSF staff estimates that fiscal year 2000 distributions will be \$699 million, still below the fiscal 1993 amount. Projected fiscal year 2001 distributions of \$768 million will exceed the fiscal year 1993 level but will not have kept up with inflation. Future changes in stock and bond prices could necessitate rebalancings that could decrease or increase future distributions.

some state endowment funds, its practical application has facilitated better management of both the investments and distributions from those funds.

Section 1-B:

Greater Investment Expertise on Governing Boards Could Improve PSF's Oversight

Most of the State's major investing entities have no statutory requirement that a majority of their governing board members possess substantial investment expertise. The complexity of the modern investment environment suggests that boards whose members had such expertise could most effectively handle their fiduciary responsibilities. Governing boards need this investment expertise because:

- Huge sums of money are involved.
- The investment environment for such large funds is extremely complex.
- The failure to understand the risk of a contemplated action or inaction could have a tremendous impact, as a small change in the investment returns can represent millions of dollars.

Except for TRS, the State's major investing entities have no statutory requirement that a majority of their governing board members possess substantial investment expertise. Although not statutorily required, The UT System Board of Regents has adopted this principle when appointing members to UTIMCO's board of directors. In addition, the Texas Constitution mandates that the four appointed public members of the nine-member Texas Growth Fund "must have demonstrated substantial investment expertise."

If most board members had investment expertise, they could rely more on personal knowledge and less on the advice of outside professionals in making important long-term investment policy decisions. Such decisions include asset allocation targets, ranges and rebalancing strategies; acceptable and unacceptable asset classes, which might include complex private investments and derivative strategies; and selection and evaluation of outside consultants and money managers and key internal investment personnel. Most of the recent problems noted at SBOE may have arisen from SBOE's need to rely too much on outside parties, including individuals who had no fiduciary responsibility to SBOE (see Texas Education Agency Sections 1 and 2).

Statute permits SBOE to create a nonprofit investment management corporation. However, even if SBOE creates this corporation, it cannot increase the investment expertise on the PSF oversight board. The statute that permits SBOE to create the corporation does not permit the appointment of any corporate trustees who are not SBOE members. Therefore, if no SBOE members have outside investment expertise, the corporation's board of trustees will not have this expertise either.

In this respect, the current statute differs significantly from the one adopted by the 74th Legislature, which permitted The UT System to create UTIMCO. That statute permits, but does not require, The UT System's Board of Regents to appoint up to five outside members to UTIMCO's nine-member board. As previously stated, the regents

have typically chosen to appoint the maximum number of outside members who have all had significant investment expertise.

Besides not permitting SBOE to bring additional investment expertise to the corporation, that enabling statute does not establish the size or selection process for the corporation's board. Although all trustees must be SBOE members, the statute does not state that all SBOE members must be trustees of the corporation. A fifteen-member corporate board seems unnecessarily large and costly. In addition, the statute does not provide guidance on how SBOE would choose which SBOE members would serve on a smaller corporate board. Without further legislative guidance, SBOE members might not be able to agree on the size and selection process for that board.

Recommendation:

To help ensure increased professional investment expertise on the governing boards of the State's major investing entities, the Legislature may wish to consider some of the following options for the entities listed or to devise other solutions.

We note that board members with substantial investment expertise are likely to be presently or previously involved in the investment business and will have potential conflicts of interest. Requirements for investment expertise on boards should also include requirements for strong ethics and conflict of interest policies.

For the State Board of Education (see also Texas Education Agency Section 1-A):

- Amend the Texas Constitution to create a separate appointed Permanent School Fund investment board to oversee PSF. The existing State Board of Education would retain its education functions. PSF investment board members should be required to have substantial investment expertise. The amendment would need to insert the name of the new investment board in place of any investment-related references to SBOE in the Texas Constitution.

The Legislature could give the investment board its own budget, possibly funded from investment returns, and permit it to appoint and replace the fund's chief investment officer. For administrative purposes, PSF's employees could remain at TEA. If the Legislature creates this separate investment board, it may wish to reconsider the need for the oversight board's ability to create a nonprofit investment management corporation.

- Explore the legality of changing the Education Code to mandate, rather than leave as an option the creation of a nonprofit PSF investment management corporation. Instead of requiring all trustees of the corporation to be SBOE members, the statute should require appointment of some outside trustees so that a majority of trustees would have substantial investment expertise. The Legislature may also wish to specify in statute the number of trustees, which should probably be considerably less than the current 15-member SBOE group, and the selection process for all trustees. SBOE would continue to have final responsibility for PSF.

- Change the elected SBOE to an appointed board and require that several appointees possess substantial investment expertise. This option may be less effective than the previous ones because it may result in diluting SBOE's education expertise without ensuring that a majority of appointees have investment expertise. Each member would still be responsible for both education and investment decisions.
- Explore the possibility that the constitutional requirement for a state board of education permits a hybrid board, consisting of both appointed and elected members. If so, the Legislature or the Governor could appoint some members to the board based on their demonstrated investment expertise while allowing voters to continue to elect the other members. This approach offers no advantages over the other options in terms of investment oversight, except that it may not require a constitutional amendment and may still allow citizens to vote for some members of the board.
- Retain the constitutionally created State Board of Education but, by statute, restrict its duties to the oversight of PSF investments and require that its members be appointed and have substantial investment expertise. Create in statute a new board responsible for education issues only. We have not investigated whether the Legislature could make this new statutory education board an elected body in order to preserve SBOE's current structure. This approach has the advantage of avoiding the need for a constitutional amendment, but it would result in an investment board whose name does not match its function.

The Constitution also makes the State Board of Education responsible for setting aside a sufficient sum of money to provide free textbooks for public school students. If the Legislature considers this an education-related function, it might need to change the Constitution if it wanted to transfer that function to the new statutory education board. Or it might be able to statutorily require that the investment board coordinate this function with the new education board. Finally, the Legislature would need to resolve any transitional legal issues related to the unexpired terms of the current elected SBOE members, including exploring the possibility of appointing them to the new education board.

For the Employees Retirement System:

- Change the statute to require that the Board have substantial investment expertise. None of three appointed trustees are required to have substantial investment expertise, nor are any of the three trustees elected from the employee class of membership.

For the Comptroller of Public Accounts (an elected official - no governing board exists):

- Create one or more outside board(s) to provide investment expertise for the various funds that the Comptroller of Public Accounts manages.

For The University of Texas System:

- Modify the statute that permits creation of UTIMCO to require most directors to have substantial investment expertise, which reflects The UT System Board of Regents' current policy.

Comments From the Teacher Retirement System:

Five of nine TRS trustees are required to "be persons who have demonstrated financial expertise, who have worked in private business or industry, and who have broad investment experience, preferably in investment of pension funds." We have found that the core duty of managing the pension trust fund is significantly enhanced by the availability of trustees having such experience.

Comments From Mr. Chase Untermeyer, Chair, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

Assuming that the Constitution is not changed to alter SBOE's responsibility over the PSF, I favor creation of a nonprofit corporation to oversee the management of the Fund. When I say this responsibility should be taken away from TEA, I mean no hostility toward the Agency. The TEA's focus is and should always be on education and nothing else. Managing a large and diversified public fund is an extraneous burden it ought not bear. There is nothing in the way of educational policy connected with running the Fund, since neither TEA nor SBOE dictates how its income is spent.

Comments From Dr. Don McLeroy, Member, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

The governance structure of the Permanent School Fund has a major and obvious flaw-- the Board is not permitted to appoint and replace the Fund's Chief Executive Officer. The Board must have the highest confidence and trust in their Chief Executive Officer; the Board also must be able to depend upon the Chief Executive Officer as their foremost adviser. In my short tenure on the Board I have witnessed many of the results of this structural flaw. Here are just three.

- *There appeared to me to be little agreement or cooperation between the Permanent School Fund Committee and the Fund's Chief Executive Officer to implement the process for issuing new RFP's for the Board's outside investment consultant services. In fact, the Fund's Executive Director abruptly resigned one week before the July 1999 Board meeting when the RFP's were to be approved. This was not your normal resignation.*
- *At the September 1999 Board meeting it was proposed to hire Plexus Group for trading efficiency analytics. (This recommendation did not come from existing staff or consultants.) Why was this service only now being adopted by the Permanent School Fund? This service saves the Fund money and helps to evaluate the quality of performance of each money manager. I asked an experienced Board member why we had not used these services before and he*

said he did not know they existed. Would not a good Chief Executive Officer, as the foremost Fund adviser, have started this process or service earlier, especially if he were interested in the best performance possible?

- *At the beginning of my second year on the Board the Commissioner abruptly ended a collaborative selection process for our new PSF Chief Executive Officer and personally selected the new Chief Executive Officer with little or no consultation with the Board.*

*Thus, I would like to add a simple recommendation to the Legislature to substitute for all your recommendations. **Permit the State Board of Education to appoint and replace the Permanent School Fund's Executive Director.***

Comments From Other State Board of Education Members:

See Texas Education Agency Section 6 for full text of letters from several SBOE members whose comments disagree with our recommendation that increased investment expertise on the governing board might improve the fiduciary oversight of the PSF.

Comments From the Employees Retirement System:

In 1963, the composition of the ERS Board of Trustees was carefully crafted by the Legislature. Its structure as well as the elected and appointed members who have sat on the Board has served the state and the beneficiaries of the trust very well over the past 37 years. Further, the Sunset Commission reviewed the governance of the system in 1992 and considered a recommendation very similar to the one under consideration and determined that no change should be made. The ERS has continued to meet its mission to provide efficient delivery of high quality benefits and the retirement trust fund is more than sufficiently able to continue to do so into the future.

The ERS believes the role of the Board is to set strategy and policy for the entire system, which does not require specific investment expertise. However, when investment expertise is required the Board is assisted by its Investment Advisory Committee which is comprised of seven investment professionals from around the state, external investment consultants and advisors and a professional internal investment staff. In fact it is felt that having a professional on the Board would significantly increase the likelihood of conflicts of interest such as has been experienced elsewhere.

The ERS believes the current system of appointments provides the greatest discretion to the Governor, Speaker of the House, and Chief Justice. The current election system allows a means for beneficiaries to participate in selecting trustees. Thus, in the view of the ERS there is no reason for the statute to be changed.

Comments From the Comptroller of Public Accounts:

We embrace the idea of an advisory board and will seek legislation to provide for it.

State Auditor's Follow-Up Comment:

We continue to believe that the benefit of including relevant expertise at the board level increases as the size of investment funds grows. We recognize that a board with a wide range of responsibilities cannot devote a majority of its members to just one function. On the other hand, boards that oversee large investment funds as one of their few primary responsibilities could benefit from resident investment expertise.

For example, a broad range of decisions confronts a university board of regents, including faculty and student issues, major construction project design and approval, bond issuance, annual budgets, research programs, and fund raising. Although virtually every university manages investments, we do not suggest that those boards would function more effectively overall if their members had significant outside investment experience.

However, for the university with by far the largest overall investment portfolio, the Legislature and The UT System Board of Regents did recognize that a separate investment entity that has a largely professional board could be an important asset to the State. Similarly, the Legislature has ensured that board members have relevant expertise at several other entities that oversee investments, including TRS, the Texas Growth Fund, the Texas Tomorrow Fund, and the Veterans Land Board.

Section 1-C:

TRS and ERS Could Better Manage Overall Investment Return and Risk if Allowed to Delegate Investment Decisions

TRS and ERS, with combined portfolios of approximately \$110 billion as of August 31, 2000, are the only major investing entities that lack authority to delegate investment decisions to external money managers. Both agencies might be able to better diversify their investment portfolios if permitted to delegate some investment decisions to outside investment professionals. This authority could permit access to additional asset classes that might be highly profitable or that could help control overall portfolio risk but that would be difficult or impossible for internal staff to manage alone.

In 1996, an independent investment consultant reported to the Legislative Audit Committee that TRS should diversify its portfolio into additional investment types. The consultant recommended that TRS could best accomplish this using external managers if constitutionally and statutorily permissible. The in-house staff may not be able to provide the special expertise and/or research resources (or might not be able to do so cost-effectively) for some types of investments.

Virtually all other major state investing entities and most smaller investing entities have been given constitutional or statutory authority to delegate investment decisions to outside investment professionals. However, based on a 1999 Attorney General

Opinion concerning TRS, TRS and ERS apparently do not have this statutory authority (see text box below). A public pension fund organization's survey of 22 U.S. public pension funds larger than \$5 billion reported that all but one use external managers to some degree.

After our previous report, TRS requested an Attorney General Opinion on whether it

Statutory Language That Did Not Give TRS Delegation Authority is Similar to Language Used Recently to Grant the Comptroller's Delegation Authority

The Attorney General ruled in May 1999 (during the 76th legislative session) that TRS did not have the authority to delegate investment decisions to outside managers. This ruling should apply equally to ERS. Both agencies have the following statutory language the Attorney General cites in reaching his conclusion about TRS:

- *The board of trustees may contract with private professional investment managers to assist the board in investing the assets of the retirement system.*

However, the 76th Legislature's action creates some confusion as to the Opinion's application. Legislative hearings and the Comptroller's resulting appropriation indicate that the Legislature was permitting the Comptroller to use external money managers. The following language the Legislature used to authorize the Comptroller to delegate its investment management is almost identical to the language the Attorney General cites as preventing TRS from delegating its authority:

- *The Comptroller may contract with private professional investment managers to assist the comptroller in investing funds under the care, custody, and control of the comptroller.*

had statutory authority to delegate investment decisions to outside managers. The Attorney General determined that TRS did not have statutory authority to delegate. However, the Attorney General supported its conclusion in part by citing rulings concluding that trustees typically cannot delegate. The 76th Legislature later changed the Property Code to expressly permit trustees to delegate investment decisions unless the trust instrument forbids delegation. It is unclear if this change would alter the Attorney General's Opinion. In addition, when the 76th Legislature gave delegation authority to the Comptroller of Public Accounts (Comptroller), it used language almost identical to the TRS language on which the Attorney General opined (see text box at left).

Elsewhere in this report, we noted that, while ERS might not have delegated its investment decisions, for all practical purposes its external advisors manage certain ERS portfolios (see Employees Retirement

System Section). ERS uses its internal investment personnel to closely monitor every recommendation or transaction of these firms through extensive review procedures. However, ERS's reviews almost never result in a change in the outside firms' recommendations or transactions. If ERS had delegation authority, it could reasonably curtail these transaction-level reviews without incurring significant additional risk. Then, its internal investment personnel could devote more of their efforts to ERS's internally managed portfolios.

On the other hand, if it stopped using these outside firms, ERS might find it necessary to reduce the fund's diversification by discontinuing certain investment types or styles. This could reduce the effectiveness of ERS's investment strategies.

The Texas Constitution, Article XVI, Section 67 (a)(3), requires both retirement system boards "to administer the system and to invest the funds of the system in such securities as the board may consider prudent investments." The boards are required to

adhere to the prudent person rule in making investments. We find this language unclear regarding the retirement systems' constitutional delegation authority. A literal and narrow interpretation of the Constitution might be that the boards must do all of the investing themselves. They therefore could not permit external money managers to decide how to invest any funds even if the board put contractual limits on those managers' decisions. A more liberal interpretation might conclude that, by carefully selecting external managers, limiting the managers' strategies to those the board considers prudent, and monitoring the managers' contract compliance and investment performance, the board could be deemed to have invested the funds as it considers prudent. This uncertainty suggests that even if the Legislature chooses to give TRS and ERS clear statutory authority to delegate decisions, the Attorney General might later declare such a statute unconstitutional.

Recommendation:

The Legislature should consider giving TRS and ERS the same statutory and/or constitutional authority to delegate investment decisions to external managers that it has given to other investing entities. Although external management fees typically entail higher costs, the managers can provide TRS and ERS with access to additional profitable investment strategies and asset classes. Such access may provide higher expected return and/or better management of overall risk through increased diversification. The governing boards and internal investment staff of ERS and TRS appear to possess sufficient skills to make prudent manager selection and retention decisions.

Furthermore, the Legislature should consider clarifying the Comptroller's statutory authority to delegate. Clarification would ensure that a future Attorney General's Opinion would not cite the 1999 TRS Opinion and then similarly conclude that the Comptroller lacks delegation authority. Such a conclusion would contradict the 76th Legislature's intent.

Comments From the Teacher Retirement System:

We support the State Auditor's Office recommendation regarding the suggested clarification on delegation of investment decisions.

Comments From the Employees Retirement System:

The ERS has been functioning for an extensive period without the recommended changes and has encountered no problems of any significance. However, the ERS does not object to the proposed changes being made statutorily since there is the possibility of some additional flexibility if needed in the future. Regarding the possibility of a constitutional amendment, the need simply does not exist to merit a constitutional amendment and the ERS would not support such a proposal.

Section 1-D:

Periodic External Reviews of Investment Practices Could Provide the Legislature With Assurances That the State's Investments Are Well Managed

A periodic, independent review of the major investing entities' investment practices and performance could provide the Legislature with useful information about the management of these large funds. Currently, only TRS receives a periodic review. An independent firm conducts this review and reports to the Legislative Audit Committee. While the first such review in 1996 reported that TRS investments were well managed overall, it contained useful recommendations for improvements. (This review covers specific technical areas beyond the scope of audits from the State Auditor's Office.)

Mandating reviews, such as the one required for TRS, could provide assurance to the Legislature that the other investments are being well managed overall. The reviews could also provide comparative information on performance and staff compensation to assess whether the major investing entities are able to offer adequate salaries to attract and retain highly competent investment professionals.

The Legislature has previously increased the ability of state investing entities to pay more competitive investment salaries. These recommended investment reviews could also help determine if and when the Legislature should consider addressing the salary issue again.

Recommendation:

The Legislature should consider requiring and overseeing periodic independent investment practices and performance reviews at all the major investing entities. Investment specialists who report directly to a legislative body such as the Legislative Audit Committee should perform these reviews. In addition to overall investment, fiduciary, and management controls, the reviews should include assessments of asset allocation decisions, investment strategies, investment performance, and benchmarks. The Legislature should consider periodic investment staff compensation studies in conjunction with these reviews.

Comments From the Texas Education Agency:

The agency would welcome periodic review of the investment practices and performance of the Permanent School Fund by a qualified third party. Should the Legislature opt to periodically review other state investing entities as well, we would recommend that information collection and reporting regarding service providers, brokerage transactions and any other areas of concern be collected by one state authority to ensure uniform definitions and minimum standards of disclosure. Many of the types of transactions identified by the State Auditor as creating potential conflicts of interest carry the same potential between two or more state funds that they do within a single fund. We believe that one agency comparing uniform disclosures

across any or all state funds would have a greater likelihood of detecting any conflicts of interest or other violations of law.

Comments From Mr. Chase Untermeyer, Chair of the State Board of Education (see Texas Education Agency Section 6 for full text of letter):

Concur.

Comments From Dr. Joe Bernal, Member, State Board of Education (see Texas Education Agency Section 6 for full text of letter):

I concur.

Comments From the Teacher Retirement System:

We support periodic reviews of investment practices as beneficial to all parties interested in state investments.

Comments From the Employees Retirement System:

The ERS Board of Trustees is constitutionally charged with the fiduciary responsibility for the operation of the System that includes the oversight of investment practices and performance. To help them with this endeavor, the Board is assisted by its internal auditing staff, its external auditor, Deloitte and Touche and its investment performance consultant, Callan & Associates. Additionally, the ERS is subject to periodic reviews by the State Auditor's Office. The ERS feels that the retention of another independent investment specialist is a redundant and unnecessary expense.

State Auditor's Follow-Up Comment:

*We agree that the ERS Board obtains useful information from the sources referred to in ERS management's comments, and this information is also available to the Legislature. However, as we noted in *A Review of Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996), the type of periodic review we recommend would require the expertise of an investment specialist and would cover investment issues beyond the scope of the State Auditor's review of investment practices controls. We believe that such an external review, successfully performed at TRS in 1996, is also beyond the scope of ERS's internal auditing activities and its external financial statement audits.*

The review we propose would be conducted by a contractor that would report directly to a legislative body, further differentiating this review from most of the existing investment oversight that ERS cites. In selecting a vendor for the 1996 TRS project, the Legislative Audit Committee (LAC) took care to ensure that potential vendors were fully aware that their client was the LAC and not TRS. Furthermore, to ensure that there was little chance that the successful bidder would use the LAC contract as a

stepping stone to obtain future business from TRS, the contract placed a limit on future TRS business that the vendor could solicit. We believe that continuation of this process in the reviews we recommend will ensure that the Legislature receives useful information free from any appearance of bias.

We note that ERS agreed with their external financial statement auditor's 1997 recommendation to contract for periodic actuarial audits that would assess the work of ERS's external actuaries. The periodic investment reviews we propose would provide the Legislature and each major investing entity with a similar second opinion on, or challenge of, each entity's investment decisions or underlying assumptions.

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Overall Summary

We are concerned that the State Board of Education's (SBOE) decision-making processes in its oversight of the \$22 billion Permanent School Fund (PSF) have been seriously weakened since our prior audit. That audit concluded that overall controls over investment practices were adequate. Numerous problems, some of which are of SBOE's own making, have impaired SBOE's oversight processes. As a result, SBOE might not have made sound decisions concerning contract awards and other issues related to the investment and management of PSF. Furthermore, while the questionable decisions might not have placed PSF assets at significant risk, the situation harms the credibility of both SBOE and PSF.

The following factors contributed to the impaired decision-making process:

SBOE Has Not Had Adequate Access to Investment Expertise

- Neither the Constitution nor statutes require that any SBOE members possess substantial investment expertise, and SBOE members typically do not possess such expertise (see Section 1-A). The lack of resident expertise contributes to the need for SBOE members to rely on other parties for expert investment advice.
- SBOE lacks access to a functioning, effective Investment Advisory Committee (see Section 1-B). A committee of independent investment experts who closely advise SBOE on investment issues could help SBOE compensate for its own lack of resident expertise.

SBOE Members May Have Been Influenced by the Advice of Outside Parties Who Had Conflicts of Interest or Other Possible Impairments to Their Independence

- Possibly as a result of their lack of adequate access to investment expertise, some SBOE members gave an informal advisor (Advisor) substantial access to the decision-making process. Much of this access occurred privately. These SBOE members did not take prudent steps to identify the Advisor's undisclosed business partner (Partner) and the Advisor's undisclosed financial interest in SBOE policies and PSF investment transactions (see Section 2-A).
- SBOE hired a consultant (Performance Consultant) who has significant undisclosed relationships with the Advisor and the Partner, resulting in a possible impairment of the Performance Consultant's independence of judgment. Furthermore, SBOE has permitted the Performance Consultant to provide services outside the scope of his firm's contract. Some of these services overlap the scope of another consultant's contract, and others appear inappropriate because of his relationship with the Advisor and the Partner (see Section 2-B).

- SBOE chose not to impose a suggested control designed to reduce the potential for improper actions related to the Performance Consultant's firm's potential conflict of interest. The consulting firm is in the brokerage business, but SBOE hired it to evaluate money managers who choose which brokers they do business with. SBOE did not prohibit the Performance Consultant from requesting brokerage business from the managers he evaluates, and it chose not to require the managers to disclose any such requests (see Section 2-C).

SBOE Has Conducted Its Business in a Manner That Impedes the Effective Management of the Permanent School Fund

- SBOE sometimes voted on important issues without first resolving last-minute assertions introduced by SBOE members that materially affected those issues. At least one assertion was apparently erroneous but probably changed the outcome of two votes. In two cases, these votes have been accompanied by unusual occurrences that raise questions of possible attempts by outside parties, including the Advisor, to influence these decisions (see Section 3-A).
- Some SBOE members have made numerous allegations, often unsupported, against PSF staff members, other SBOE members, former consultants, and several of PSF's external money managers (see Section 3-B).

Some SBOE Members Have Not Acted Prudently to Minimize PSF's Investment Costs When Implementing a State-Mandated Economic Development Goal

- While attempting to send more business to Texas-based historically underutilized business (HUB) brokerage firms, to comply with state law, some SBOE members have suggested that PSF staff should pay higher brokerage commissions than normal for similar services (even higher than requested by one of those firms). (See Section 4.)

Finally, our follow-up review indicated that SBOE and the PSF staff have made some improvements on the most significant prior audit recommendations (see Section 5).

Section 1:

SBOE Has Not Had Adequate Access to Investment Expertise

The law does not require SBOE members to possess substantial investment expertise, and members typically do not have such substantial expertise to help them make knowledgeable decisions on the complex issues involved in overseeing the \$22 billion Permanent School Fund. Disagreement between the former Commissioner of Education and some SBOE members has left SBOE without a functioning Investment Advisory Committee (IAC). Prior to the disagreement, the IAC did not meet frequently enough to be fully effective. SBOE members without investment expertise, lacking access to an effective IAC to provide investment advice, have looked to outside parties to provide expert advice. This situation gives these outside parties more influence on investment decisions than might be desirable.

Section 1-A:

SBOE Members Are Not Required to Individually or Collectively Possess Substantial Investment Expertise

Although SBOE is charged with overseeing a large endowment fund (\$22 billion in assets as of August 31, 2000), neither the Texas Constitution nor statute requires its members to have substantial investment expertise. SBOE members who have investment backgrounds are more likely to make well-informed decisions on the complex investment issues affecting PSF's success. In addition, SBOE members without expertise are more likely to need to rely on advice from outside parties, giving those parties a greater impact than necessary on the oversight and management of PSF. Because SBOE members are currently elected, requiring members to have investment expertise to qualify for holding office might be impractical.

According to the biographical information on SBOE's website, SBOE is composed of intelligent, educated, successful individuals committed to public education issues. Several have professional experience in education. Members' academic credentials include doctorates and other postgraduate degrees in education-related fields, dentistry, and law. Service on the Committee on School Finance/Permanent School Fund (PSF Committee), which most closely oversees PSF, seems to have enhanced some SBOE members' understanding of institutional investment issues.

However, with the exception of one SBOE member who has a degree in business administration, no member's biography indicates formal education in investment-related areas. None holds the designation of Chartered Financial Analyst (CFA), perhaps the most comprehensive investment-related certification. Three members are involved with real estate and/or insurance sales including one who holds a securities license, the closest to an investment credential reported on the website. However, none appears to have worked in institutional investment environments such as banking, insurance, or portfolio management.

Some SBOE members have acknowledged their lack of understanding of investment issues. One PSF Committee member stated that he did not ask to be on the Committee because he knows little about investments.

In June 2000, another SBOE member not on the PSF Committee told a legislative committee charged with investigating SBOE's oversight of PSF that he "doesn't know anything about investing." He also stated that until May 2000 he was not aware of PSF's \$15 million annual brokerage commission expense and the discretionary interrelationships between money managers and brokers in that process. He had served on SBOE for almost a year and a half prior to gaining this understanding. However, records indicate that before May, he voted on at least six brokerage-related issues. In three cases, which resulted in decisions that did not eliminate or mitigate

potential conflicts of interest, 8-7 votes decided the issues with this SBOE member voting on the prevailing side.²

For the most part, SBOE members campaign on issues related to the State's system of public education. One PSF Committee member testified to a legislative committee that he did not know what PSF was when he was elected to SBOE. Their education backgrounds might suit them, therefore, to shaping and overseeing the State's public education system. However, effectively overseeing a \$22 billion investment fund requires different knowledge and skills. Conversely, an SBOE member with substantial institutional investment fund experience would not necessarily have the appropriate qualifications to best address important education issues.

The State's education policy and investment oversight needs might be more effectively served if separate boards handled each function. The board that deals with education policy could continue to be composed of members with specific interest and expertise in education issues. Likewise, the investment board could be comprised of members with expertise specific to institutional investing. Such a change may require an amendment to one or more sections of the Texas Constitution.

Recommendation:

The Legislature may wish to consider ensuring substantial investment expertise for the oversight of PSF through one of the options detailed in the recommendations under Legislative Issues, Section 1-B. Those options include:

- Amend the Texas Constitution to create a separate appointed investment oversight board comprised of members who have investment expertise.
- Make implementation of the nonprofit PSF investment management corporation mandatory instead of optional and requiring most of the corporation's trustees to have investment expertise.
- Return to an appointed SBOE in which several appointees have investment expertise.
- Determine the allowability of a hybrid SBOE to include, in addition to the elected members, appointees who had investment expertise.
- Appoint the current constitutional SBOE and restrict it to oversight of PSF while creating in statute a new education board, which could possibly be an elected board.

² Board minutes show that this board member participated in the following votes prior to May 2000:

- At least three brokerage policy issues.
- Twice voted to hire a firm that derives half of its income from brokerage commissions as a consultant to evaluate the performance of the PSF's money managers. The managers generate brokerage commissions, some of which could be directed to the consultant. (8-7 vote)
- Voted against imposing restrictions designed to prevent the consultant in the brokerage business, whose duties include recommending when the Board should terminate any of its money managers, from requesting any favors such as extra brokerage business from those managers. (8-7 vote)

If the Legislature chooses not to revise SBOE's structure, the recommendations in the sections that follow, related to an IAC, stronger ethics policies, and use of consultants, become even more important.

Management's or Board Members' Responses:

No comment by agency management.

See Section 6 for SBOE members' responses.

Section 1-B:

SBOE Lacks Access to a Functioning and Effective Investment Advisory Committee

SBOE has not recently had access to a functioning Investment Advisory Committee (IAC). Although SBOE established the IAC's existence in Texas Administrative Code, Chapter 33, Rule 33.20, and in internal SBOE rules, the IAC has not met in several years. Texas Education Agency (TEA) and SBOE have disagreed on SBOE's authority to appoint IAC members. In the past, the IAC's large size and infrequent meetings limited its effectiveness in compensating for SBOE members' lack of investment expertise. As a result, SBOE members have not had access to a formal committee of investment experts to help them oversee PSF.

The legal dispute arose in 1998, with TEA's Chief Counsel stating that SBOE apparently did not have the authority to appoint members to a committee. According to 1998 SBOE minutes, the prior Commissioner of Education might have insisted that he had the final appointment authority for the IAC members, although SBOE could make recommendations. Apparently, neither the SBOE Chair nor the PSF Committee Chair attempted to assert their authority to convene the IAC. (SBOE's Investment Procedures manual provides that authority.)

Even before the dispute disrupted its operations, the IAC was too large and met too infrequently to be much help in advising SBOE. The established practice of permitting each SBOE member to name an IAC member resulted in a committee of fifteen members, which seems unnecessarily large and potentially costly, as TEA reimbursed the members for their expenses. In addition, the IAC did not typically meet before each PSF Committee meeting, and sometimes met less than once a year. In contrast, the Employees Retirement System's (ERS) investment policy requires its IAC to have between five and nine members, all of whom must either be experienced in investment management or be economics or finance educators. The ERS IAC generally meets the day before each board meeting to consider investment issues in depth and provide technical investment recommendations to the board.

Unfortunately, implementing a smaller, more useful IAC might be difficult for TEA and SBOE. SBOE and/or TEA management would need to determine the membership selection process if each SBOE member no longer names one representative. As discussed in Section 3-B, several SBOE members have demonstrated deep mistrust of the TEA staff and some outside PSF service providers. Unless SBOE members trust the IAC, and they may not do so if they cannot appoint

the members, a retooled IAC still will not resolve SBOE's major decision-making weaknesses.

Recommendation:

If the Legislature does not change the composition of SBOE to ensure that a large number of SBOE members have substantial investment expertise, TEA and SBOE should work together to determine how to create an effective IAC. Issues to be resolved include the following:

- Whether current law permits SBOE to appoint the IAC.
- The minimum qualifications for membership (All ERS IAC members as of November 2000 held Ph.D. or Chartered Financial Analyst designations or were otherwise involved in investment-related businesses).
- Ethics and disclosure policies to ensure the IAC members' independence. SBOE's new ethics policy, and standards promulgated by the Association for Investment Management and Research (AIMR), should apply to the IAC.
- The optimal size of the IAC (as of November 2000, ERS uses a seven-member IAC). The IAC should have substantially fewer than 15 members.
- The meeting frequency and expectations. We recommend that the IAC meet publicly prior to each PSF Committee meeting and provide SBOE with written recommendations.
- How members will be reimbursed, if at all.
- Terms for which IAC members serve. Staggered terms might be helpful.
- A process for removing IAC members.

Management's or Board Members' Responses:

The opinion from the agency Chief Counsel in 1998 (discussed in the second paragraph on page 39) addressed the authority of the State Board of Education to form an advisory committee under its statutory authority over textbooks. Based in part on Attorney General's Letter Opinion 98-099 (1998), the opinion concluded that no statutory authority existed to create such a committee and that one could not legally be formed. However, the agency has subsequently advised the State Board that under its constitutional authority to manage the Permanent School Fund, the Board may create an Investment Advisory Committee. The agency does believe that only a committee appointed by the commissioner of education qualifies for reimbursement of expenses pursuant to Rider 15 of the Texas Education Agency appropriation in the current appropriations act.

The agency is prepared to assist the State Board in naming an Investment Advisory Committee that has appropriate expertise to serve the best interests of the PSF.

See Section 6 for SBOE members' responses.

State Auditor's Follow-Up Comment:

The exact date of, or underlying support for, the legal dispute is not relevant to our overall finding and recommendation. TEA has since provided a copy of the legal memo referred to in their response; however, our finding does not refer to this memo. Instead, we have cited statements made by the PSF staff, the Chief Counsel, and SBOE members according to unofficial transcripts of the March and May 1998 PSF Committee meetings. These unofficial transcripts also support statements made in the response signed by six SBOE members that the initial dispute about who could appoint IAC members actually arose prior to 1998 (see Section 6).

Section 2:

SBOE Members May Have Been Influenced by the Advice of Outside Parties Who Had Conflicts of Interest or Other Possible Impairments to Their Independence

Without access to resident investment expertise on SBOE or an IAC, SBOE has needed to rely more extensively on other parties to help it make important investment decisions. However, SBOE members used some outside parties for this purpose who had business or personal relationships that resulted in conflicts of interest or other possible impairments to their independence of judgment. Moreover, those individuals did not disclose most of these relationships to SBOE. By accepting advice from individuals whose independence of judgment is not assured, SBOE increased the risk that it would unknowingly rely on advice that was not intended solely to benefit PSF.

Section 2-A:

SBOE Members Relied on an Informal Advisor Who Failed to Disclose a Conflict of Interest

Certain SBOE members permitted an informal advisor (Advisor) to influence SBOE decisions without ensuring that the Advisor was free from any conflicts of interest. The Advisor benefited financially from PSF brokerage commissions after his business partner (Partner), who did not disclose their financial relationship, successfully lobbied SBOE to change PSF's brokerage policies. As a result, SBOE members exposed themselves and PSF to the risk that the Advisor, who had no fiduciary obligation to SBOE, might be more concerned with obtaining personal profit than with providing advice that would protect PSF's interest (see text box on next page for some of the Advisor's known activities).

In addition, because the Advisor and these SBOE members communicated privately, the rest of SBOE, the Legislature, and the public may have been unaware of how important decisions were made and who was involved in making those decisions. SBOE members' lack of investment expertise and their lack of access to an official advisory committee apparently contributed to the Advisor's ability to gain their trust.

Finally, the Advisor's ongoing relationship with one or more SBOE members seems to make him subject to the requirements of SBOE's new ethics policy that was mandated by the 76th Legislature. The new policy took effect April 2, 2000, and it identifies individuals subject to the policy because they act as "PSF Service Providers." The policy describes an individual as a PSF service provider if an SBOE member "gives the person access to records or information that are not currently available to the public or without otherwise complying with the Public Information Act" or asks the person to interview or meet with current and potential PSF contractors. If the Advisor had continued his prior relationship with some SBOE members after the policy's effective date (see text box at left), he would have met the criteria of a PSF service provider. Evidence exists showing that, after April 2, an SBOE member sent the Advisor copies of correspondence to and from that SBOE member involving PSF business. As a result of receiving this direct access to PSF information, the Advisor appears to have become subject to the new policy and apparently violated it by not making the required written disclosures, such as his apparent conflict of interest.

Much of the SBOE Members' Communication with the Advisor Occurred in Private. Some of the Advisor's Publicly Disclosed Activities for Certain SBOE Members Suggest He Had a Substantial Involvement With SBOE Business:

- At a November 4, 1999, PSF Committee meeting, an SBOE member stated that the Advisor would be his financial advisor at every meeting.
- An SBOE member asked that a bidder for a consulting contract consent to be interviewed by the Advisor.
- The Advisor accompanied two SBOE members to Chicago to interview the SBOE's finalist for a consulting contract. (After that interview, the finalist declined the contract.)
- An SBOE member asked the PSF staff to provide information directly to the Advisor so the Advisor could review banking costs.
- The Advisor helped prepare a comparative analysis of bids for PSF banking services. His presentation of this analysis to the PSF Committee generally contradicted the PSF staff's analysis on the cost impact of a contemplated SBOE decision.
- An SBOE member asked the PSF staff to provide extensive financial information to the Advisor, estimated by staff to cost more than \$14,000 to compile.
- An SBOE member asked the Advisor to obtain information from another State agency about a bank bidding on an SBOE contract.
- The Advisor gave some SBOE members access to tape recordings of his conversations with members of a consulting firm bidding on two SBOE contracts. Based on those recordings, an SBOE member erroneously accused the bidder of lying to the PSF Committee, virtually eliminating that firm from its position as finalist for those contracts.
- The Advisor helped some SBOE members pursue complaints to the SAO and Attorney General's Office about the activities of several PSF money managers.

By law, SBOE must enforce its ethics policy. However, SBOE cannot ensure thorough enforcement until it identifies all PSF service providers including those who are informal because they have no contract with TEA. The PSF staff, for example, must solicit and obtain periodic disclosures from all PSF service providers. If SBOE members meet privately with informal PSF service providers, those SBOE members must disclose those relationships to effectively identify everyone who is subject to the ethics policy.

providers. If SBOE members meet privately with informal PSF service providers, those SBOE members must disclose those relationships to effectively identify everyone who is subject to the ethics policy.

Neither the Advisor Nor His Partner Disclosed to SBOE Their Business Relationships

The Advisor failed to disclose to SBOE his 49 percent ownership interest in two companies (Parent Company and Subsidiary Company) that could benefit if SBOE voted to direct 20 percent of PSF's brokerage commissions to historically underutilized businesses (HUBs). Because PSF paid approximately \$15 million in commissions on stock transactions in 1999, this new policy could result in HUB brokerage firms receiving at least \$3 million per year in commissions from PSF transactions.

The Advisor's Partner owns the remaining 51 percent of these two companies. On at least three occasions in 1999, the Partner lobbied the PSF Committee in favor of that change in PSF brokerage policy, but neither he nor the Advisor disclosed their business relationship. Furthermore, the Partner misrepresented himself as a member of another brokerage firm (Third Company, a HUB brokerage firm) each time he lobbied the PSF Committee and in all his dealings with the PSF staff. Such actions possibly violated the National Association of Securities Dealers (NASD) rules governing his and the Subsidiary Company's conduct. Had the Partner disclosed his involvement with the Parent or Subsidiary Company, SBOE, the PSF staff, or the public could have been alerted that the Advisor had a financial interest in the proposed policy change.

The Partner told the PSF Committee that the Third Company could provide competitive brokerage services to PSF. However, he did not disclose that his Subsidiary Company would receive 60 percent of the commissions the Third Company earned from all PSF trades.

The Advisor started privately consulting with at least two SBOE members in late 1997. In early 1998, the Advisor and the Partner began researching the use of HUB brokerage firms by state investing entities. The Partner told us that he asked an assistant to file several Open Records requests so that he could obtain this information without revealing his identity to the state entities that received these requests. The Advisor and the Partner's subsequent activities positioned them to benefit from HUB brokerage business with PSF:

- In the summer of 1998, the Advisor invited the Partner to attend a dinner function at which the two SBOE members he advised were to be honored. The Advisor, who was a guest at a table purchased by one of the SBOE members, introduced the Partner to the two SBOE members.
- In July 1998, the Advisor and the Partner chartered the Parent Company. The Advisor owns 49 percent of the Parent Company and the Partner owns 51 percent. Although later certified as a HUB, it is not a brokerage firm registered with NASD. It is therefore precluded from earning brokerage commissions.
- In late 1998, the Parent Company began the acquisition of the Subsidiary Company, which was an NASD-registered brokerage firm. According to information filed with NASD, the acquisition became effective July 1, 1999.

These filings report that the Subsidiary Company had employed the Partner since September 1998, and he became its president in December 1998.

- In March, July, and September 1999, the Partner addressed the PSF Committee, misrepresenting himself as a member of the Third Company. He spoke to the Committee in support of SBOE's HUB brokerage policy change. The Third Company, an NASD-registered brokerage firm, is a Texas-certified HUB. The Partner never disclosed to the PSF Committee that he was an officer and owner of the Subsidiary Company. All five PSF Committee members told us they assumed the Partner was either an employee or principal of the Third Company.
- During 1999, the Partner distributed business cards and brochures stating that he was the Managing Director and/or the General Securities Principal of the Third Company at a Houston location. The Houston telephone numbers on these materials were apparently the Partner's home telephone numbers. In his sworn testimony to a legislative committee in June 2000, the Partner admitted that he was never an employee of the Third Company. The testimony of the Third Company's president and CEO confirmed that admission and indicated that the Third Company did not have a Houston office. He indicated that such an office would need to be registered with NASD. The Partner then testified that his misrepresentation occurred for not more than a month or two. However, documents indicate that the Partner held himself out as a member of the Third Company for no less than six months.

The Partner's misrepresentations may have violated one or more rules applicable to the Partner and the Subsidiary Company as NASD registrants. NASD filings confirm that the Partner was never registered as an employee of the Third Company. To protect investors and ensure compliance by registrants, NASD created NASD Regulation, Inc. (NASDR). Statements on NASDR's website indicate that the organization wants to know about any potential misconduct by members.

- On July 8 and 9, 1999, the PSF Committee and the full SBOE, respectively, voted to adopt the HUB brokerage policy advocated by the Partner. The policy established a goal of directing 20 percent of PSF's brokerage business, or approximately \$3 million per year, to HUB brokerage firms.
- The Third Company's President agreed to pay the Subsidiary Company 60 percent of any commissions his firm earned through the Partner's solicitations on behalf of the Third Company.

As a result of these efforts, the Subsidiary Company earned approximately \$183,000 in commissions between July 1999 and May 2000 from the Third Company's stock trades for PSF. The Subsidiary Company may have had additional earnings if it received some brokerage business directly from PSF external managers during this period.

All profits distributed by the wholly owned Subsidiary Company would normally belong to the Parent Company, and all profits distributed by the Parent Company would be expected to go to the Advisor and the Partner, who were its owners. Any profits not distributed but instead reinvested in the Subsidiary Company serve to

increase that firm's market value. Thus, the Advisor directly benefited from PSF's brokerage policy.

SBOE Members Consulting Privately With the Advisor Did Not Attempt to Identify His Apparent Conflict of Interest, and Three SBOE Members Did Not Share Important Information With Other SBOE Members

Although two influential members on SBOE's PSF Committee had worked with the Advisor since late 1997, neither attempted to discover this apparent conflict of interest. Such discovery procedures, including requesting disclosure of all income sources, are consistent with their fiduciary obligation to protect PSF's assets. (When SBOE later hired its primary investment consultant, also referred to as the lead consultant, the Request for Proposal appropriately required that bidders disclose all financial relationships with affiliated organizations, potential conflicts of interest, other business services provided, and the amount of fees received from money managers. SBOE considered that information in assessing those firms' freedom from possible conflicts of interest.)

Furthermore, these two SBOE members neglected to share the following important information with the rest of SBOE's members on any of the three occasions in 1999 when the Partner appeared before the PSF Committee:

- The Advisor had introduced the Partner to them in the summer of 1998 at a dinner function.
- At the Partner's request, one SBOE member had met prior to the 76th Legislative Session with the Partner and a legislator interested in HUB issues.
- The same SBOE member knew that the Advisor and the Partner had a business relationship at the time the Partner made his first presentation to the PSF Committee (March 1999). The SBOE member provided this information in response to a direct question during his sworn testimony to a legislative committee on May 19, 2000.

In his April 24, 2000, written response to us, however, the SBOE member did not disclose specific knowledge of such a relationship. Instead, he wrote, "I am aware only that [the Advisor] spoke of considering forming a business with [the Partner] at some time in the past." Whichever response, written or testimonial, more accurately describes the SBOE member's knowledge, it is apparent that, by early 1999, he had information which he should have shared with other SBOE members as soon as the Partner made any presentations to the PSF Committee.

A third PSF Committee member also failed to disclose to SBOE that:

- His longtime friend was a consultant for the Third Company and would benefit financially if the Third Company received PSF brokerage business.
- He attended a meeting in a restaurant in which his longtime friend and the Partner discussed the brokerage business.

SBOE members, as fiduciaries, would reasonably be expected to be concerned with such information. Furthermore, several SBOE members had publicly expressed their discomfort with the Advisor's extensive involvement in SBOE business.

Unlike PSF's paid consultants, advisors, and staff, the Advisor had no contractual fiduciary obligation to SBOE or PSF. One PSF Committee member who relied on the Advisor told us that he did not believe he could sue the advisor in the event the Advisor had knowingly provided self-serving advice. In addition, the Advisor had no license or professional certification that would have subjected him to regulatory oversight or adherence to professional ethics standards. Such standards typically forbid, or require full disclosure of, any personal interest that might conflict with PSF's interests. As a result, the Advisor had little incentive to disclose his financial interest in PSF transactions.

Recommendation:

Specific Actions Related to Possible Violations of Law, the New Ethics Policy, or NASD Regulations

SBOE should revise its ethics policy to require that all SBOE members disclose any individual not under contract with TEA who has served them as a PSF service provider since the policy took effect. SBOE, in consultation with TEA's chief counsel, should then determine if the actions of the Advisor, the Partner, and possibly other parties named by SBOE members, have violated the Education Code's conflict of interest disclosure provisions, which became effective September 1, 1999, or SBOE's new ethics policy, which became effective April 2, 2000.

SBOE may also need to assess whether its ethics policy includes sufficient and effective enforcement capability to deter misconduct. The policy imposes insufficient disincentives to violators, particularly those who are not under contract with SBOE or TEA, SBOE should consider adding such disincentives. Disincentives could include termination of any current PSF business, debarment from future PSF business for a specific period of years, and possibly a directive to other PSF service providers not to conduct any PSF business with the violator.

SBOE or TEA should assess the appropriateness of filing a complaint or a regulatory referral with NASDR concerning the Partner's various oral and written misrepresentations to the PSF Committee, the PSF staff, and PSF contractors or Request for Proposal respondents.

General Actions

In general, we recommend that individual SBOE members avoid extensive private consultation with outside parties related to the oversight and management of PSF. All members should have access to the same professional advice about PSF management, and the public should be able to observe the process. If the Legislature chooses to require increased investment expertise on SBOE, or if SBOE has an effective IAC, SBOE members should not need such private advice.

Nevertheless, to the extent that SBOE members seek private consultation, members should resolve to adhere to the following good business practices, which SBOE should consider including in its ethics policy:

- Fully disclose in writing, to the Commissioner of Education and the SBOE chair, all such personal advisory relationships. Official notification will help SBOE and the PSF staff enforce the ethics policy by identifying everyone subject to the policy's disclosure requirements.
- Refrain from sharing confidential information with, or relying on the advice of, anyone lacking the technical qualifications to provide sound investment advice. Members who use informal advisors should disclose information about the advisors' technical qualifications to provide investment advice.
- Refrain from sharing confidential information with, or relying on the advice of, anyone lacking independence. To demonstrate independence, advisors should disclose in writing the nature and source of all monetary compensation they receive. SBOE members should acknowledge their own responsibility to perform sufficient due diligence procedures to verify the completeness and accuracy of these disclosures.
- Communicate in writing to the Commissioner and the SBOE chair, for distribution to all SBOE members, the subjects about which the advisor is providing advice or information, and the content of that advice or information.

In addition, to avoid even the appearance of any conflict of interest or favoritism in decision making, SBOE should commit to, and consider including in the ethics policy, the following:

- Disclose publicly any outside relationships, whether personal, political, or financial, with any individual who appears before the PSF Committee or SBOE to speak on an issue before SBOE.
- Discuss with TEA's legal counsel, the SBOE chair, or the PSF Committee chair the need to recuse oneself from any discussion or vote when an individual with whom an SBOE member has a disclosable relationship speaks on that issue.

Management's or Board Members' Responses:

The agency understands this recommendation to be directed to the State Board of Education. Agency staff is available to assist the Board on this recommendation in any matter that the Board chooses to authorize.

See Section 6 for SBOE members' responses.

Section 2-B:

The Performance Consultant's Undisclosed Relationships With the Advisor and the Partner and His Provision of Services Outside the Scope of His Contract May Conflict With Statute, SBOE Policy, or His Contract With the Agency

Education Code, Section 43.0032, Conflicts of Interest (Added by the 76th Legislature, effective September 1, 1999)

- (a) A member of the State Board of Education, the commissioner, an employee of the agency, or a person who provides services to the board that relate to the management or investment of the permanent school fund who has a business, commercial, or other relationship that could reasonably be expected to diminish the person's independence of judgment in the performance of the person's responsibilities relating to the management or investment of the fund shall disclose the relationship in writing to the board. (Emphasis added)

- (c) A person who files a statement under Subsection (a) disclosing a possible conflict of interest may not give advice or make decisions about a matter affected by the possible conflict of interest unless the board, after consultation with the general counsel of the agency, expressly waives this prohibition. . . . (Emphasis added)

A consultant (Performance Consultant), hired by SBOE in September 1999 and again in January 2000 to measure and evaluate the performance of PSF's investment managers, did not disclose his significant financial and advisory relationships with the Advisor and the Partner. As a result, it appears that the Performance Consultant may have violated the disclosure requirements of the Education Code, SBOE's recently adopted ethics policy, and the consulting contract he signed with TEA.

The Education Code, the ethics policy, and the consulting contract (which cites the Education Code's conflict of interest provisions), require that the Performance Consultant disclose in writing to SBOE any relationships that might reasonably be expected to diminish his independence of judgment with respect to PSF (see text box at left). Had the Performance Consultant disclosed these relationships to SBOE either before or after his hiring, SBOE might have

made different hiring decisions or taken steps to limit the scope of his involvement in SBOE decisions.

The Advisor testified to a legislative committee on June 30, 2000, that the Performance Consultant had previously loaned the Advisor and the Partner as much as \$60,000. Although the creditor and debtors testified somewhat differently on the extent of repayment of any loans, each indicated that the loans had not been fully repaid as of June 30, 2000. The testimony indicated that the loans began in 1998 and helped the Advisor and Partner form the Parent Company and acquire the Subsidiary Company. The Partner's sworn testimony indicated that he and the Advisor had already received some loans prior to the time they disclosed their business plan to the Performance Consultant. He testified that the Performance Consultant was supportive of their plan and said something to the effect of, "Here's something to keep you all floating while you're building this thing." The Advisor testified that sometimes the Performance Consultant gave him money and told him, "Take care of (the Partner) on this."

The Advisor, the Partner, and the Performance Consultant's testimonies also revealed that the Performance Consultant hosted the Parent Company's annual meeting at his home on July 11, 1999. That date was two days after SBOE adopted its HUB

brokerage policy and two months before SBOE hired the Performance Consultant. (The unusual circumstances under which the Performance Consultant was hired, and the Advisor's role in those circumstances, are discussed in Section 2-C.)

The Partner testified that he filed HUB paperwork with the General Services Commission in which he listed the Performance Consultant as an "advisor" to the Parent Company in connection with the annual meeting. He testified that the Performance Consultant participated in an informal role as a mediator, sage, and advisor to the Parent Company. He paraphrased the Performance Consultant's advice as, "I've been around thirty years. You guys have been around ten. Maybe you should look at it this way and not kill each other." The Advisor testified that the Performance Consultant mediated disagreements between the Advisor and Partner, including their dispute concerning the best way for the Parent Company to acquire its brokerage subsidiary (Subsidiary Company).

In response to direct questions, the Advisor's testimony also indicates that attendees of the annual meeting discussed the Parent Company's first year accomplishments, which included its success in lobbying SBOE to pass the HUB brokerage policy. Discussion also included HUB brokerage strategies related to PSF, including the Parent Company's affiliation with the Third Company.

Testimony about these personal advisory and financial relationships demonstrates that the Performance Consultant knew about, was involved with, and supported, the Advisor and Partner's business plan. In short, that plan included acquiring the Subsidiary Company and entering into a relationship with the Third Company to obtain HUB brokerage business from state funds (such as PSF).

The Performance Consultant's support of the Advisor and Partner's business endeavor, and his position as their creditor, could reasonably diminish his independence of judgment on any issue that might affect the Advisor and Partner's business interests. Although testifying that he did not expect the loans to be repaid, the Performance Consultant stated that he would like to be paid back if the Advisor and Partner were able to do so. Additionally, the Performance Consultant's role as evaluator of PSF's money managers creates at least the potential that he could treat more favorably the money managers who gave brokerage business to HUBs affiliated with the Advisor and Partner. Therefore, we believe that, under the law, the ethics policy, and his contract with TEA, the Performance Consultant should have disclosed to SBOE these advisory and financial relationships with the Advisor and Partner.

SBOE Has Not Limited the Performance Consultant's Role to That Specified in His Firm's Contract

The Performance Consultant often participates in SBOE business unrelated to the performance measurement and evaluation function for which his firm was hired. In responding to SBOE's Request for Proposal for a broad range of consulting services, the Performance Consultant's firm clearly stated that it preferred to be hired only to provide performance measurement services. SBOE hired another firm (Lead Consultant), in a separate bid evaluation process, concluding that firm was the best qualified to provide all of the remaining required consulting services such as asset allocation recommendations and money manager selection. By allowing the

Performance Consultant's actions to overlap the Lead Consultant's role, SBOE may permit confusion and conflicting advice to occur, and does not ensure that technical services are performed by those it has judged to be the best qualified to perform each specific task.

In addition, as noted previously, the Performance Consultant has certain personal and financial relationships with the Advisor and the Partner. Therefore, the Performance Consultant's involvement in some of the following issues, in which the Advisor and the Partner could benefit financially, appears inappropriate.

For example, during a May 11, 2000, discussion of HUB brokerage commission rates, meeting tapes indicate that SBOE did not formally request the Performance Consultant's involvement but rather that he raised his hand to speak on this issue. The Education Code and SBOE's ethics policy prohibit a person who discloses an actual or potential conflict of interest from giving advice on a matter affected by the possible conflict unless SBOE expressly waives that prohibition. The Performance Consultant's advice on HUB brokerage commissions was relevant to his undisclosed relationships with the Advisor and the Partner. We believe that, by advising on this issue, he may have violated the intent of the law and SBOE's new ethics policy. His relationships with the Advisor and the Partner's HUB venture represented a material fact that he should have disclosed to all PSF Committee members before they decided whether to permit his participation on this topic.

From testimony to the legislative committee described previously, it is reasonable to conclude that the Performance Consultant knew that the Advisor and the Partner may benefit if the PSF staff took his advice about brokerage commissions. A financial benefit to the Advisor and the Partner could increase their ability to repay their debts to the Performance Consultant. Therefore, even if the Performance Consultant provided sound advice on this issue, his undisclosed potential financial interest created at least the appearance of a conflict of interest. As discussed below, moreover, his advice did not appear to promote PSF's best interest.

Also unrelated to his performance measurement function, the Performance Consultant contacted SBOE's Lead Consultant to suggest revising the asset allocation alternatives that the Lead Consultant would present to SBOE in May 2000. At the March 2, 2000, PSF Committee meeting, we heard the Performance Consultant advise the Committee that PSF should never get involved with certain investment types. At the September 14, 2000, PSF Committee meeting he advised the Committee to eliminate another investment type in which PSF currently invested. Providing this type of asset allocation advice is clearly within the mandate of the Lead Consultant. The Performance Consultant testified to a legislative committee on June 30, 2000, that his firm's proposal, which SBOE incorporated into his contract, made it "very clear" that the firm did not want to perform the asset allocation function.

In another instance, he evaluated cost proposals of the banks bidding on custody and securities lending services for SBOE. (He might have actually performed this function before being hired, in which case he was not bound by a contractual fiduciary obligation to SBOE.) Unbeknownst to SBOE, the Advisor and the Partner at one time had a potential financial interest in doing business with those banks. The Partner had solicited brokerage business from some of those banks during the bidding process, so both the Advisor and the Partner would have benefited financially if the Partner's

solicitations had been successful (see Section 2-C regarding the award of banking contracts). Had SBOE known about the Advisor and the Partner's activities related to the banks and the Performance Consultant's relationships with the Advisor and the Partner, it might not have permitted the Performance Consultant's involvement with this evaluation.

The Performance Consultant's Brokerage Advice to the PSF Committee Did Not Promote Protection of PSF's Assets by Minimizing Investment Costs

Part of the Performance Consultant's advice on the brokerage commission issue discussed above does not appear to give highest priority to SBOE's fiduciary responsibilities. The Performance Consultant had an opportunity to suggest how SBOE could reduce costs on some of its brokerage commissions. Instead, he suggested that PSF send more trades to HUB brokers at "full service" commission rates. Most HUB brokers are likely to offer a reduced range of brokerage services that can ordinarily be obtained at a discount (see text box on page 68). In his first presentation to the PSF Committee in March 1999, the Partner had asserted that SBOE should insist on receiving a discounted commission rate for such services and that the Third Company was willing to provide such discounts (see text box on page 69).

The Performance Consultant advised that the PSF internal staff presently gives far more business than necessary to large, established brokerage firms. He stated that a much lower level of business would provide PSF with maximum access to the investment research and related services those firms provide. He suggested that PSF could redirect some of this "excess" brokerage business to HUB brokers without reducing the level of investment information the internal portfolio managers receive.

This assertion, and in particular the exact level below which service would begin to decline, is difficult to validate. The investment staff at PSF and another large state fund told us that their funds would probably experience a decline in service if they significantly cut their business with the large firms. The PSF staff relies heavily on the information they receive from the large brokerage firms because PSF lacks a large in-house research function. In addition, if PSF ranks among these firms' top clients, the firms are more likely to provide the PSF staff with direct access to high-ranking executives of the firms in which PSF invests.

The Performance Consultant concluded that PSF is currently paying a higher commission rate than necessary on what he considered to be the excess trades through these large firms that provide both research services and trade execution. Therefore, he advised that it was not unreasonable to pay the same "full price" commission to the HUB brokers, such as the Third Company, even if those firms offer to provide only trade execution.

Sound fiduciary principles and written SBOE policy require that PSF's investment managers seek the lowest price and best trade execution in determining which brokers to use. The Performance Consultant may be correct that PSF could reduce its business with the full-price, full-service brokers without suffering any decline in service. In that case, the Performance Consultant's fiduciary responsibility indicates that he should have recommended that PSF routinely seek a discounted brokerage rate

whenever research is not provided, regardless of whether the discount broker is another large firm or a HUB.

Recommendation:

We recommend that the SBOE chair, the Commissioner of Education, and TEA's chief counsel and ethics officer assess whether the Performance Consultant violated the conflict of interest disclosure provisions of the Education Code and/or the SBOE ethics policy which are referred to in his contract. If these parties conclude that the Performance Consultant failed to make the required disclosures, they should recommend an appropriate course of action to enforce the ethics policy as mandated by statute.

Regardless of the outcome of this assessment, SBOE should formally clarify each consultant's expected duties. The Performance Consultant's firm was selected based on its stated interest in restricting its role to that of performance measurement and evaluation. In addition, SBOE will likely avoid confusion and conflict by keeping the lead consulting function separate from the performance consulting function. Therefore, SBOE should restrict the Performance Consultant's activities to that function unless the PSF Committee or full SBOE officially directs otherwise.

Management's or Board Members' Responses:

The agency believes that a determination of whether the State Board of Education's ethics policies have been violated would ultimately have to be made by the Board itself. The commissioner and agency staff will assist the Board and its Chair in whatever actions they determine are appropriate under this recommendation.

See Section 6 for SBOE members' responses.

Section 2-C:

SBOE Chose Not to Adopt a Control to Mitigate the Performance Measurement Consultant's Inherent Potential Conflict of Interest Resulting From His Brokerage Activities

In addition to the undisclosed relationship with the Advisor and the Partner, the Performance Consultant's brokerage relationships with money managers inherently entail a potential conflict of interest related to his duties for SBOE. The Performance Consultant was hired to evaluate the performance of PSF's money managers, some of whom might be providing him with substantial brokerage income. SBOE did not adopt a member's suggested restriction designed to help ensure that this potential conflict would not become an actual impairment of the Performance Consultant's independence. To effectively oversee PSF, SBOE must ensure that it is receiving impartial advice related to the performance of its investment managers.

Investment literature routinely notes an increased potential for conflicts of interest when a fund's investment consultant is also in the brokerage business

(see text box below). Prior to its initial hiring, the Performance Consultant's firm disclosed that it derives about half of its revenues from brokerage business. Investment managers have discretion in determining the brokers to whom they send trades, resulting in commission revenue for those brokers. This financial relationship sets up at least the possibility that the level of brokerage business the managers send to the Performance Consultant or other members of his firm could influence the broker/consultant's performance evaluation and hiring or firing recommendations regarding a fund's money managers.

Considerations for Fiduciaries When Selecting an Investment Consultant

Is the investment consulting firm totally independent of all investment managers, investment bankers, and stock brokerage firms? Or, is the firm owned by a parent organization that could benefit indirectly from your pension fund's business relationship? Is the outside consultant making full disclosure of any "economic involvements" with the plan's investment managers?

Outside investment consultants can contribute to the success of the plan's investment program - but only if the consultant is free of conflicts of interest. Virtually all consultants claim that they are independent. The board should insist that the pension committee hold the investment consultant to the highest level of ethical standards and business practices.

For example, most brokerage firms have consulting divisions that offer "free" or low-cost consulting services if you use their broker. But, in fact, these services are not free; they are paid for with commissions and execution costs generated by trades in your fund's account. Sometimes, these hidden costs can be substantial. The pension committee needs to be aware of and consider such hidden costs in its decision-making process. And, it should be aware that broker-consultants tend to recommend managers who have a relationship with the brokerage firm. This may inadvertently skew the manager selection process - and create fiduciary liability.

Excerpt reprinted with permission. *A Guide for Directors: How to Satisfy Pension Fund Fiduciary Responsibilities, Directorship*, November 1996, Volume 23, Issue 10, pages 3-6.

Nevertheless, in January 2000, on an 8-7 vote, SBOE chose not to adopt a motion that included requiring all PSF money managers to disclose any non-routine business requests from the Performance Consultant or members of his firm.³ The motion would have made any manager subject to termination if that manager failed to report "any contact by employees of the [Performance Consultant's firm] wherein business requests or favors are made of them [the managers] other than in the normal course of seeking information related to performance measurement." These non-routine business requests could, for example, include requests that a manager send additional brokerage business from its other clients' accounts to the Performance Consultant's firm or any other brokerage firm, including the Third Company or the Subsidiary Company. (We have not seen any

evidence or heard of any allegations indicating that anyone from the Performance Consultant's firm has made such requests of PSF managers.)

At its March 2000 meeting, SBOE enacted a new ethics policy that prohibits managers from executing PSF brokerage trades with the Performance Consultant (or with any other PSF service provider). The policy also requires disclosure of the external managers' non-PSF business with the Performance Consultant. However, the policy does not require that internal or external managers disclose non-routine business requests made by employees of any PSF service provider, including the Performance Consultant's firm. Moreover, the policy does not prohibit any PSF

³ At that same meeting, and by the same 8-7 vote, the Board awarded the Performance Consultant's firm a three-year contract to evaluate the performance of the PSF's internal and external investment managers.

service providers from making such non-routine requests. By not including such disclosure requirements or prohibitions on such requests, SBOE missed an opportunity to help ensure that it would know if a potential conflict of interest caused by the Performance Consultant's participation in the brokerage business had become an actual conflict of interest.

The recently discovered financial relationship involving the Performance Consultant, the Advisor, and the Partner creates additional concerns that current controls are not sufficient to prevent or detect inappropriate requests by the Performance Consultant. Because the Performance Consultant exerts significant influence over SBOE's decision to retain money managers, those managers could be placed in a difficult position if they are subjected to any special requests from the Performance Consultant. As a result of his debtor-creditor relationship with the Advisor and the Partner, the Performance Consultant also stands to benefit if the PSF's managers choose to send more business to the Third Company or directly to the Subsidiary Company. Although SBOE was aware of the Performance Consultant's involvement in the brokerage business, it should also have been told about his involvement with the Advisor and the Partner before it made its decision not to adopt the recommended control.

Recommendation:

We recommend that SBOE include the following requirements in its contracts with all PSF service providers and in its Code of Ethics:

- All PSF service providers should be prohibited from making non-routine requests from other PSF service providers. The term "non-routine requests" should be clearly defined to avoid ambiguity and facilitate enforceability of the prohibition by SBOE.
- All PSF service providers should be required to disclose any non-routine requests received from any PSF consultant firm.

Because identification of violators is difficult without voluntary disclosure, SBOE should consider mandating the strongest penalties on anyone who makes or fails to disclose a non-routine request.

Management's or Board Members' Responses:

No comment by agency management.

See Section 6 for SBOE members' responses.

Section 3:

SBOE Has Conducted its Business in a Manner That Impedes the Effective Management of the Permanent School Fund

SBOE has permitted votes on important issues without first resolving last-minute allegations or technical assertions that materially affected the decisions on those issues. In addition, SBOE business has been surrounded by a climate of mistrust due to numerous allegations of wrongdoing directed by some SBOE members and the Advisor at the internal professional investment staff, some external money managers, and some former consultants. Both of these issues impaired SBOE's ability to make prudent, well-reasoned investment decisions. In addition, SBOE's mistrust of the internal staff, which has a fiduciary responsibility to PSF, may have caused SBOE to rely more heavily than necessary on some of the outside parties discussed in Section 2. Furthermore, the way SBOE has conducted its meetings and other actions it has taken have apparently begun to harm SBOE's and PSF's reputations in the investment community.

Section 3-A:

The Way SBOE Has Conducted Its Meetings Has Impaired the Soundness and Appearance of Fairness of Its Decision-Making Process

SBOE has allowed material allegations or technical issues to be introduced at its meetings at the last minute without insisting on adequate resolution of these issues before voting on important PSF management decisions. In one case, an SBOE member's allegations that a bidder had lied changed the vote on two contracts. However, evidence the Advisor provided much later to a legislative committee does not support the allegations. As a result, SBOE has impaired the soundness of its decision-making process by taking action without knowing all of the facts or resolving important issues. Furthermore, these actions have undermined the appearance of impartiality in the decision-making process. These events, which have been reported in widely read investment journals, also may have harmed SBOE's and PSF's reputations in the investment community.

The allegations or technical issues and the supporting facts, if any, were not disclosed to all SBOE members or PSF staff prior to the meeting at which the decision would be made, leaving no time to research these uncertainties. Such last-minute assertions, some of which were surrounded by unusual circumstances, appear to have influenced at least the following three important contracting or investment decisions:

- The selection of a lead investment consultant and an investment performance measurement consultant. One firm was the PSF Committee's choice for both contracts but was rejected after an SBOE member made an unsupported assertion on the day of the final SBOE vote. The SBOE member claimed that a member of the firm lied to the PSF Committee, an assertion we later found to be erroneous. (See Appendix 2 for transcripts of the SBOE member's allegations and the purported evidence, which does not corroborate those allegations.)

- The selection of one or more banks to provide custody and securities lending services. An SBOE member disclosed on the day of the PSF Committee's vote that the bank recommended by PSF staff members as best and lowest bidder was not in good standing regarding state franchise taxes. That SBOE member would not tell us who gave him this tax status information. Documents indicate that someone associated with one or more SBOE members knew about this tax problem at least 16 days before that meeting but did not promptly alert the PSF staff, SBOE, or the bank to permit resolution of the issue prior to the vote.
- The decision to remove \$300 million from only one external portfolio manager's PSF holdings to accomplish a recommended shift from stocks to bonds. The PSF staff recommended a proportional reduction from several external managers' holdings. However, SBOE members cited technical reasons on the day of the final vote (without providing supporting statements from an independent consultant regarding the soundness of these reasons) to take the entire amount from one manager. By not providing technical justification for its decision, SBOE's action did not dispel concerns that the method it chose to accomplish this rebalancing was motivated by some SBOE members' dislike for this manager, not by considerations of fiduciary prudence.

In at least two of these three issues, the Advisor or another outside party alerted certain SBOE members to the point of contention. The Advisor's undisclosed financial interests increase the risk that his involvement in SBOE's decision-making process was motivated by self-interest rather than by PSF's interest. As a result, SBOE members may have incorrectly viewed the Advisor as independent when he offered this information.

An SBOE Member Made an Unsupported and Apparently Erroneous Allegation About a Potential Consultant That Influenced the Consultant Selection Process

At the September 10, 1999, meeting, the full SBOE rejected the consulting firm the PSF Committee recommended to receive two important contracts just the day before. One contract was to provide asset allocation and other investment advice (the lead consulting role), and the other was for investment performance evaluation services. SBOE rejected the firm after an SBOE member alleged at the meeting, but provided no supporting evidence, that two days earlier the firm's representative had lied to the PSF Committee about not having violated SBOE's "no contact" rule. Almost a year later, evidence provided by the Advisor to a legislative committee indicates that the SBOE member's allegations were incorrect and that SBOE's resulting contracting decisions were, therefore, based on erroneous information.

The SBOE member's statements suggested that he possessed more than one recorded conversation that proved that the representative had lied when asserting his firm had not contacted, or asked other parties to contact on his firm's behalf, any SBOE members. The SBOE member alleged that the firm's representative and its owner each asked other parties to contact SBOE members. He told SBOE, "I have it recorded." He also said, ". . . if necessary, we can provide some affidavits, and we can provide some recorded conversations . . ." to prove that the firm tried to get others

to communicate with SBOE members. On May 19, 2000, in sworn testimony to a legislative committee, this SBOE member stated that he did not have any such recordings and knew of only one relevant recording in the Advisor's possession. He testified that this tape, a recorded voice mail message, proved that the firm's owner had asked for the Advisor's assistance in delivering votes for his firm.

Even though the SBOE member did not produce any recordings for all members to review at the September 1999 meeting, SBOE voted, with no further inquiry, to hire two other consulting firms not recommended by the PSF Committee. Despite our March 2000 request, the SBOE member did not provide any recordings for our investigation. The Advisor provided two recordings (both recordings involved the Advisor and the consulting firm) to a legislative committee in June and July 2000 at the committee's request. However, we found no evidence on either recording that the rejected consultant violated the "no contact" rule by asking the Advisor or anyone else to contact SBOE members on the firm's behalf. (See Appendix 2 for excerpted transcripts of the SBOE meeting and the Advisor's recordings in their entirety.)

SBOE's rejection of the recommended consulting firm therefore appears to have been based on erroneous information. Had the full SBOE insisted on reviewing the recordings prior to awarding the contracts, we believe it would have concluded that the PSF Committee's recommended consultant did not violate the "no contact" rule. As a result of its failure to adequately resolve this last-minute concern, SBOE apparently eliminated the consulting firm the PSF Committee judged to be the best-suited for SBOE's needs.

At the same meeting, the full SBOE then awarded the performance evaluation contract to the Performance Consultant although he had admitted numerous instances of requesting others to contact SBOE members and PSF staff during the "no contact" period. The SBOE member who made the allegations of lying justified the final selection on the grounds that the accepted consultant broke SBOE's rule but *admitted* it, while the rejected consultant broke the rule and *lied* about it. However, SBOE's rules state that any firm found in violation of the no contact rule "shall be disqualified from the bidding process."

When SBOE approved the Performance Consultant, it knew that the Performance Consultant had a long-time personal friendship with the Advisor. However, the Performance Consultant did not make any written disclosure, that we believe was required, of his financial and business advisory relationships with the Advisor and the Partner (see section 2-B). Without knowledge of these relationships by one bidder, and without receipt of evidence supporting the SBOE member's assertions that another bidder lied, SBOE lacked information it should have had before voting on this contract.

A Last-Minute Revelation About a Bank's Franchise Tax Status Could Have Been Disclosed and Possibly Resolved Prior to Voting on Two Banking Contracts

In a second instance, a bank that SBOE was considering for investment custody and securities lending services was rejected in part because of a last-minute disclosure. The PSF staff had recommended the rejected bank as offering the best combination of price and services. An SBOE member disclosed on the day of the PSF Committee

meeting that the bank was “Not in Good Standing” on the Comptroller’s franchise tax database. State law prohibits a state agency from awarding a contract to a corporation that is delinquent in franchise tax.

A tax status document indicates that someone connected with SBOE knew of the bank’s tax status at least 16 days before the meeting; however, SBOE gave the bank no opportunity to resolve the issue before awarding the contract to another bidder. (An individual at the bank told us that the bank had reasonable cause to believe it was not subject to the Texas franchise tax; it resolved the issue with Comptroller’s office after its rejection.) Had SBOE delayed its vote to allow the bank reasonable time to resolve the issue, SBOE could have based its decision solely on the bidding banks’ qualifications and price.

The decision-making process appears to have been compromised by the following facts that, if made known to all SBOE members, could have affected their contract decisions:

- The SBOE member who introduced evidence of the bank’s franchise tax status at the meeting told us he received a tax status document the day before the meeting. He said he did not download the information from the Comptroller’s website himself, but he refused to tell us who gave him the document.

Another SBOE member’s subsequent letter to the rejected bank included a tax status document whose date shows that it was downloaded from the Comptroller’s website 16 days before the PSF Committee meeting. It is possible that the person who downloaded the document intentionally withheld the status information until the last minute to affect SBOE’s vote. The first SBOE member’s refusal to disclose who gave him his information prevented us from investigating possible motives.

- Had this tax status information been provided promptly to the PSF staff or to the bank, as recommended by the instructions on the Comptroller’s website, the bank would have had a chance to resolve the issue prior to the meeting.
- The Advisor’s Partner had apparently contacted at least three of the competing banks while the PSF staff and SBOE were evaluating their bids. He solicited brokerage business from at least two of those banks.
- In a letter to a legislative committee, one bank has alleged that the Partner offered to use his influence with key SBOE members to help the bank win the contract in exchange for brokerage business. In his June 30, 2000, sworn testimony to that legislative committee, the Partner denied making such an offer. However, he admitted having told an employee of that bank (a vice-president in the global custody sales department) that he knew some key decision makers on SBOE and also that he would like to obtain brokerage business from that bank.
- Two other banks reportedly received inquiries from the Partner. Neither bank made any written representation that the Partner had made a specific offer to influence SBOE’s vote, and, in a letter to the legislative committee, one bank

denied that any such offer occurred. However, that letter did indicate that the Partner had offered to assist the bank during the custodian search process, and that the bank had declined the offer. That letter and statements by PSF staff members suggest that all three banks promptly contacted PSF to disclose these inquiries by the Partner.

We have no evidence that either the Advisor or the Partner actually recommended hiring any specific bank, or that the Advisor and the Partner's brokerage firm received income from any of the banks. However, testimony to a legislative committee by two SBOE members suggests that the Advisor affected some SBOE members' votes through the following actions he performed for one of the SBOE members he advised.

At an SBOE member's request, the Advisor helped prepare an analysis of the banks' proposed bids, which he presented at the PSF Committee meeting immediately preceding SBOE's final approval of the banking contracts. This analysis questioned several of the PSF staff's conclusions on banking costs. The staff had estimated that SBOE would spend an extra \$1.2 million per year on banking costs because of SBOE's decision to split the banking services between the two particular banks rather than awarding a combined contract to a third bank. (The PSF staff had identified the third bank as the lowest cost acceptable bid, but that bank also had the recently discovered and unresolved franchise tax issue.)

At the full SBOE meeting the next day, the SBOE member who requested the Advisor's written analysis submitted only a portion of it for inclusion in the minutes. That portion of the Advisor's analysis omitted the lowest cost acceptable bid from the cost analysis. Because that portion of the Advisor's analysis included only two banks, it was not directly comparable to the PSF staff's analysis, which also included the third bank.

The partial analysis entered in the minutes concluded that the decision to split the services between two banks, instead of using only one of them, resulted in a cost increase of \$334,000. This cost increase was significantly less than the \$1.2 million estimated cost increase in the PSF staff's analysis, primarily because it did not consider the increase resulting from the exclusion of the third bank. As a result, some SBOE members might have mistakenly believed that their decision not to use the bank recommended by the PSF staff and instead to split the banking services between two other banks would result in a cost increase estimated by the Advisor to be only \$334,000. Evidence of this mistaken belief was demonstrated by an SBOE member's subsequent sworn testimony to the legislative committee that the separate cost analysis showed that the increase in cost was only \$300,000 instead of \$1.2 million.

In addition, SBOE members might have placed greater reliance on the Advisor's complete or partial analysis than they would have if they had known about the Advisor and his Partner's business activities. Had SBOE's new ethics policy been in effect during the banking contract deliberations, we believe the Advisor would have been required to disclose a conflict of interest resulting from his Partner's attempts to provide assistance to, and solicit brokerage business from, the bidders. As a result of making such a disclosure, the ethics policy would have forbidden the Advisor from giving any advice to SBOE members on the banking issue to the extent the issue was affected by the conflict of interest.

Statements Made at a Meeting to Vote on Rebalancing PSF's Investments Were Not Adequately Researched or Supported

In November 1999, some SBOE members persuaded SBOE to rebalance PSF in a manner that contradicted the PSF investment staff's recommended approach. In deciding to move \$300 million from stocks to bonds, SBOE took that entire amount from one external stock manager's portfolio instead of accepting the PSF staff's recommendation to allocate the reduction proportionally from each of six stock managers. Some SBOE members cited two technical reasons in support of the need to rebalance PSF entirely at the expense of this particular manager. The SBOE members who offered these reasons are not themselves investment professionals, yet they did not offer any opinion from their outgoing Lead Consultant to support the soundness of their reasoning on this important issue. (The Lead Consultant was still under contract, but SBOE was then in the process of hiring a new Lead Consultant.)

To retain the Legislature and public's trust, SBOE members, as fiduciaries, should be able to demonstrate that they are making reasonable decisions. For this reason, and because other SBOE members raised strong concerns that this course of action seemed unfair, SBOE would have been well-served if it had first asked an investment expert to review and validate this course of action.

Several SBOE members expressed concerns during the SBOE meeting that personal vendettas, prior allegations, and even racial discrimination (one of the firm's principals is African American) were the true causes for the recommendation to take money only from that manager. Two other SBOE members told us that they believed that one SBOE member's desire for retaliation against this manager probably played a role in the recommended action.

Some SBOE members and the Advisor had previously made numerous allegations of wrongdoing against that manager. These allegations generally had nothing to do with the firm's actual management of PSF's money but were instead concerned with the process by which the firm obtained the PSF contract. At the time of the rebalancing vote, three independent entities had already reviewed and rejected those allegations of wrongdoing, yet these same allegations persisted even after the vote. Therefore, SBOE's failure to provide expert technical assurance that it had chosen a prudent course of action did not put to rest the concerns that this action was motivated by something other than the stated technical reasons.

The two technical reasons cited to support SBOE's specific method of rebalancing were PSF's status as that manager's largest client (four times the size of the manager's next largest client), and the need to "harvest" gains. SBOE's decision to rebalance, in general, was well supported by outside advice, its own investment policy, and investment research on the importance of periodically rebalancing. However, we believe that SBOE did not adequately research or publicly discuss the two assertions to demonstrate that these reasons were valid and that both reasons supported the chosen approach.

In our opinion, assessing the PSF account in terms of its percentage of a manager's total assets is more important than only comparing the size of the PSF account to the size of the next largest client. If the manager has many smaller clients, its single largest account might represent only a small component of its client base, yet there was no discussion at the SBOE meeting that such an analysis had been performed.

The only assertion about this issue was that SBOE was fiduciarily imprudent if it permitted the PSF account to remain four times the size of the manager's next largest client. One SBOE member questioned this rationale, noting that SBOE knew this same relationship existed when it first gave funds to the manager (in March 1998). That SBOE member did not receive any information that explained why this relative account size posed risk in March 1998 or more than a year and a half later. The SBOE member who cited the relative client size as a reason for concern told us he did not request advice from the existing Lead Consultant because he lacked confidence in that consultant.

Recent advice from SBOE's new Lead Consultant, who was hired after the rebalancing vote, reinforces the appropriateness of comparing the PSF account to an aggregate level for that manager. The consultant suggested that SBOE should generally avoid representing more than about 25 or 30 percent of a manager's specific investment product.

The SBOE member who raised the technical concern told us afterward that he thought PSF represented 25 percent of that manager's accounts prior to the rebalancing. Data we obtained from the manager indicated that the PSF account represented 17.5 percent of the manager's accounts for all products combined. The SBOE member might have been referring to the percentage of the specific product managed for PSF, rather than all of the manager's accounts. If the PSF account was actually 25 percent of the manager's specific product, this level would not exceed the guidance mentioned above from the new Lead Consultant. SBOE might well prefer to establish a lower limit than suggested by the Lead Consultant. However, because the relative size of the PSF account and the manager's total product or accounts was not discussed at the meeting, there is no evidence that the full SBOE considered this issue at all. Furthermore, in our interviews with four of the five PSF Committee members, we asked them if they could describe any specific risk to PSF because its portfolio was four times larger than that of the manager's next largest client. None, including the member who raised this issue at the SBOE meeting and referred to the associated fiduciary risk, was able to explain any specific risk to PSF.

The fifth PSF Committee member declined our request for a face-to-face interview, indicating that he preferred to respond to written questions. His responses described one specific risk he believed might result from PSF being the manager's largest client. Because we were unable to ask our questions in an impromptu setting, however, we cannot reliably assess that member's awareness of this issue at the time of the vote to rebalance.

Regardless of that PSF Committee member's awareness at the time of the vote, tapes of the SBOE meeting demonstrate that SBOE members did not publicly discuss any specific reason that being a manager's largest client posed any risk to PSF. The PSF Committee meeting tape reveals that no reason was stated for the proposed course of action even though one SBOE member can be heard asking why one firm is being singled out by the motion. We have observed, from attending SBOE and PSF Committee meetings or listening to the tapes, that the PSF Committee members tend to be among the best informed SBOE members concerning technical investment issues. Therefore, the inability of four PSF Committee members to describe to us any specific risks, our review of the full SBOE's discussion prior to the vote, and the absence of any formal guidance from SBOE's existing Lead Consultant suggest to us

that most SBOE members lacked sufficient information to adequately assess the soundness of the technical reason cited for the action.

The second technical issue raised at the meeting and during our later interviews addressed the importance of “harvesting large gains” from portfolios.⁴ All six of the external “large cap” stock managers had generated substantial gains in the form of high investment returns. Barring a reduction in the manager’s account, almost all of the returns are retained in the managers’ portfolios (the managers must remit all dividend income, a very small component of return, for the Available School Fund). Performance reports indicate that for the one-year period prior to the rebalancing, there were only slight differences in the gains generated by the top three of these six managers. The manager who absorbed the entire rebalancing was top performer in this period, earning a return of about 33 percent. This return was about two percentage points higher than the second and third best performers. Even the lowest performer of the six produced a return of 23 percent.

Therefore, SBOE’s decision to harvest gains from only one manager meant that the substantial gains earned by the other five managers would not be harvested at all, yet there was no discussion at the meeting, nor any report from an investment expert, that SBOE had considered the impact of this outcome in assessing the prudence of its rebalancing method.

Furthermore, there may have been substantial similarities in the holdings of all six large cap managers, although there is no evidence that any SBOE members requested or received such an analysis prior to the vote. If substantial similarities existed, it is likely that many of the same holdings sold by the top performer to accomplish the \$300 million reduction (representing more than 40 percent of the manager’s \$700 million PSF portfolio) could instead have been sold by other large cap managers, resulting in essentially the same net effect on PSF’s total stock holdings.

Reports from the two top-performing managers, for the month ending just before the rebalancing decision, did indeed show similarities in their portfolios. The second best performing manager’s report listed its top 10 stock holdings. The manager who absorbed the entire rebalancing held 9 of these 10 stocks. Combined, those nine stocks represented a similar portion of each manager’s PSF portfolio—24.5 percent of the second best performer’s holdings and 22.3 percent of the top performer’s holdings.

We recognize that SBOE has full responsibility to determine or adjust each manager’s account balance, and its obligation is to protect the financial interests of PSF rather than the interests of any of its managers. Nevertheless, if a proportionate reduction from all managers would have affected PSF’s stock holdings in much the same way as taking the entire amount from one manager, the proportionate approach might have served SBOE’s interests by reducing the disharmony among SBOE members caused by this rebalancing. We believe SBOE should have obtained an analysis from its Lead Consultant to obtain assurance that SBOE’s approach was not likely to expose PSF to more risk than the approach recommended by the PSF staff.

⁴ Taking money from a manager does not automatically mean that only gains are harvested. The manager might deem it prudent to sell stocks that have declined in value since acquisition and that are considered to have a poor future outlook. In that case, PSF would be “harvesting losses” to return money to itself. Had the Board not reduced the manager’s portfolio, the manager probably would have sold those stocks anyway and reinvested the proceeds in stocks with a more favorable future outlook.

Recommendation:

To ensure that its actions and votes are based on fully understood facts and fully supported assertions, and are not excessively open to charges of inequitable treatment, we recommend that SBOE as a whole and each member individually:

- Postpone, to the extent possible, any vote affected by material last-minute information until that information has been subjected to sufficient research and comment by the PSF staff or independent consultants as appropriate.
- Immediately communicate information to the appropriate parties (who may include current or prospective vendors, the PSF staff, and paid independent consultants) when information relevant to a decision is available in advance.
- Accompany all allegations of wrongdoing with supporting evidence when such evidence exists, and refrain from making such allegations if no such evidence exists or if unwilling to make the evidence public.

Management's or Board Members' Responses:

No comment by agency management.

See Section 6 for SBOE members' responses.

Section 3-B:

The Climate of Allegations and Mistrust That Surrounds SBOE's Actions Impedes Effective Management of PSF

Some SBOE members and the Advisor have fostered a climate of allegations and mistrust toward both internal staff members and some outside PSF service providers. This atmosphere distracts SBOE and staff attention from the more important business of running a \$22 billion investment fund. If permitted to continue, this climate might result in unnecessary turnover of investment staff members and outside vendors, causing further harm to PSF's reputation in the investment community. Some prestigious outside vendors may be reluctant to offer their services to SBOE if the situation continues.

Furthermore, changing managers could result in an unnecessary increase of investment costs if the changes occur only as a result of the mistrustful atmosphere. As it implements its recently hired Lead Consultant's asset allocation model, SBOE has required all of its money managers to reapply for their assignments. According to a letter to the newspaper editor written by an SBOE member and published in the *Austin American Statesman*, this decision was needed "to clear up the cloud of impropriety that has surrounded the fund." SBOE members had previously alleged wrongdoing by several external managers and had requested several independent reviews of their allegations. None of those reviews found any manager wrongdoing. Some replacement of managers is likely in a change in asset allocation; a wholesale replacement of managers would seem unusual, especially when the Performance

Consultant regularly reports that PSF's investment performance tops all state investment funds.

Among the investment costs that occur when large portfolios are substantially changed, changing portfolio managers will result in a one-time increase in commission costs. The new managers who take over the outgoing managers' portfolios will undoubtedly restructure the holdings to match their own investment styles, incurring commission costs on the resulting stock transactions. In 1999, stock commissions were approximately \$15 million.

Events at SBOE's September 15, 2000, meeting suggest that initial implementation of this reapplication process probably did not clear the air of controversy and mistrust for the following reasons:

- SBOE selected three managers to fill the three newly created style categories ("core style," "value style," and "growth style") in its "large cap" stock portfolio. The six existing large cap managers had not previously been selected based on specific styles. For the core and value styles, SBOE chose to rehire two of its existing managers. Reportedly, the only existing manager who applied in the growth style category was the manager who had previously been subject to many unproven allegations by some SBOE members and the Advisor. Several SBOE members expressed strong concern that the growth style was the only category for which SBOE chose a new manager to replace an existing manager.
- SBOE apparently ignored its unanimous (10-0) vote at its May 12, 2000, meeting. The approved motion stated that the PSF staff would continue to manage at least part of PSF's large cap "core style" portfolio. At the September meeting, SBOE instead awarded PSF's entire "core" allocation, based on the recently adopted asset allocation plan, to one of the existing external managers. Although this issue was discussed at the PSF Committee meeting the previous day, the Committee took no formal action and did not inform the full SBOE that its vote in September conflicted with the earlier vote.
- New questions arose about whether some PSF Committee members had improperly discussed the manager selection process prior to a PSF Committee meeting.

Indications that SBOE's actions are contributing to a negative nationwide perception of PSF include the following:

- An article about SBOE controversies and an alleged assault outside the SBOE meeting room appeared in a national investment journal. The article's headlines included "Lone Star Soap Opera, Texas fund spoiling for a fight" and "In the latest chapter in the continuing saga of Texas' Permanent School Fund..." Newspapers throughout the State have carried articles about the unusually contentious issues discussed elsewhere in this report.
- One consultant was offered the lead consulting contract but subsequently declined the engagement, citing concerns about the lack of a cohesive,

positive working relationship between SBOE, the PSF staff, and the lead consultant. That consultant later submitted another bid for the contract, acknowledging that its concerns had been resolved. Recent controversies demonstrate, however, that a positive working relationship between at least some SBOE members and the PSF staff still does not exist.

- The bank eliminated from the contracting process due to the franchise tax concerns wrote a letter to the PSF Committee Chair criticizing the way the bank's representatives were treated at that meeting. They expressed concern that technical questions, which could easily have been submitted to them in advance and resolved before the meeting, were instead posed to them for the first time at the meeting. They believe the surprise questions and revelations were intended to embarrass the presenters and the bank.

In exercising its fiduciary duties, SBOE should maintain a healthy distance between itself, as PSF's overseers and policy makers, and the PSF staff and outside vendors, who directly manage and invest the fund. SBOE should ensure that it has control procedures in place to obtain the independent information it needs to effectively oversee the fund. These procedures include, but are not limited to, receipt of periodic investment reports, internal and external audit reports, and independent consultants' comments and reports. Clearly, SBOE members who become aware of indications of wrongdoing on the part of the staff or outside parties should pursue this information as they deem appropriate. However, the number and intensity of allegations, many of which are not accompanied by any supporting evidence, have created an environment in which the emphasis seems to be on finding something that management or vendors have done wrong instead of obtaining reasonable assurance that those parties are doing things right.

The hostile climate created by the numerous allegations is compounded by the fact that the charges have been:

- Offered without supporting evidence.
- Offered without being subject to proof.
- Contradicted by available facts or subsequent investigations by outside parties.
- Exaggerated, characterizing acknowledged mistakes as intentional misdeeds.
- Made selectively, only criticizing some parties while others not accused are known to have committed the same behavior.

Examples of these allegations include the following:

- An SBOE member wrote to the Commissioner of Education that PSF's Executive Administrator "falsifies State documents." He offered no proof of this claim of intentional wrongdoing. It appears that the allegation arose from a mistake that the Executive Administrator acknowledged. When the PSF staff included a firm on a list of eligible HUB brokers, the firm had already lost its HUB certification. However, the PSF staff did not verify the firm's assertion that it had a valid certificate but could not locate it. Because the

SBOE member had evidence that an internal control process was missing or ineffective, perhaps he should have requested assurance that the PSF staff had corrected this weakness, rather than making an accusation suggesting that the Executive Administrator deliberately violated the law.

- The SBOE member who made the allegation about PSF's Executive Administrator has asserted repeatedly, including in his public testimony to a legislative committee, that the prior Executive Administrator resigned without giving advance notice. However, the Executive Administrator apparently did give notice to the Commissioner of Education to whom he reports. Although this resignation letter exists, the SBOE member continues to repeat this claim.
- Some SBOE members and the Advisor made numerous allegations against several of the external money managers hired in 1998. These allegations persist despite having been investigated and substantially rejected by several independent outside parties including the Office of the Attorney General, AIMR, and the State Auditor's Office.

The Attorney General rejected the allegations of wrongdoing directed against the PSF staff, the former Lead Consultant, and the external managers. The Attorney General's report included the following comments that coincide with our conclusions about the questionable and selective nature of some allegations leveled by SBOE members and the Advisor:

“These allegations [that external managers placed funds in unauthorized accounts] are representative of attempts to find the most nefarious explanation for actions rather than looking for, and finding, the obvious and innocent explanations.” (Source: November 4, 1999, correspondence to the SBOE Chair from the Office of the Attorney General, *Summary of Review*, page 3.)

“It is noteworthy that in [one external manager's] case no allegations have been raised about these changes, but in [another external manager's] case such allegations of improper placement were raised. Yet in both cases, the managers are doing exactly what they were asked to do and the failure to treat both situations the same raises some concerns as to the selective nature of the allegations brought forth to the OAG [Office of the Attorney General]. In any event, these investment management firms have conducted themselves according to their contractual requirements.” (Source: November 4, 1999, correspondence to the SBOE Chair from the Office of the Attorney General, *Summary of Review*, pages 3-4.)

- The SBOE member alleged to the SBOE Chair that certain money managers, specifically naming the one that absorbed the entire \$300 million asset rebalancing, “have ‘purchased’ their way into the Permanent School Fund with significant campaign and PAC contributions to SBOE members and state capitol officials.” Such assertions are controversial and not normally subject to proof. These statements may undermine other SBOE members' confidence in the PSF service providers, possibly resulting in unnecessary costs to the fund if “suspect” providers are replaced based only on these allegations.

- Some SBOE members criticized PSF's Executive Administrator because the internal staff did not make substantial progress in sending more trades to HUB brokers during 1999 when SBOE first adopted this goal. The Executive Administrator informed the Committee at a November 4, 1999, PSF Committee meeting that certain restrictions in SBOE's current brokerage policy needed modification. Without that modification, most HUBs, and particularly most Texas-based HUBs, would be ineligible to do business with PSF. SBOE did not change its brokerage policy to eliminate these barriers to most HUB brokerage firms until its March 3, 2000, meeting. Perhaps SBOE should have questioned why the PSF staff did not bring these needed changes to SBOE's attention closer to the July 1999 meeting when the HUB brokerage goal was approved. Instead, these SBOE members were in effect criticizing the Executive Administrator for being reluctant to break the existing SBOE rules.
- SBOE members have accused PSF's Executive Administrator of discriminating against minority businesses because he has insisted that all brokerage firms, whether HUBs or larger firms, that provide reduced services to PSF (trade execution but not research) should be paid the same discounted commission rates. Commission reports indicate that the internal staff also routinely pays discounted commissions when it uses execution-only brokers who are not HUBs (see Section 4). Such accusations are inflammatory and potentially damaging.

Recommendation:

Suspected improprieties for which conclusive proof does not exist should first be brought to the attention of the appropriate parties for investigation prior to making public allegations of wrongdoing. Appropriate parties to investigate suspected improprieties include TEA's internal audit department and chief counsel, the Commissioner of Education, the SBOE chair, SBOE's independent consultants, the State Auditor's Office, the Attorney General, law enforcement officials, and self-regulatory organizations (NASD and AIMR, for example).

Many of the allegations discussed above were brought to the attention of one or more of these parties. If none of these entities conclude there is any basis for the accusations, and no new compelling evidence is found, SBOE members should consider accepting those conclusions and conduct SBOE business accordingly.

Management's or Board Members' Responses:

The agency understands this recommendation to be directed to the State Board of Education. Agency staff is available to assist the Board in any investigation that body chooses to authorize.

See Section 6 for SBOE members' responses.

Some SBOE Members Acted in a Manner Inconsistent With Their Fiduciary Duty to Minimize Costs When Implementing a State-Mandated Economic Development Goal

While SBOE has taken commendable action to increase the ability of HUB investment brokers to compete for PSF business, it has implemented its HUB brokerage policy in a way that needlessly conflicts with its fiduciary duty to minimize investment expenses. Some SBOE members most active in adopting this policy have criticized PSF's Executive Administrator for his insistence on paying discounted commission rates to all brokers, including HUBs, that provide a reduced level of brokerage services to PSF. (See Section 3-B for a discussion of an SBOE member's allegation of discrimination related to this issue.) Fiduciary prudence and SBOE's formal brokerage policy require that investment brokerage transactions be executed at the lowest overall cost (see text box below). PSF would unnecessarily spend several million dollars per year if, for example, its portfolio managers were to overpay stock commissions by an average of one cent per share on the hundreds of millions of shares they trade annually.

By insisting that the PSF staff pay HUB brokers higher commissions than necessary, these SBOE members appear to violate their own policy, their fiduciary obligations to protect PSF's assets, and the State's HUB policy. The Fund's external managers, in their efforts to please SBOE, are also likely to feel pressure to pay higher than necessary commissions to HUBs. Although SBOE should be commended for its efforts to comply with state HUB policy, overpaying HUBs for their services is not part of the State's policy. The State's HUB policy is intended to give HUBs a fair chance to compete for state business. However, according to the General Services Commission, nothing in the legislation underlying SBOE's HUB policy requires, or even

Duties of a Fiduciary

It is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.

Source: Restatement of Trusts 3d: Prudent Investor Rule, Section 227, Comment *m*, at 58 (1992)

The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person.

Source: Restatement of Trusts 2d, Section 170, Comment *q*, at 371 (1959)

condones, agencies doing business with HUBs that fail to provide competitively priced services.

The SBOE brokerage policy, codified in the Texas Administrative Code, Chapter 33, Section 33.40(a)(1), begins with the following guiding principles for all PSF transactions:

- (A) Best execution and lowest cost must apply to each PSF trade.
- (B) Ongoing efforts must be made to reduce trading costs, in terms of both commissions and market impact, provided the investment returns of PSF are not jeopardized.

SBOE, as fiduciary of PSF, should ensure that commission rates, which are negotiable, remain as low as possible while also obtaining assurance that the brokers provide cost-effective trade execution. Portfolio managers should negotiate rates based on the level of service the broker provides, regardless of the HUB status of the brokerage firm. Generally speaking, brokers who provide fewer services should receive a lower commission than full-service brokers.

The PSF staff, several external PSF managers, and another state investment fund generally pay lower commissions when they use brokers only for investment trade execution. That is true whether or not the broker is a HUB. The ERS investment policy mandates discounted commissions on execution-only trades. On the other hand, portfolio managers typically pay higher per share commission rates to “full service” brokers who also provide them with needed investment research, access to industry analysts and corporate executives, commitments of the broker’s capital, execution of complex trades, and other specialized services. As a rule, the range of services a broker provides should determine its commission.

Commission reports for PSF as well as for ERS, demonstrate these wide variances in commission rates. Internal PSF managers pay commissions as low as one or two cents per share to non-HUB firms and as high as five cents per share to HUBs and non-HUBs. External PSF managers also pay a variety of commission rates, while ERS’s commission reports show stock commissions of two, three, and five cents per share.

Some SBOE members, and even the SBOE Performance Consultant (see Section 2-B), however, have suggested that the PSF staff could justify paying the “full service” price (five cents per share was discussed at a May 2000 PSF Committee meeting) to all HUBs even if they provide no research services. Most Texas-based

HUB brokers are likely to be small firms that are unable or unwilling to incur the expense of generating the proprietary investment research needed by the PSF staff.

The informal Advisor’s Partner told the PSF Committee that the Third Company expected to function as a “discount” broker. (The Third Company later received the largest share of PSF HUB commissions after the policy was implemented.) He said his firm was willing to charge a competitive rate of four cents per share or less (see text box at left). Despite that public offer, some SBOE members and the Performance Consultant appear willing to insist that PSF forego an opportunity to minimize costs.

Some Board Members Insist That the PSF Staff Should Pay HUBs Higher Commissions, Although the PSF’s Largest-Volume HUB Broker Told Board Members It Expected to Be Paid a Reduced Commission

“We don’t have any desire to hire a hundred analysts and become research brokers.”

“Execution-only brokers should be used at a reduced commission rate . . . I’m glad that debate was going on before we got here, because we totally agree. We suggest four cents per share or less and our firm is very, very capable and willing to work at four cents or less and be competitive.”

Source: The unpaid Advisor’s Partner, representing the Third Company in a March 4, 1999, presentation to the PSF Committee

In the Partner’s June 30, 2000, sworn testimony to a legislative committee, he stated that the PSF managers have paid the Third Company between four and six cents per share on most of their trades. He testified that the Third Company received three cents per share only on some very large trades. Based on the Partner’s March 1999 offer, the external money managers might be paying the Third Company more than

necessary. Whether or not external managers are doing this to avoid receiving the same criticism from SBOE members the PSF Executive Administrator has received does not alter the fact that PSF is paying higher commissions than the level of services received appears to justify.

If SBOE agrees that its fiduciary obligations require it to pay discounted commissions to all firms that provide reduced brokerage services to PSF, it needs to acknowledge the impact its HUB percentage goal will have on PSF use of full-service brokers. If HUB brokers were to function mainly as discount brokers, the current SBOE policy target of using HUBs for 20 percent of PSF commission *dollars* would require that HUBs receive far more than 20 percent of PSF *shares traded*. PSF would then need to reduce its business with full service firms to far less than 80 percent of its trades.

Recommendation:

We recommend that SBOE members continue their efforts to implement their HUB brokerage policy, but do so in a way that does not unnecessarily increase the cost of administering PSF. It appears that SBOE could implement its HUB policy in compliance with state law while keeping commission costs to a minimum. We also recommend that SBOE obtain a thorough assessment of several issues related to its HUB brokerage policy to ensure that the policy will not impair investment performance or prohibit effective cost control. SBOE or TEA might benefit by hiring an expert, independent of HUBs, full-service brokers, and money managers, to perform the following:

- Assess whether the investment performance of internally managed portfolios is likely to suffer if the PSF staff substantially reduced its business with large, full-service brokers to give more business to smaller, reduced-service HUB brokers.
- Assess how PSF, in total, can minimize its commission costs, for example through the use of discounted or recaptured commission transactions, without jeopardizing the internal or external portfolio managers' investment performance.
- Assess the appropriate role of both the full-service brokers and Texas-based HUB brokers in the resulting lowest-cost framework.

Management's or Board Members' Responses:

Agency staff is available to assist the Board on this recommendation in any matter that the Board chooses to authorize.

See Section 6 for SBOE members' responses.

Status of Prior Findings

The most significant finding from the prior report was the suggestion that the creation of a nonprofit investment management corporation to manage PSF would not accomplish an important improvement in the oversight of PSF. This prior finding is revised and moved to the Legislative Issues section of this report because we recommend that the Legislature consider modifying the enabling legislation for the corporation. Table 1 below summarizes the status of the most significant prior findings.

Table 1

Implementation Status of Significant Recommendations to the State Board of Education and the Texas Education Agency		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 1:</p> <p>Legislators and the SBOE should revisit the issue of whether a nonprofit PSF investment management corporation, as presently envisioned, would provide meaningful benefits to the State.</p>	N	<p>An important benefit, placing individuals with substantial investment expertise on the corporation's board of trustees, cannot be ensured under the current legislation. We suggest that the Legislature consider changing the statute to permit a majority of the corporation's board to be individuals with substantial investment expertise. (See Legislative Issues, Section 1-B.)</p>
<p>Section 2-A:</p> <p>The PSF staff should develop a procedures manual to document various operational investment-related processes.</p>	I	<p>Implementation noted during previous PSF financial statement audits.</p>
<p>Section 2-C:</p> <p>The SBOE should develop more detailed ethics standards for all PSF staff. Ethics policies should cover topics such as gifts, financial disclosure, personal investments, dealings with various external parties, and other relevant matters. The SBOE and staff should sign a yearly statement affirming that ethics policies have not been violated.</p>	I	<p>Education Code, Section 1, Chapter 43, Section 43.0031-43.0034, 76th Legislature, required SBOE to adopt a comprehensive ethics policy covering SBOE members, the PSF staff, and PSF outside service providers. SBOE's policy, which took effect in April 2000, after the statutory deadline, addressed the Legislature's requirements.</p> <p>However, issues discussed in Sections 2 and 3 suggest that a strong ethics policy alone cannot ensure that potential conflicts of interest will not exist or will be voluntarily disclosed as required.</p>

Table 1

Implementation Status of Significant Recommendations to the State Board of Education and the Texas Education Agency		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
Section 3-A: The Texas Education Agency's legal staff should work with the Legislature to resolve differences noted in the statutes that govern the Permanent School Fund during the next [75 th] legislative session.	N	Legislative action would be required to implement this recommendation. Investment restrictions imposed by sections of the Education Code appear to be outdated, considering the Constitution's 1988 amendment. We will not follow up on this issue in future audits.
Section 3-B: The minutes of the Investment Advisory Committee (IAC) meetings should be formally approved and signed by the chairman. The approved IAC minutes should be forwarded to the SBOE or the PSF Committee. PSF staff should provide meeting materials in advance to the IAC to allow time for review.	N	The IAC has not met for the past several years. Therefore, this recommendation could not have been implemented. Section 1-B of this report suggests that the creation of an effective IAC could strengthen SBOE's oversight function.
Section 3-C: TEA should develop consistent training and orientation on investment-related matters for the SBOE. Issues covered should include investment policy development, investment risks, performance analysis, economic trends, and portfolio monitoring. This training can be combined with other SBOE member training and developed into a formal, ongoing program.	P	The PSF staff has directly provided or organized some investment training for all SBOE members. The new Lead Consultant has also provided training and, for a fee, offers additional comprehensive training for SBOE or the PSF staff. However, the training provided to SBOE has not occurred as part of a formal, ongoing program. In addition, even more training may be advisable to compensate for the lack of a requirement that most SBOE members possess professional investment expertise and in view of the problems or issues noted in Sections 1 through 4.

Section 6:

Responses From State Board of Education Members

Several SBOE members responded individually. One response, referred to here as the Group Response, was signed by five current members and one former member. Some individual responses concurred with some of our recommendations, but strongly disputed others. One response found our factual descriptions fairly accurate but disagreed with our recommendations. Other individual responses and the Group Response disagreed with almost all of the conditions, results, and conclusions of our report. None of the responses introduced accurate new information that caused us to change our conclusions and recommendations.

We received the following SBOE member responses. We gave all SBOE members the opportunity to respond to any or all of our findings and recommendations in this TEA section and to any relevant issues in the Legislative Issues section. We initially requested a three-week turnaround time for these responses, but extended by 10 days the response deadline for all SBOE members after three members informed us that they could not meet our original deadline.

Our follow-up comments to some of the statements in these responses with which we disagree are included in a previous section of this report (see the State Auditor's Office Summary of State Board of Education Members' Responses and State Auditor's Follow-Up Comments on page 5).

Response From Mr. Chase Untermeyer, Chair, State Board of Education

Thank you for your letter of 7 December, seeking my response to the State Auditor's Office draft report on the State Board of Education (Board) and the Permanent School Fund (PSF). Before commenting on certain sections of the report, I first would like to make some general observations:

- (1) *The Permanent School Fund is in excellent condition, having grown from approximately \$19 billion in value when I joined the Board two years ago to approximately \$22 billion now, an increase of nearly 16%. This is the result of many things and the efforts of many people: The general increase in stock values during most of this period; prudent management by the PSF staff at the Texas Education Agency (TEA), aided by able consultants; actions taken by SBOE to rebalance the Fund, converting \$1.3 billion worth of capital gains into income-earning bonds that preserved these gains for the benefit of current and future Texas schoolchildren; and vigilant Board oversight of outside money management firms, who handle a third of the Fund's holdings.*
- (2) *The incidents mentioned in the report involving some of my colleagues have indeed embarrassed the entire Board. I shall let my colleagues respond to these particular allegations. But I want to emphasize that, notwithstanding these events, the PSF has been the best-performing public fund in Texas and one of the best in the nation. Its assets are secure and are sufficiently diversified to weather economic storms.*
- (3) *To say that ordinary citizens, elected to the State Board of Education, not necessarily possessing "substantial investment experience," are incapable of being wise stewards of a major public fund is refuted by the PSF's performance. The underlying presumption of this finding in the report – that people from ordinary walks of life cannot make informed choices involving billions of dollars of public money – is also an unintended slap at the Legislature. After all, the Texas Legislature (of which I am proud once to have been a member) is comprised of citizens elected by their peers to go to Austin and cast votes on spending the people's tax dollars. Few state legislators are bankers, tax attorneys, or business executives – the sort of people with "expertise" in finance –yet they must make decisions on a*

biennial budget currently amounting to more than \$40 billion. This they do, relying on whatever information they can get and motivated sometimes by 181 different reasons, and they do a good job. To say that elected members of SBOE cannot be trusted with public money because they are not financial “experts” is to accuse the Legislature of the same thing.

- (4) With regard to whether SBOE should be elected or appointed, a decision I am comfortable leaving to the Legislature, I have but one overall comment. It is based not on my two years’ experience chairing SBOE but on more than 25 years’ experience in a variety of governmental positions – local, state, and federal; elected and appointed; fulltime and parttime. It is this: **There is no governmental structure that will yield a policy result; only people can do that.** This seems obvious, and yet policymakers always talk about structure, of moving this or that box on an organization chart or redrawing the lines that connect them. An appointed board – for education, for dentistry, for fire ants, or for the Guadalupe River – will be no more wise or foolish than an elected one, and vice versa. All depends on who is appointed or who is elected. A good group of people can make a bad structure work, but the most brilliantly-conceived structure can’t work if bad people are in charge.
- (5) Sorry experience in Texas and places like Orange County, California, shows that people with “substantial financial expertise” can make colossal errors, violate ethical standards, and simply do a poor job. The Permanent University Fund, created at the same time as the PSF, is managed by UTIMCO, a nonprofit corporation whose board is composed of the sort of financial experts whom the report says should run the PSF. And yet last year the PSF was a close second (essentially tied) with the PUF in total return and exceeded the returns of the teachers’ and public employees’ retirement funds. Neither has UTIMCO been free from alleged ethical lapses. Its reported insider deals and favors handed out to buddies is far likelier to occur with a group of appointed experts than with elected laypersons, who can come at financial issues with common sense rather than cronyism.
- (6) If the Legislature were to follow the report’s recommendation and put the management of the PSF solely in the care of people with “substantial financial expertise,” I predict that within a very few years the State Auditor’s Office would be issuing a report condemning conflicts of interest and favor-giving among the good-old-boys who advise on the Fund’s investments.
- (7) Finally, there is an inherent tension between SBOE and TEA over the management of the Permanent School Fund. This tension was born in the decision made in 1995 to take from the Board any voice or choice over the commissioner of education. While in general I support “cabinet government” in Texas (i.e., giving the governor greater authority to choose agency heads), this act exacerbated the SBOE-TEA relationship. The State Board of Education has responsibility for the Fund mandated by the Texas Constitution, yet a commissioner not chosen by the Board appoints the Fund’s day-to-day manager who in turn chooses his/her staff. As a fellow appointee of the Governor, I have good relations with Commissioner Nelson and try to make this awkward situation work. But the tension will continue until either the Constitution is amended to place responsibility for PSF elsewhere than

SBOE or until the Board creates a nonprofit corporation like UTIMCO and chooses its own staff.

These general observations having been made, I shall now comment on specific conclusions of the report.

LEGISLATIVE ISSUES

Section 1-A Recommendation for a “total return strategy” for the PSF:

This is an ironical recommendation, considering that the report accuses SBOE of imprudence in managing the PSF. “Total return” would be a major leap backwards from the prudent, cautious, and conservative approach the Fund’s creators specified in order to preserve it for untold generations of Texas schoolchildren. Especially if management of the Fund were put in the hands of appointed financial speculators, the Fund’s integrity could be endangered – and move a future state auditor to issue a report lamenting the adoption of the imprudent “total return strategy.”

Section 1-B Recommendations on management of the PSF:

Assuming that the Constitution is not changed to alter SBOE’s responsibility over the PSF, I favor creation of a nonprofit corporation to oversee the management of the Fund. When I say this responsibility should be taken away from TEA, I mean no hostility toward the Agency. The TEA’s focus is and should always be on education and nothing else. Managing a large and diversified public fund is an extraneous burden it ought not bear. There is nothing in the way of educational policy connected with running the Fund, since neither TEA nor SBOE dictates how its income is spent.

Section 1-C (Not provided.)

This issue was not relevant to the SBOE members therefore the SAO did not provide the issue to the members.

Section 1-D Recommendation that “the Legislature should consider requiring and overseeing periodic independent investment practices and performance reviews.”

Concur.

TEXAS EDUCATION AGENCY

Section 1-A Recommendation that “the Legislature consider ensuring substantial investment expertise for the oversight of the PSF” through one of several listed options.

As stated above, this requirement threatens a conflict of interest for the individuals put in charge of the PSF. It is also elitist and antidemocratic, implicitly calling into question the Legislature’s competence to make wise fiscal decisions, given its members’ general lack of financial expertise, a concept I emphatically reject.

In truth, the SBOE has access to many people with “substantial financial expertise”: namely, the consultants we ourselves have hired, like Callan & Associates, the Plexus Group, and Crestwood Asset Management, not to forget the PSF staff. Then, operating under the “prudent person rule” established by the Texas Constitution, we make our decisions. At least that is how I have based my decisions as member of the Board and its PSF Committee.

Section 1-B Recommendation on “a functioning and effective Investment Advisory Committee” (IAC):

The IAC ceased to function prior to my joining the Board. I have no objection to its being revived, but before the Board acts, we must answer some basic and practical questions: When and how is this body to be used? A panel that gives continuous review and advice on PSF investments would be fine, but it would be additive to (and possibly no more influential than) existing consultants and the PSF staff. If the PSF Committee is to meet and consider some major investment issue, would the IAC have to convene beforehand and make a recommendation? What if many of its members, volunteers all, cannot meet? With or without a quorum, would the IAC always give the Committee and the whole Board the best advice? Might they, in fact, give ignorant, biased, or corrupt advice? In the end, the Committee and the full Board would have to make its decision based on best-available knowledge, and they should not be required to limit their information and guidance to a single source. That is exactly the situation now.

Section 2-A Recommendations with regard to “board members [who] may have been influenced by the advice of outside parties who had conflicts of interest or other possible impairments to their independence”:

Inasmuch as this section speaks to actions by my colleagues, I defer to them for a response. By all means, conflicts of interest must be disclosed and all improprieties avoided or punished. I am confident that the Travis County attorney and district attorney are paying due concern to this matter.

Section 2-B Recommendations on the Board’s performance consultant:

Concur.

Section 2-C Recommendation on PSF service providers and the Code of Ethics:

Concur.

Section 3-A Recommendations on board actions:

The events described in the report were indeed embarrassing to the whole Board, and (especially since I was in the minority on the key votes mentioned) I will not seek to explain or rationalize them. The State Board of Education, just like the Legislature or any other board or commission, is a democratic body that may from time to time take actions that do not seem wise or that do not distinguish itself. But it should be noted that these events took place in 1999. Perhaps as a direct outgrowth of the bad publicity and legislative comment that followed – and, my colleagues will say, my leadership -- the whole Board in 2000 moved in an orderly fashion to hire an

investment consultant (Callan & Associates), to rebalance \$1.3 billion worth of the Fund, to adopt an asset allocation strategy, and, in an open and thorough process, to select a limited list of outstanding money managers who will be held to strict performance benchmarks. While not always free of controversy, these actions were taken either unanimously or by substantial bipartisan majorities, unlike the 8-7 votes mentioned in the report.

Section 3-B Recommendations on “the climate of allegations and mistrust that surrounds the Board’s actions”:

Speaking for myself, I have confidence in the TEA staff managing the PSF, and I have worked to mitigate conflict. But, as the report notes, this has not been the case with some of my colleagues. While not endorsing their comments or actions, I note again what I said in Item # 7 in my opening general comments, how there is inherent tension between SBOE and TEA over management of the PSF which extends beyond the members alluded to in the report and which I predict would be the case even with a different set of individuals.

Section 4 Recommendation on HUB brokerage policy:

Concur.

Section 5 Status of Prior Findings:

Noted as the basis for further action.

(End of comments.)

Thank you again for asking my thoughts on the draft report. I stand ready to discuss any or all of these matters with your office or any committee of the Legislature.

Response From Ms. Geraldine Miller, Vice Chair, State Board of Education

In response to your draft report “A Follow up Review of Controls Over Investment Practices at State Investing Entities” relevant to the State Board of Education and the Texas Education Agency.

I respectfully disagree with your final recommendations to the legislature, specifically the SBOE oversight of the PSF and also mandating a “total return strategy” for the PSF. The reasons are as follows:

- 1. PSF is the best performing fund in the state.*
- 2. It is the only agency fund to provide an income above the appropriation budget legislative mandate. Thus allowing education monies appropriated from the General Revenue Fund to be re-directed to other non-primary education agencies.*
- 3. The elected SBOE has prevailed over staff recommendations and always kept the Fund protected from investment fads.*

4. *The thread of commonality that has woven together the PSF's 100 plus years of success has been an SBOE that has only the long term best interest of education of the state's school children at heart. That commitment cannot be duplicated by a financial industry appointed board that would from day 1 be dealing with firms and individuals that are inter related with other potential clients.*
5. *It is well publicized that an appointed body active in the investment world can lead to possible conflicts of interest and mischief.*
6. *It is also well documented that the SBOE has the most stringent ethics policy of any state board or agency.*
7. *It is important to note, this SAO report attempts to hold the SBOE and its advisors to a much higher standard than any other elected state official, their advisors, or advisors' firm.*
8. *The SBOE has successfully met every challenge issued when our legislative leaders have requested additional monies to augment General Revenue Funding for primary education.*
9. *The SBOE studied the "total return" issue several years ago and concluded it would not benefit the PSF, and by basic definition, corpus of the PSF would be spent and therefore forever lost.*
10. *The record is well documented on the issues of:*
 - A. *The non-functioning, but soon to be activated Investment Advisory Committee (IAC), which the former Commissioner of Education obstructed the IAC from performing its job description.*
 - B. *The "disconnect" of SBOE's lack of authority over PSF staff, that is not responsible to the SBOE was not the fault of the SBOE.*
 - C. *Both of the above referenced issues can be corrected simply by returning the SBOE an appropriation budget, and placing PSF staff in a direct reporting obligation to the SBOE.*

*In the 16 years I have been involved on the SBOE, the PSF has more than doubled in value, **\$21 Billion**, and has generated and distributed **\$10.9 billion**. It continues to be ranked in the top 20% percentile of educational endowment funds nationally... far exceeding the rate of inflation and preserving the purchasing power of the Fund. The result of: prudent management by the SBOE and a solid investment strategy. Why? Because the elected SBOE, with advice of outstanding financial advisors and consultants, respect and honor its Constitutional authority to uphold, protect and preserve in perpetuity the PSF benefiting the school children in Texas. The elected SBOE is an important ingredient... the check and balance to this process. I urge you to allow this well-proven process to continue because it works.*

In conclusion, I have served the SBOE for 16 years, first as an appointed member from 1984-1988, then as an elected member having been re-elected in November 7th of 2000. I have never known of an instance or circumstance in which the SAO has not allowed a state board, elected or appointed, to respond as a full body. I believe the SAO's position in not allowing the full board to respond to the SAO draft report is unprecedented.

Response From Dr. Joe Bernal, Member, State Board of Education

As per your letter of December 7, 2000 suggesting review and response, the following are responses to some of the items, remarks, or recommendations made in the report: A Follow-Up Review of Controls Over Investment Practices at State Investing Entities, including the Permanent School Fund.

Before I go into detail regarding the responses, however, I do wish to remark to two general impressions:

Firstly, while I agree with the Report that most of us on the SBOE do not have the expertise nor the proper degrees or credentials to expertly oversee the PSF, I do have a very good understanding regarding the seriousness of the duties and responsibilities I have as an SBOE member, especially in light of having to respond to Texas voters who elect us to office. Having served in the past as a member of the State Senate Finance Committee, neither I nor any of my former Senate colleagues, to my knowledge, were ever questioned as to whether we had the necessary credentials in finalizing and overseeing a state biennial budget of several billion dollars. To recommend that a majority of the SBOE members possess such expertise, which can only be accomplished with an appointed board, begs for a counterpoint, for fairness sake. A non-elected board overseeing the present \$22 billion permanent school endowment fund, but which would answer only to the governor or some other high-placed state official(s) and not directly answerable to the public could well produce greater problems than those cited in the Report. In this regard, I am convinced that as we make mistakes, the public, having greater access to us directly, would have us correct those mistakes faster and in a more thorough and appropriate manner than if we were appointed.

Secondly, the impression left by the Report that the PSF is in trouble and might get worse seems to me to be somewhat exaggerated. When I first began to serve on the SBOE board in January 1997 the PSF was at \$13 billion and in the ensuing four years the Fund has grown to the present amount of close to \$22 billion. We've got to be doing something right! The following is quoted directly from an article, "School Fund posts greater annual returns than expected," appearing in the Texas Education Agency publication entitled Texas Education Today (p.6, November/December 2000):

Texas endowment fund for school children, the Permanent School Fund, posted a 12.82 percent total return for the 12-month period ending September 30, beating the benchmark return of 12.3 for that same period.

State Board of Education members noted that the performance of the \$21.5 billion PSF exceeded that of its sister fund the Permanent University Fund. The agency that manages the \$8.5 billion endowment reported in October that the PUF generated an 8.91 percent return during the first eight months of the year, which was nearly 4 percentage points above the benchmark rate for such investments.

The following are responses to items, remarks, or recommendations found in the report:

Section 1-A - Total Return Strategy recommendation

Response: While I am impressed by your reference to a 1999 study that only 4 percent of the 473 of the participating endowment funds reported basing their annual distributions on the amount of their current income (interest, dividends, and gains), it seems that what we have been doing, drawing income from interest and dividends has been working quite favorably for our growing PSF fund. However, the Total Return strategy item has not been discussed in the PSF committee during the past 2 years. I would certainly want to listen to experts on the matter before I would commit to changing from what has otherwise been working quite well for the PSF up until now.

Section 1-B - The Board lacks access to a functioning and effective Investment Advisory Committee (IAC)

Response: While I think the concept is a good one (I could certainly use an advisor), the Report indicates that a 15-member IAC is unworkable or too costly. I would add that it is also politically unfeasible. There exists a disconnect between TEA and the Board in that the Executive Administrator of the PSF is not named by the SBOE. He is hired by the TEA Commissioner, who in turn is named by the Governor. Adding another 15 “disconnected” advisers, regardless of their investment expertise, in that they would be named by the SBOE could well add to the existing friction. The PSF Investment Procedures Manual (Section A 2.) makes it quite clear that the authority to name an IAC is with the SBOE. The exact words are: “The State Board of Education shall appoint the Investment Advisory Committee, comprised of 15 members having investment backgrounds...” Yet the Report’s comment that “TEA and the Board have disagreed on the Board’s authority to appoint IAC members” seems to contradict the cited procedure and perhaps that disagreement defines the problem more clearly than any comment I could make.

On the other hand, present investment procedures (B 1) allow for engaging an investment counsel, which would be recommended by the PSF Committee and retained by the SBOE. In addition to the PSF administrator, such a person could be accessible to all SBOE members and serve as an official adviser on all PSF related issues.

Section 1-D - Periodic external reviews of investment practices could provide the Legislature with assurances that the State’s investments are well managed.

Response: I concur.

Section 2-C - That all PSF providers be prohibited from making non-routine requests from other PSF Service providers.

Response: I concur.

Section 4 - Some Board members acted in a manner inconsistent with their Fiduciary duty to minimize costs when implementing a State mandated economic development Goal.

Response: The action alluded to in the Report is analogous to Monday morning quarterbacking in simplistically charging that certain members who advocated for establishing the best Historically Underutilized Business (HUBs) program the SBOE could provide were going against their Fiduciary duty in minimizing costs.

It seems like Monday morning quarterbacking in that it fails to recognize a series of barriers encountered in the establishment of the HUB. Such barriers exacerbated the disconnect between the PSF administrator and the PSF Committee and finally caused a heated discussion regarding fees paid to HUB broker dealers.

A brief history of such efforts on the PSF committee reveals several barriers beginning with

- (1) A rejection of the HUB concept by the former administrator of the PSF suggesting that it was in a budget rider and not in the law, temporarily forcing me to conclude that the mandate to have state agencies adopt the (HUBs) concept was not applicable to the SBOE.*
- (2) A second barrier was encountered when we found out that in order to establish a HUB policy the HUB broker dealer would have to have all of the attributes of a non-HUB. In order to do business, the HUB, among many other requirements, had to have: in-house research capabilities, be a member in good standing of the major financial exchanges, and be financially able to accommodate a capital commitment trade over an industry standard settlement.*
- (3) With the help of the present PSF administrator, we eventually were able to provide exemptions regarding the above. However the conflict flared up again when the PSF Committee later ratified by the SBOE, passed a motion to limit broker dealers to those domiciled in Texas. Most all of the HUBs the PSF was doing business were from out-of-state. One in particular from Florida wasn't even a HUB. However, because these broker dealers were certified to do business in Texas, business continued as usual. The PSF Executive Administrator explained that we would have to continue doing business with them until their 3-year certificates expired.*
- (4) Thus, when the question of fees paid to HUBs came up for discussion it seemed like another barrier. It was reported that fees paid to brokers began from a high 6 cents a trade to a low of 2 cents per trade. The reason for the variance we were told was that some of the broker dealers were providing soft dollars or research to the PSF. If we had had an investment policy that mandated discounted commissions on execution-only trades the matter would have been settled then and there. And while investment managers typically pay higher per share commission rates to broker dealers who provide them with research that is not always the case. We heard from some of the investment managers say they had so much research it would take years to read and digest its content. My feelings during this discussion was that*

certain broker dealers were being treated more equal than others. Further still, I had no way to know why certain broker dealers were getting 2 cents and which were getting 3, 4, or 5 cents per trade because that is a matter between investment managers and the broker dealers with which they chose to do business.

I agree with the Report that the Board obtain a thorough assessment of several issues related to the PSF's HUB Policy to ensure that the Policy would not impair investment performance or prohibit effective cost control. Such an assessment should certainly include the reason(s) for paying a different level of trade fees.

Thank you for the opportunity to comment on the Report. If you have any questions please feel free to call me.

Group Response From Mr. David Bradley, Mr. Richard Watson, Dr. Richard Neill, Dr. Don McLeroy, Dr. Robert Offutt, and Ms. Judy Strickland, Members, State Board of Education

RESPONSE OF BOARD MEMBERS:

In Re Overall Summary:

- (1) *Performance is the only measurement required for validating success or for gauging risk. The Auditor has completely ignored the following facts of public record which nullify the Auditor's assertions that the decision-making by members of the State Board of Education has been "seriously weakened," "impaired," "questionable" or "[un]sound," or that such decision-making has "harm[ed] the Board and the Fund's credibility":*
 - (a) *The Permanent School Fund is the best-performing public fund in Texas and one of the highest performing funds of its size in the nation.*
 - (b) *Income paid to the Available School Fund for Texas education needs has increased considerably in the past year. The projected income increase will soon exceed \$100 million over the budgeted requirements set by the Legislature.*
 - (c) *The Permanent School Fund is the only state agency fund to provide income above the appropriation budget mandated by the Legislature, thus allowing appropriated education monies from the General Revenue Fund to be redirected to other non-primary education agencies.*
 - (d) *Upon completing a new asset allocation plan and manager review and replacement (November 2000), operational expenses were reduced by almost \$3 million per annum for Large Cap Domestic Equity management.*

- (e) *The outstanding performance of the Permanent School Fund resulted from the Board's proper positioning of fund assets to take advantage of an unprecedented 10-year "bull" market.*
 - (f) *Securities lending income was almost \$10.5 million for 2000, an increase of over \$4.62 million from the prior year.*
 - (g) *The State Board of Education has enacted the most stringent ethics policy of any state fund or board.*
- (2) *Previous years' audits and reports from the State Auditor's Office were generally limited to discussions of accounting principles, reporting and revenue projections, and internal administrative procedure. The overwhelming attention to elected officials' policy-making roles included in this present report is unprecedented, as is the SAO's refusal to allow the State Board of Education to respond as an entity.*
 - (3) *The detail level of events recorded in this report addresses only the SBOE, with no discussion of TEA Agency deficiencies, which were prevalent in previous reports.*
 - (4) *The Auditor has also chosen to focus on what he describes as "reliance" on an "Advisor" in an informal capacity by some Board members. Absent is any disclosure by the Auditor of the Auditor's personal knowledge of the so-called "Advisor's" professional qualifications, financial expertise and high level of experience in Texas public funds. In fact, the Auditor, on page 13, states that the Advisor has "no license or professional certification that would have subjected him to regulatory oversight or adherence to professional ethics standards," implying that the Advisor is merely some unknowledgeable bystander off the street. In actuality, the Advisor previously was employed by a major institutional investment consulting firm and also by one of the state's public funds.*
 - (5) *Also absent is disclosure by the Auditor of a prior relationship with the "Advisor," when the Advisor alerted the Auditor and helped identify significant deficiencies in management of another Texas public fund. The Auditor's previous relationship with the Advisor was a long and close working relationship and ended with some animus. Therefore, the Auditor's failure to disclose this prior personal relationship taints this entire report, and brings into question the balance and fairness of the findings and recommendations of the SAO.*

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"Section 1:

The Board Has Not Had Adequate Access to Investment Expertise

The law does not require Board members to possess substantial investment expertise and members typically do not have such substantial expertise to help them make knowledgeable decisions on the complex issues involved in overseeing the \$22 billion Permanent School Fund. Disagreement between the former Commissioner of Education and the Board has left the Board without a functioning Investment Advisory

Committee (IAC). Prior to the disagreement, the IAC did not meet frequently enough to be fully effective. Board members without investment expertise, lacking access to an effective IAC to provide investment advice, must look to outside parties to provide expert advice. This situation gives these outside parties more influence on investment decisions than might be desirable.”

RESPONSE OF BOARD MEMBERS:

In Re Section 1:

- (1) *State Board of Education members do have adequate access to investment expertise through (a) TEA personnel; (b) investment consultants selected by the SBOE; and (c) an Investment Advisory Committee (IAC).*
- (2) *Additionally, the Board does employ, at its discretion, investment advisory professionals. One of the advantages the Board enjoys as a result of the size of the fund is its ability to attract and employ the best and largest investment firms available in the nation. Currently, four firms are retained for (a) asset allocation and manager selection; (b) performance measurement; (c) trading cost analysis; and (d) an investment consultant counsels the TEA internal investment staff and the board on market trends and direction.*
- (3) *Also, representatives from the State Auditor’s Office, Texas Comptroller’s Office, General Land Office, liaisons to the Governor’s Office, Lieutenant Governor’s Office and occasional visitors from legislative leadership do attend and give input at Finance Committee discussions.*
- (4) *The Board has considered and intends to provide additional investment training experience for current and incoming Board members. Contracts with current investment advisory entities provide for such training.*
- (5) *The Auditor is erroneous in describing what transpired between the Commissioner of Education and the Board as a “disagreement” which “left the Board without a functioning Investment Advisory Committee (IAC).” When given enough time for the Board to respond, the corresponding records and facts will prove otherwise.*

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“Section 1-A:

Members of The State Board of Education Are Not Required to Individually or Collectively Possess Substantial Investment Expertise

. . . Board members who have an investment background are more likely to make well-informed decisions on the complex investment issues affecting the PSF’s success. In addition, Board members without expertise are more likely to need to rely on advice from outside parties, giving those parties a greater impact than necessary on the oversight and management of the PSF. Because the Board is currently elected, requiring them to have investment expertise to qualify for holding office might be impractical

However, with the exception of one Board member with a degree in business administration, no member's biography indicates formal education in investment-related areas. None holds the designation of Chartered Financial Analyst (CFA), perhaps the most comprehensive investment-related certification. Three members are involved with real estate and/or insurance sales including one who holds a securities license, the closest to an investment credential reported on the Internet site. However, none appears to have worked in institutional investment environments such as banking, insurance, or portfolio management. . . .

If the Legislature chooses not to revise the Board's structure, the recommendations in the sections that follow, related to an IAC, stronger ethics policies, and use of consultants become even more important."

RESPONSE OF BOARD MEMBERS:

In Re Section 1-A:

- (1) *SBOE bylaws and structures are already sufficient to achieve the desired level of expertise. The Texas Legislature made funding appropriations to ensure and effect the availability of multiple investment advisory firms, including:*
 - (a) *services of professional money management firms, whose other clients are similar to the Permanent School Fund;*
 - (b) *the services of investment consulting firms, such as Callan & Associates, one of the largest investment consulting firms in the nation;*
 - (c) *performance measurement services to closely track fund performance and trends; and*
 - (d) *trade and brokerage cost analysis to inform the Board of inefficiencies and excess expenses. This hiring was implemented only this past year at the insistence of Board members.*
- (2)
 - (a) *Large funds, such as the Permanent School Fund, should and have easily attracted the best available advisors and the largest firms in the investment industry. We now enjoy the benefits of such professional relationships.*
 - (b) *The consultants employed by the Board at this date are nationally recognized firms which represent clients with over \$1 trillion under management collectively. Historically, other state offices and agencies have employed smaller firms.*
- (3)
 - (a) *The Auditor's opinion that Board members "relied on advice from outside parties, giving those parties a greater impact than necessary on the oversight and management of the PSF" is erroneous and inflammatory.*

- (b) *At no time did Board members “give” their authority to oversee and manage the PSF to any outside party. At no time did Board members allow any outside party to “impact . . . their oversight and management of the PSF.*
 - (c) *That information received by any Board member from any “outside party” MAY HAVE BEEN “relied on” as the compelling impetus for a Board member’s actual decision or vote, or the degree to which such MAY have occurred, is an unproveable premise on its face.*
 - (d) *On page 27 of the report, the Auditor offers and then quickly dismisses the notion that “racial discrimination . . . [was] the true cause for the recommendation,” an overt admission that such outside opinions of Board members’ thought processes are subjective and therefore of no value or effect.*
 - (e) *Summarily, the Auditor’s use of terms such as “greater impact than necessary” or “more influence . . . than might be desirable” to describe the effect any outside party “MAY” have had on oversight and management of the PSF are completely insupportable, incalculable and inflammatory. That any “outside advising parties” had any impact at all, measurable or otherwise, on the Board’s oversight of the Fund is a completely subjective and biased conclusion on the part of the Auditor.*
- (4) (a) *As for requiring any other financial/investment expertise over and above that held by the elected members of the Board, the Constitution makes no such requirement, nor does the Constitution require such financial expertise of any other state elected officials and legislators who deal with many billions of dollars of expenditures. Our government is a representative government.*
- (b) *Would the Auditor suggest that all elected officials carry minimum requirements of expertise in any field?*
 - (c) *Surely the Auditor would not recommend an appointed Legislature to ensure expertise on all committees.*

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“Section 1-B:

The Board Lacks Access to a Functioning and Effective Investment Advisory Committee

. . . a retooled IAC will not resolve the Board’s major decision-making weaknesses.”

RESPONSE OF BOARD MEMBERS:

- (1) *The Board is provided, as documented in its Investment Procedures Manual, an Investment Advisory Committee of professionals appointed by each individual Board member.*
- (2) *Any lack of access to the duly authorized IAC was wholly due to Agency interference with Board function.*
 - (a) *The Auditor is incorrect in stating that “The Legal dispute arose in 1998.” Board records and correspondence indicate that the Commissioner interfered with Board function at the beginning of 1997.*
 - (b) *The Auditor is incorrect in stating that the “prior Commissioner MIGHT have insisted that he had the final appointment authority for the IAC members although the Board could make recommendations.” Board records and correspondence between Board members and the Commissioner demonstrate beyond doubt that the Commissioner reserved the right to appoint members of his choosing by his mere authority to authorize reimbursement for travel expenses for said appointees.*
 - (c) *The Auditor’s opinion that “Apparently, neither the Board chairman nor the PSF Committee chairman attempted to assert their authority to convene the IAC” is offered without supporting evidence and carries no weight nor relevance.*
- (3) *The Auditor has recommended a higher minimum qualification for IAC membership (a Ph.D. or Chartered Financial Analyst designation) than that held by the current executive director of the \$22 billion Permanent School Fund, who was promoted by the Commissioner of Education contrary to the previously agreed-upon research process and without input from the Board.*
- (4) *The Auditor’s statement that the Board demonstrated “major decision-making weaknesses” is unsupported by the available facts and record of high productivity/returns of the Fund while benefiting from this Board’s oversight. (See previous response to Summary.)*
- (5) *The Auditor recommendation that the IAC meet the day prior to each PSF Committee meeting and provide the Board with written recommendations is a good idea if practically possible.*
- (6) *The recommendation for instituting a Board, separate or otherwise, “whose members have investment expertise” is unwarranted. A non-investment Board eliminates the obvious issues of conflict that would germinate from an advisory consultant working for a board that was composed of other investment industry parties or people.*

- (7) *Where are the recommendations to restore the appropriation budget for the SBOE and to correct the “disconnect” between the SBOE and PSF staff?*

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“Section 2:

Board Members May Have Been Influenced by the Advice of Outside Parties Who Had Conflicts of Interest or Other Possible Impairments to Their Independence”

RESPONSE OF BOARD MEMBERS:

- (1) *The Auditor has reached no definitive conclusion.*
- (2) *The Auditor’s intimation that members “may have been influenced” or “needed to rely more extensively” is unsubstantiated and inflammatory.*
- (3) *No conflicts of interest are established by the Auditor.*
- (4) *When the House Investigative Committee studied these same issues, with the Auditor’s assistance, no findings, indictments, charges or referrals were made.*
- (5) *“Possible impairments to their independence of judgment” are not supported by the available facts and records.*
- (6) *No risk nor increased risk to the Fund has been substantiated by the Auditor, only accusations of same.*
- (7) *The Auditor’s opinion that certain information provided by “outside parties” to Board members “was not intended solely to benefit the PSF” cannot be substantiated by available facts.*
- (8) *The Auditor has neglected to demonstrate that providing such information, if any, to Board members in any way “harmed” the PSF. (See discussions of Fund performance in response to Summary, above.)*

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“Section 2-A:

Board Members Relied on an Informal Advisor Who Failed to Disclose a Conflict of Interest”

RESPONSE OF BOARD MEMBERS:

- (1) *The Auditor’s statement that “Board members relied on an informal advisor who failed to disclose a conflict of interest” is an exaggeration that mischaracterizes the actions of the Board’s members and is not supported by the evidence.*
- (2) *The Auditor’s statement that “some Board members gave an informal advisor (Advisor) substantial access to the decision-making process” is offered*

without supporting evidence. At no time did the so-called "Advisor" impact or have substantial access to the decision-making process, nor did any Board members "give" the so-called "Advisor" such access.

- (3) *Board members possess the right, as do all elected officials, to seek and receive informal input when comfortable with the expertise of an individual.*
- (4) *It is neither unprecedented nor inappropriate for constituents to offer informal input to Board members, even if they are "uncredentialed" in the eyes of the Auditor.*
- (5) *Disclosure requirements and ethics policies mandate disclosure by the vendors, consultants, and advisors of their relationships.*
- (6) *At the March 5, 1998 meeting, both the TEA General Counsel and the Executive Administrator of the PSF opined that broker/dealer firms are not considered under contract with the Board and are therefore not subject to disclosure.*
- (7)
 - (a) *With regard to PSF investment transactions, the Board does not make investment transaction decisions. There is no contract between the SBOE and brokerage firms. Therefore, there is no conflict.*
 - (b) *Contracts are executed between investment money managers (both TEA and external) and brokerage firms.*
 - (c) *The TEA General Counsel reaffirmed this assertion during the year 2000 as well, stating that "My assumption is that there is no privity of contract; there is no direct legal relationship between us [SBOE] and someone the external manager happens to hire to execute a securities transaction. So, I'm pretty sure they would not be covered [held to the ethics disclosure rule]."*
- (8) *All external managers and the TEA personnel responsible for HUB trading had knowledge of the "Advisor's" relationships from inception.*
- (9) *As brokerage firms are not contracted with the SBOE, disclosure by those firms cannot be required nor legally enforced.*
- (10) *All transactions by brokerage firms are governed by a "best price" and "best execution" rule; so preference cannot be given to any firm, including the "Advisor" or the "Partner."*
- (11) *The Auditor is singling out SBOE members with the spurious notion that they should be required to research, identify and evaluate every individual with whom they come into contact in the course of their duties or social lives. To suggest that any elected official investigate every financial dealing and/or relationship of every constituent, citizen or social contact who offers an observation or opinion is ridiculous.*
- (12) *The State Auditor is attempting to hold the SBOE and its advisors to a higher standard than any other elected state officials or other public fund board*

members. To focus only on the SBOE demonstrates an attempt to reach a particular, preconceived result.

- (13) *The State Board of Education has enacted the most stringent ethics policy of any state fund.*
- (14) *The State Board of Education actively supports studying the creation and adoption of uniform standards by all State funds.*

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“Section 2-B:

The Performance Consultant’s Undisclosed Relationships with the Advisor and the Partner and His Provision of Services Outside the Scope of His Contract May Conflict With Statute, Board Policy, or His Contract with the Agency.

A consultant (Performance Consultant), hired by the Board in September 1999 and again in January 2000 to measure and evaluate the performance of the Fund’s investment managers, did not disclose his significant financial and advisory relationships with the Advisor and the Partner. As a result, it appears that the Performance Consultant may have violated the disclosure requirements of the Education Code, the Board’s recently adopted ethics policy, and the consulting contract he signed with the Texas Education Agency.”

RESPONSE OF BOARD MEMBERS:

In Re Section 2-B:

The Auditor’s conclusion is erroneous and unsupported by the available facts and records.

The Performance Measurement Consultant answered all questions openly and accurately in his interview with the Permanent School Fund Committee and in no way violated the disclosure requirements of the Education Code, the recently adopted ethics policy, or the consulting contract he signed with the Texas Education Agency.

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“The Performance Consultant’s support of the Advisor and Partners business endeavor, and his position as their creditor, could reasonably diminish his independence of judgment on any issue that might affect the Advisor and Partner’s business interests. Although testifying that he did not expect the loans to be repaid, the Performance Consultant stated that he would like to be paid back if the Advisor and Partner were able to do so. And, the Performance Consultants role as evaluator of the PSF money managers creates at least the potential that he could treat more favorably those money managers that gave brokerage business to HUBs affiliated with the Advisor and Partner. Therefore we believe that, under the law, the ethics policy, and his contract with TEA, the Performance Consultant should have disclosed to the Board these advisory and financial relationships with the Advisor and Partner.”

RESPONSE OF BOARD MEMBERS:

- (1) *The performance measurement consultant is required to:
 - (a) calculate manager returns using custodian bank statements;
 - (b) reconcile those returns with each manager; and
 - (c) compare the manager returns to the Board-established benchmark indexes which are independently calculated and published for use by the investment industry.*
- (2) *Thus, the Performance Measurement Consultant cannot treat one manager more favorably than another, as all managers are compared to the SAME benchmarks mutually agreed upon by SBOE members, PSF staff, portfolio manager, and consultant.*
- (3) *Thus, neither acquaintances nor past dealings with individuals could in any way constitute a diminution of independence of the Performance Measurement Consultant's judgment.*
- (4)
 - (a) *There are no present barriers to entry, nor have barriers to entry existed in the past to forming a Texas-based HUB broker-dealer.*
 - (b) *All portfolio managers of the Permanent School Fund are contractually mandated to execute fund transactions with all brokerage firms, including HUBs, at "best price" and "best execution." Therefore, it is impossible for any portfolio manager to project what firm can offer best price/best execution at some undetermined time and place in the market.*
 - (c) *The PSF's previous investment consultant and performance measurement consultant firms (pre-1999) owned broker-dealer firms or were registered with a broker-dealer firm.*
 - (d) *Prior PSF consulting firms and numerous other consulting firms, which advise numerous other Texas state boards and funds, do so freely without the State Auditor making an issue of broker-dealer relationships in a State Auditor report.*
 - (e) *However, the State Auditor's Report attempts to hold the SBOE and one particular Performance Measurement Consultant firm to a different standard than all other elected state officials, their advisors and their advisors' firms.*
 - (f) *In the recent State Auditor's presentation to the House Investigative Committee, the Auditor said, "There is no evidence that the Performance Measurement Consultant asked for or received any favorable treatment."*
- (5) *The State Auditor's concerns delineated in Section 2-B, raised to advance the proposition that the SBOE advisors, official or unofficial, have not acted in*

the best interest of the Permanent School Fund, are contradicted by available facts and records.

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“The Board has not Limited the Performance Consultant’s Role to That Specified in His Firm’s Contract”

RESPONSE OF BOARD MEMBERS:

The Auditor is erroneous in implying that the SBOE acted improperly in permitting “the Performance Consultant to provide services outside the scope of his firm’s contract.” Board members can allow comment from any investment professional as part of a deliberative process, hired or not, formal or informal.

- (1) Precedence has allowed advisors to provide input to Board members on topics outside of their primary contracted role.*
- (2) Our ten-year-plus internal “stock picker” consultant has provided input to Board members on topics ranging from the safety of securities lending and applying firms’ abilities to the appropriateness of owning and adding high-yield bonds to our asset allocation. Both of those roles are covered by another advisory contract, but his input was welcomed.*
- (3) The current Performance Measurement Consultant’s contract (a TEA standard contract) includes a clause in Section C, permitting the Board or the TEA to contract for other services up to and including a fee of up to \$25,000 per year.*
- (4) To selectively draw from a lengthy discussion a conclusion that the Performance Measurement Consultant would know that a specific HUB broker-dealer firm would benefit from a discussion in which the Performance Measurement consultant participated is offered without evidence.*
- (5) The fact that (a) all PSF trades must be executed at “best price/best execution” and (b) there being no barrier to entry for Texas-based HUBs doing business with the PSF, it would be impossible for any one party to know what firm or firms would benefit from the above referenced discussion.*
- (6) The role of the Performance Consultant is to analyze and report fund investment performance to the SBOE. The Performance Measurement Consultant has no role and no impact on contracts executed between external money managers or TEA staff’s trading with brokerage firms, HUB or otherwise.*

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“The Performance Consultant’s Brokerage Advice to the PSF Committee Did Not Promote Protection of the Fund’s Assets by Minimizing Investment Costs

“Part of the Performance Consultant’s advice on the brokerage commission issue discussed above does not appear to give highest priority to the Board’s fiduciary responsibilities. The Performance Consultant had an opportunity to suggest how the Board could reduce costs on some of its brokerage commissions. Instead, he suggested that the PSF send more trades to HUB brokers at “full service” commission rates.”

RESPONSE OF BOARD MEMBERS:

- (1) *The State Auditor’s assertion is erroneous and is contradicted by available facts and records:*
 - (a) *The unedited tapes of the PSF Committee’s discussion show that the concern was one of potential discrimination against Texas-based HUBs by the Agency.*
 - (b) *The issues were:*
 - (i) *How does TEA staff deal with Texas-based HUBs; and*
 - (ii) *How do PSF’s external management firms, which also manage other public funds, deal with HUBs (i.e., is the PSF treating HUBs differently than standard industry practice)?*
 - (c) *The Performance Measurement Consultant’s comments pointed to the illogical position of TEA staff that the “full-price” commission above a certain dollar amount (approximately \$500,000) provides exponential value.*
 - (d) *Reports by Wellington (with total assets under management of \$250 billion, ten times larger than the PSF) available at that meeting show that their firm’s policy is to compensate HUBs equally with larger firms, regardless of research provided, as long as all transactions are executed at best price/best execution.*
 - (e) *The Performance Measurement Consultant simply illuminated the executive director’s illogical explanation of TEA staff’s policy of paying excess “full-price” commissions to large firms and TEA staff’s unwillingness to treat HUBs equally, even on “best price/best execution” basis.*
 - (f) *The State Auditor’s report ignores the record reflecting the numerous times the PSF Committee members stated their position was one of treating HUBs “equally,” NOT preferentially.*
- (2) *Selective recognition of certain facts and omission of others demonstrates the State Auditor’s attempt to reach a particular, preconceived report.*

- (3) *The Auditor's assertion that the "best interest of the fund" is ill-served by the Performance Measurement Consultant's assistance in bringing to light the fact that TEA staff is dealing with HUBs differently than standard industry policy (followed by outside managers that manage trillions of dollars for other public funds) is a complete mischaracterization of the spirit and intent of the PSF Committee discussions.*

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"Section 2-C:

The Board Chose Not to Strengthen Controls to Mitigate the Performance Measurement Consultant's Inherent Potential Conflict of Interest Resulting from His Brokerage Activities

In addition to the undisclosed relationship with the Advisor and the Partner, the Performance Consultant's brokerage relationships with money managers inherently entail a potential conflict of interest related to his duties for the Board. The Performance Consultant was hired to evaluate the performance of the PSF's money managers, some of whom might be providing him with substantial brokerage income. The Board did not adopt a member's suggested restriction designed to help ensure that this potential conflict would not become an actual impairment of the Performance Consultant's independence. To effectively oversee the PSF, the Board must ensure that it is receiving impartial advice related to the performance of its investment managers."

RESPONSE OF BOARD MEMBERS:

In Re section 2-C:

- (1) *It is erroneous to criticize the SBOE for not taking action on a policy in January that singled out an individual firm. The Chairman of the Finance Committee fully explained to the SBOE members the reason for the delay, which was to have time to create a policy covering ALL service provider firms.*
- (2) *The Auditor's assertion of lack of responsiveness is contradicted by available facts and records. Sixty days later, the Board voted unanimously for an ethics policy covering all service provider firms.*
- (3) *As previously noted, the PSF's former consulting firms were either owned or registered with a broker-dealer.*
- (4) *Those firms formerly contracted with the PSF and other consulting firms presently under contract with other state funds, where the State Auditor has audit review responsibilities, have never been criticized for the existence of such relationships, nor is there any public record of this particular concern having been raised by the SAO in any report. The SBOE is being singularly criticized by the Auditor about an issue which has been commonly acceptable to the Auditor in other state funds and previously in this fund.*

- (5) *The SBOE would support conducting a study for obtaining and adopting a STANDARD ethics policy for all state boards and public funds.*

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“Section 3:

The Board Has Conducted Its Business in a Manner That Impedes the Effective Management of the Permanent School Fund

The Board has permitted votes on important issues without first resolving last-minute allegations or technical assertions that materially impacted the decisions on those issues. In addition, Board business has been surrounded by a climate of mistrust due to numerous allegations of wrongdoing directed by some Board members and the Advisor at the internal professional investment staff, some external money managers, and some former consultants. Both of these issues impaired the Board’s ability to make prudent, well-reasoned investment decisions. In addition, the Board’s mistrust of internal staff, which has a fiduciary responsibility to the PSF, may have caused the Board to rely more heavily than necessary on some of the outside parties discussed in Section 2. And the Board’s conduct of its meetings and other actions have apparently begun to harm the Board and the PSF’s reputation in the investment community.”

RESPONSE OF BOARD MEMBERS:

In Re Section 3:

- (1) *The State Auditor’s opinion is offered without supporting evidence. In actuality, the State Auditor’s opinion of Board impairment is contradicted by available facts and records.*
- (2) *We concur that the Board’s mistrust of staff is directly attributable to staff’s actions that would not be recurring if not for the “much discussed disconnect” of TEA staff’s accountability to the SBOE.*
- (3) *The frustration and void created by the deprivation of timely and accurate information due to the actions or inactions of an unaccountable TEA staff would naturally be filled by “other parties of trust and competence.”*
- (4) *The Auditor has conspicuously refrained from criticizing the Texas Education Agency staff and/or Commissioner with respect to conflicts between Agency and the SBOE members arising from such events as:*
- (a) *TEA’s redacting of 1997 RFP documents provided at the request of a Board member;*
- (b) *Failure of advisory consultants to provide any documentation, notes, or work product related to the 1997 manager selection, even after being directly requested to do so by a Board member;*
- (c) *Board minutes reflect Commissioner’s statements affirming his purposeful instructions to advisory consultant to withhold pertinent information from Board members until the day of a meeting,*

denying Board members sufficient time to digest and contemplate significant information.

- (d) Commissioner's refusal to comply with PSF Committee chairman's request for financial data. Subsequent demand for \$14,400 to Board member under Open Records Request was unwarranted. Information requested was "push-button" data available from custodian bank.*
- (e) Commissioner's refusal to appoint investment advisory committee members;*
- (f) In replacing the hastily departed executive director of the PSF, the Commissioner abandoned an agreed-upon search process in favor of promoting a staffer with minimum credentials. No input was solicited from any SBOE members.*
- (g) The executive director of the PSF substituted a page of his own creation within a document provided by a consultant without disclosure to the Board.*
- (h) Our current executive director failed to disclose his working relationship with a newly hired investment manager, both having arrived at the PSF at approximately the same time.*
- (i) More grievous was that while questions were being asked in 1998 about that newly hired manager's qualifications and performance and resume', the incoming executive director failed to inform this Board that the firm had been terminated by the Kansas City Retirement Fund for poor investment performance just six months prior, while he was executive director of that fund.*
- (j) A recent report issued by TEA staff and reprinted numerous times in the Austin American Statesman erroneously estimated the cost of implementing the Board's newest asset allocation and manager hirings at \$115 million in attempt to stall the process. Subsequent data from Plexus Consulting Group have shown the costs thus far to be at \$4.4 million, with the Domestic Large Cap Equity trade transition completed.*
- (k) A critical report generated by TEA staff regarding the cost of splitting the custodial banking and securities lending services was proved to be fraught with mathematical errors and flawed assumptions. Again, the report was published numerous times in the papers, casting the SBOE in an unfavorable light, even though the SBOE's correct decision proved to have added over \$4 million in additional income to the fund.*
- (l) The Attorney General report issued at the request of Chairman Untermeyer regarding the 1997 investment manager selection process identified that TEA personnel and investment*

consultants failed to provide and withheld from members of the SBOE information developed in the RFP/selection processes which would have significantly impacted Board decisions.

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“Section 3-A:

The Board’s Conduct of Its Meetings Has Impaired the Soundness and Appearance of Fairness of Its Decision-Making Process”

... These events, which have been reported in widely read investment journals, also may have harmed the Board’s and the Fund’s reputation in the investment community.”

RESPONSE OF BOARD MEMBERS:

- (1) The SBOE and PSF have enjoyed a long history of positive media coverage as compared to other state funds in the past.*
- (2) The genesis of any negative media has been TEA staff.*
- (3) The Board’s conduct of its meetings has in no way impaired the soundness and appearance of fairness of its decision-making process. In fact, practically all recent PSF votes/decisions have been unanimous, which is virtually unheard of in today’s political environment.*
- (4) The Auditor is merely opining and gives no supporting documentation, explanation or evidence of “harm” to “the Board’s and the Fund’s reputation in the investment community.”*
- (5) The indisputable facts and records indicate:*
 - (a) The Permanent School Fund is the best-performing public fund in Texas and one of the highest performing funds of its size and unique character in the nation;*
 - (b) The Permanent School Fund is the only state fund whose projected income increase will soon exceed \$100 million over the budgeted requirements set by the Legislature; and*
 - (c) The State Board of Education has enacted the most stringent ethics policy of any state fund.*

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[Section 3-A(1)]:

“ • The selection of a lead investment consultant and an investment performance measurement consultant. One firm was the PSF Committee’s choice for both contracts but was rejected after a Board member made an unsupported assertion on the day of the final Board vote. The Board member claimed that a member of the firm lied to the PSF Committee, an assertion we later found to be erroneous. (See Appendix 2

for transcripts of the Board member's allegations and the purported evidence, which does not corroborate those allegations.)”

(Page 56)

- and -

“A Board Member Made an Unsupported and Apparently Erroneous Allegation About a Potential Consultant That Influenced the Consultant Selection Process”

(Page 57)

- and -

“The Board’s rejection of the recommended consulting firm therefore appears to have been based on erroneous information. Had the full Board insisted on reviewing the recordings prior to awarding the contracts, we believe they would have concluded that the Committee’s recommended consultant did not violate the “no contact” rule. As a result of its failure to adequately resolve this last-minute concern, the Board apparently eliminated the consulting firm the PSF Committee judged the best suited for the Board’s needs.”

RESPONSE OF BOARD MEMBERS:

The Auditor’s opinion is erroneous; and, in fact, available records prove otherwise.

- (1) The Board member’s assertion was neither unsupported nor erroneous. As evidenced by the recording, an agent of the consulting firm had contacted an intermediary in order to effect contact with one or more Board members.*
- (2) The entire line of questioning surrounded whether direct or indirect contact was made with Board members or intermediaries.*
- (3) The central theme of questioning was to what degree of contact did any prospective consultant have with respect to influencing selection of that consultant.*
- (4) The “lead” investment consultant, when questioned, clearly avoided giving honest, complete answers, thus intentionally violating the spirit and full meaning of the Board member’s questions.*
- (5) The “last-minute concern” was “adequately resolved” by a vote of the entire Board. Each Board member voted individually, based on his understanding of the information and his knowledge of the integrity of the Board member presenting the information. The “lead” investment consultant was not chosen.*
- (6) The Auditor is making assumptions with no basis of fact in impugning the integrity of the Board member in question and intimates that Board members must rely entirely and walk lock-step with the recommendations of TEA staff.*

- (7) *The SAO's selective recognition of points ignores the full and complete available record, making it appear that the State Auditor is simply trying to reach a particular, preconceived opinion.*

(Page 57):

“ . . . On May 19, 2000, in sworn testimony to a legislative committee, this Board member stated that he did not have any such recordings and knew of only one relevant recording in the Advisor's possession. He testified that this tape, a recorded voice mail message, proved that the firm's owner asked for the Advisor's assistance in delivering votes for his firm.

Even though the Board member did not produce any recordings for all members to review at the September 1999 meeting, with no further inquiry the Board voted to hire two other consulting firms not recommended by the PSF Committee. Despite our March 2000 request, the Board member did not provide any recordings for our investigation.”

RESPONSE OF BOARD MEMBERS:

The Auditor contradicts his own report. In one paragraph, the Auditor acknowledges that the Board member “did not have any such recordings.” Yet in the next paragraph, the Auditor criticizes the Board member for not providing the recording which he did not have.

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[Section 3-A(2)]:

“ • The selection of one or more banks to provide custody and securities lending services. A Board member disclosed on the day of the PSF Committee's vote that the bank recommended by PSF staff as best and lowest bidder was not in good standing regarding State franchise taxes. That Board member would not tell us who gave him this tax status information. Documents indicate someone associated with one or more Board members knew about this tax problem at least sixteen days before that meeting but did not promptly alert the PSF staff, the Board, or the bank to permit resolution of the issue prior to the vote.”

- and -

(Page 57)

“A Last-Minute Revelation About a Bank's Franchise Tax Status Could Have Been Disclosed and Possibly Resolved Prior to Voting on Two Banking Contracts”

RESPONSE OF BOARD MEMBERS:

- (1) *An analysis of staff's recommendation of lowest bidder proved false. Mathematical errors were exposed in the letter provided by staff to a Board member on the cost of splitting the bid.*
- (2) *The tax status information cited by the Auditor was public information available on the Secretary of State/Comptroller web sites, as evidenced by the document provided to the Auditor. "Who gave him this tax status information" is irrelevant to the proceedings had at the time and now.*
- (3) *The Auditor is making an unsubstantiated allegation based on unidentified "Documents [to] indicate someone . . . knew about this."*
- (4) *It is the responsibility of TEA staff to verify for the Board the eligibility and conformance with State bid and contracting requirements, information which, as evidenced by the document provided to the Auditor, was public information available on the Secretary of State/Comptroller web sites. It is unfortunate that staff failed to detect and/or report the fatal deficiency in its favored applicant to the Board.*

(Page 56:)
[Section 3-A(3)]:

The decision to remove \$300 million out of only one external portfolio manager's PSF holdings to accomplish a recommended shift from stocks to bonds. PSF staff recommended a proportional reduction from several external managers' holdings. However, Board members cited technical reasons on the day of the final vote without providing supporting statements from an independent consultant of the soundness of these reasons to take the entire amount from one manager. By not providing technical justification for their decision, the Board's action did not dispel concerns that the method it chose to accomplish this rebalancing was motivated by some Board members' dislike for this manager, nor by considerations of fiduciary prudence

- and -

(Page 60:)

"Statements Made at a Meeting to Vote on Rebalancing the Fund's Investments Were Not Adequately Researched or Supported"

RESPONSE OF BOARD MEMBERS:

- (1) *Contrary to staff's recommendations, the decision to remove \$300 million from one manager was a correct decision, saving the Permanent School Fund millions of dollars as demonstrated by available facts and records.*
 - (a) *\$300 million was moved from the only firm that managed funds as a Large Cap Growth style manager;*

- (b) *Large Cap Growth style had, to that point, been the best performing style for the longest period of time and, therefore, had the greatest volatility or risk.*
 - (c) *The Committee and the Board correctly voted to “sell high after buying low” and, in the process, also saved almost \$1 million per year in active management fees.*
 - (d) *For the year 2000, it should be noted that, contrary to the recommendations of TEA staff, the other two styles of management, Core and Value, have substantially outperformed the Growth style.*
 - (e) *The Large Cap Growth benchmark was the worst performing style for the year 2000.*
 - (f) *Had assets been proportionately taken from the Value style managers, as suggested by the Auditor and TEA staff’s recommendation, the negative impact to the Permanent School Fund’s principle or market value would have been in the tens of millions of dollars.*
- (2) *TEA staff’s and the PSF executive director’s continued protest of removing assets from the favored manager rings hollow as the PSF executive director has yet to disclose his prior relationships with the affected firm or that firm’s role in assisting the executive director in transitioning to the Permanent School Fund.*
 - (3) *Contrary to the best interest of the Permanent School Fund, the executive director’s close relationship with the favored manager clouded his judgment as to recommending harvesting the \$300 million from the only growth manager.*
 - (4) *While the Auditor was critical of the Board’s appropriate “harvesting” the \$300 million from a so-called high-performing manager, the Auditor correctly avoided criticizing the Board’s replacement of that same manager when the manager failed to even qualify for reappointment when evaluated against other peer growth style managers.*

SECTION 3-A SUMMARY RESPONSE OF BOARD MEMBERS:

- (1) *The SAO report’s selective critical presentation of these two Board decisions displays the Auditor’s:*
 - (a) *fundamentally skewed premise that members of the SBOE should “rubber-stamp” inadequate TEA staff recommendations;*
 - (b) *contrived attempt at “picking and choosing” certain scenarios in order to reach a particular, preconceived result; and*

(c) *determination to ignore the uncontroverted facts and records exemplifying the Board's effective management of the Permanent School Fund:*

(i) *Banking/Lending*

A. *TEA staff memo projected \$5,780,000 in securities lending income from Citibank vs. the actual \$10,403,346 for the 12-month period ending September 30, 2000.*

B. *The Performance Measurement Consultant's analysis of TEA staff's letter dated May 18, 1999, showing a fundamental flaw in TEA staff's recommendation, to this day stands uncontroverted.*

(ii) *Portfolio Rebalancing*

A. *Year-to-date returns for the period ending November 30, 2000:*

<i>Russell 1000</i>	<i>Growth</i>	<i>- 21.08</i>
	<i>Core.....</i>	<i>- 7.26</i>
	<i>Value</i>	<i>+ 6.64</i>

B. *If the SBOE had liquidated \$50 million of the Large Cap Value style manager, the difference in style index returns alone was 27.72% of Growth vs. Value and 13.82% on Growth vs. Core.*

C. *The SBOE liquidated Large Cap Growth appreciation and moved proceeds to bonds, therefore increasing the PSF's income and saving almost \$1 million per year in active management fees.*

(2) *The SAO is erroneous in criticizing two examples of correct Board decisions which added millions of dollars of value to the PSF.*

(3) *It is erroneous for the SAO to assert that SBOE conduct has impaired the soundness and fairness of its decision-making process based merely on SAO opinion, when the incontrovertible and available records and facts state just the opposite.*

(4) *It is erroneous for the SAO to overlook the cycles of progress and change that all boards experience and to ignore the current positive workings of the Board, including recent unanimous votes.*

(5) (a) *What taxpayers, voters, children or governmental body is well-served if normal Board membership changes and Board leadership changes are not recognized and if the current Board members are held*

to more debilitating and encumbering standards than any other elected official?

- (b) *Certainly, the Legislature, taxpayers, voters, and, ultimately, the school children of this state would be ill-served and disenfranchised if the SBOE were to adhere to the unworkable and unfounded recommendations of the SAO.*

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“Section 3-B:

The Climate of Allegations and Mistrust That Surrounds the Board’s Actions Impedes Effective Management of the Fund

Some Board members and the Advisor have fostered a climate of allegations and mistrust toward both internal staff and some outside PSF service providers. This atmosphere distracts Board and staff attention from the more important business of running a \$22 billion investment fund. If permitted to continue, this climate might result in unnecessary turnover of investment staff and outside vendors, causing further harm to the PSF’s reputation in the investment community. Some prestigious outside vendors may be reluctant to offer their services to the Board if the situation continues “

RESPONSE OF BOARD MEMBERS:

The SAO’S opinion is offered without supporting evidence and is contradicted by available facts and records which were made available to the SAO.

CONCLUSION OF BOARD MEMBERS:

All SAO issues were meticulously documented by Board members to the SAO staff. The Auditor had access to and, in fact, reviewed memoranda and accompanying notes, but chose to ignore a majority of what was presented to the SAO by Board members in preparing this subject report.

It is unfortunate that the SAO afforded this Board the very limited extension of time (from December 29, 2000 to January 8, 2001) to ensure that responses of the Board members would be included in the final report.

The SBOE Board cannot be expected to respond to activities of which the Board members have no actual or first-hand knowledge. The voluminous list of Auditor’s opinions of activities of the so-called “Advisor” and “Partner” should in all rights be answered by those parties, which is hereby officially requested. Otherwise, any observations, opinions, criticisms, or false assertions on the part of the SAO regarding the “Advisor” and “Partner” will go unanswered and entered into the SAO’s report as truth.

It is understood that heretofore a relationship existed between the Auditor and the “Advisor” which ended on a conflict of interest and apparent substantial animus by both parties. This relationship and conflict has not been disclosed by the Auditor and,

in all likelihood, has tainted -- and accounts for the depth of -- the report's focus on the Advisor and the Partner.

Concerns exist about the SAO draft's containing factual errors and unreasonable tone, wording and content which mischaracterize the spirit, intent and true record of the SBOE. It should be noted further that the present time constraints do not allow the SBOE or its individual members to fully address these concerns.

It is our assumption that the State Board of Education will have an opportunity to respond further during this Legislative session.

Response from Dr. Don McLeroy, Member, State Board of Education

Thank you for this opportunity. I would like to respond to several sections of your report.

Legislative Recommendations

Section 1-A:

As a citizen, I voted against the constitutional amendment to allow the Permanent University Fund to "raid" its "corpus" to keep the cash flowing into the Available University Fund. I do not believe it was a wise decision for the Permanent University Fund and especially do not believe it would be a wise decision for the Permanent School Fund. I am very surprised to see this recommendation in your report. I believe our Texas pioneers showed great wisdom in the prudent restrictions they established for the Permanent School Fund over a hundred years ago.

Section 1-B:

The governance structure of the Permanent School Fund has a major and obvious flaw-- the Board is not permitted to appoint and replace the Fund's Chief Executive Officer. The Board must have the highest confidence and trust in their Chief Executive Officer; the Board also must be able to depend upon the Chief Executive Officer as their foremost adviser. In my short tenure on the Board I have witnessed many of the results of this structural flaw. Here are just three.

- *There appeared to me to be little agreement or cooperation between the Permanent School Fund Committee and the Fund's Chief Executive Officer to implement the process for issuing new RFP's for the Board's outside investment consultant services. In fact, the Fund's Executive Director abruptly resigned one week before the July 1999 Board meeting when the RFP's were to be approved. This was not your normal resignation.*
- *At the September 1999 Board meeting it was proposed to hire Plexus Group for trading efficiency analytics. (This recommendation did not come from existing staff or consultants.) Why was this service only now being adopted by the Permanent School Fund? This service saves the Fund money and helps to*

evaluate the quality of performance of each money manager. I asked an experienced Board member why we had not used these services before and he said he did not know they existed. Would not a good Chief Executive Officer, as the foremost Fund adviser, have started this process or service earlier, especially if he were interested in the best performance possible?

- *At the beginning of my second year on the Board the Commissioner abruptly ended a collaborative selection process for our new PSF Chief Executive Officer and personally selected the new Chief Executive Officer with little or no consultation with the Board.*

*Thus, I would like to add a simple recommendation to the Legislature to substitute for all your recommendations. **Permit the State Board of Education to appoint and replace the Permanent School Fund's Executive Director.***

Texas Education Agency

Section 1-A:

I believe it is not necessary for Board members to have investment expertise. Competent Board members know what they don't know; they can, however, still make wise judgments. I believe the history of the Permanent School Fund supports this point.

Also, the Board and it's newly hired outside investment consultants conducted a process, recently completed, that has left the Fund in excellent condition. In the words of an experienced Board member (paraphrased) "This Fund is in the best shape ever - don't mess it up".

Response from Dr. Robert Offutt, (Former) Member, State Board of Education

I appreciate the opportunity to respond to the report prepared by your office under your project manager, Roger Ferris, entitled "Follow Up of Review of Controls Over Investment Practices at the Major State Investing Entities" dated January, 2001. The copy that I have reviewed is a draft sent to me in mid-December.

I must begin by reminding you of my first interview with Mr. Ferris several months ago at my place of business in New Braunfels at which, to the best of my recollection, you [Carol Smith, Audit Manager] were present. During that interview Mr. Ferris and I at one point engaged in a discussion - a philosophical discussion in which we each revealed some of our most basic feelings - about an appointed board versus an elected board as overseer of a large public fund. Mr. Ferris strongly and adamantly espoused his belief that public funds were much better served by appointed boards with board members from the financial community. It comes as no surprise then, with a project manager bringing to the table these preconceived prejudices, that the report issued by Mr. Ferris would be replete with half-truths and selectively disclosed

information. It is clear that this report was crafted to accomplish the goal of advancing the project manager's preconceived opinion.

Mr. Ferris' report cites four different instances of Board or Committee actions which he says are indicative of the Board's impairment in making appropriate decisions. In two of those instances he used incorrect examples which unfairly questioned the ethics and or impugned the integrity of the Board.

>>One such mischaracterization appears on page 53 of the draft report. The report claims that the Board voted against tightening up an ethics policy. This is egregiously misleading. As the record clearly indicates, the proposed ethics policy action to which the report refers, as initially submitted, singled out one particular vendor, the Performance Measurement Consultant. The Permanent School Fund Committee made it clear that the policy should be redone so as to cover all vendors, not just one, and for it (the proposed ethics policy) to be resubmitted for consideration at the next meeting. This was done, and the ethics policy was adopted at the next meeting. The State Board of Education has enacted the most stringent ethics policies of any state fund or board. For the State Auditor's Office to issue a report that deliberately misleads the reader is appalling. When you compound this with the knowledge that the readers that the State Auditor's Office is attempting to mislead are the 181 members of the Texas Legislature, it is more than I can fathom.

>>In another instance, the report makes reference to the Board overriding a recommendation made by PSF staff with regard to the bank custody/securities lending contracts. The PSF staff did an analysis, conducted at the behest of one PSF Committee member after the decision was made. This analysis estimated that the Board's decision would cost the fund \$1.2 million during the biennium. However, upon further review, the staff's analysis was found to be deficient in many respects. The SAO's report failed to note not only any of the flaws in PSF staff's analysis, but also that the ultimate decision made by the Board to override staff's recommendation was correct. The Permanent School Fund benefitted well in excess of \$4 million during the past fiscal year alone because of the SBOE's bank custody/securities lending decision, versus the \$1.2 million shortfall estimated by staff during the biennium. By noting the estimated impact of a decision made two years ago - an estimate made two years ago - and failing to provide the reader - the 181 most important readers - with the actual after-the-fact results of the decision is, in my mind, criminal - if not literally, certainly figuratively.

>>In another instance, the SAO cited a \$300 million rebalancing of a large cap growth portfolio manager as an instance of the Board's impairment in making decisions. The staff's recommendation at the time was to harvest the \$300 million across all large-cap equity investment styles, which included value and core. The Committee instead chose to rebalance only the large-cap growth style, which affected only one investment firm. This investment firm, which has an extremely close relationship to the PSF's Executive Director (predating his tenure with the PSF) - including providing luxury box seating to UT football games to both the present and past PSF Executive Directors and to the then-Commissioner of Education - objected. However the Committee made its decision in an unbiased and fair manner since all indicators suggested that the

large cap growth style was overvalued. It was not simply that the large cap growth style had outperformed, but that this style was at an historic disequilibrium relative to the other competing large cap equity investment styles of value and core. Clearly the Board made the right decision at the time to reallocate its equity portfolio by paring back the large cap growth style, and redeploying those assets into higher-yielding, high-quality fixed income securities. The resultant effect was a material increase in distributable income to the Available School Fund, as well as a timely equity portfolio realignment. It should be noted that since that time, large-cap growth managers have subsequently trailed the performance of both large-cap value and core style managers by a substantial margin.

I could continue write paragraph after paragraph pointing out misleading statements and half-truths contained in this report, for there is not a single section of the report that is entirely accurate or gives the reader a complete picture of events that occurred. To say that I am surprised that the State Auditor's Office would allow the personal opinions and prejudices - and perhaps even personal vendettas - of a single project manager to come through so clearly in a report bearing the State Auditor's name is an understatement. Rather than expand this letter further, let me close by indicating that I have read Chairman Untermeyer's letter in response to your request, and I agree with his statements. I have communicated with Mr. Bradley and am signing on to the more lengthy item-by-item response that may already be in your possession. I can only pray, as someone who loves Texas, that all of the other information provided by various agencies to our legislators to help guide them through thousands of bills on myriad issues is more accurate than this report.

Response from Ms. Grace Shore, Member, State Board of Education

After a thorough review of the draft report, A Follow-Up Review of Controls Over Investment Practices at State Investing Entities, several comments came to mind.

While most of the summaries were accurate, they were incomplete. The information stated does not reflect the views of the entire board. Many of the decisions made were decided by only a few of the members, but the article leads the reader to believe the whole board made the decision.

Regarding the oversight of the permanent school fund, I believe the report gave a very narrow viewpoint. While there were many members of the board who did use outside counsel, there were also many, like myself, who did not. Even though there were problems, overall the board did well in managing the fund. There was a good return on investments and the fund was kept in good shape. The recommendations the report made would not help the situation, I believe the board should retain control of the fund. However, I do agree that an advisory board could be helpful.

Also, the votes should be identified by name rather than just number. This will better reflect the views of the complete board.

Thank you for your consideration.

Response from Ms. Judy Strickland, Member, State Board of Education

As a State Board member NOT on the Finance Committee, may I offer an “outsider” viewpoint?

I have read the Dec. 29, 2000 letter to you from Chase Untermeyer. I concur wholeheartedly, especially points 1, 3, 4, 5 and 7.

I would like to add that the 5 bipartisan members of the committee are outstanding men who have dedicated LONG hours to research and produce the best possible decisions concerning this awesome responsibility. They have (in my opinion) cleaned-up and streamlined the PSF into the best performing state fund. Results speak loudly.

Additionally an important aspect, often overlooked, is the dedication of the 5 members. Remember they work hard to protect this fund, for Texas school children, without salary or staff and spend hours away from family and business. I have observed, admired and respected these fine men.

It is unfortunate this controversy has even occurred and I trust it is properly addressed from both sides. The report comes across as a biased and incomplete account. Hopefully that will be corrected.

Thank you for allowing me to respond.

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The University of Texas System/UTIMCO

Overall Summary

The University of Texas Investment Management Company (UTIMCO), the nonprofit corporation that manages the investment assets of The University of Texas System (UT System), implemented most of our 1996 recommendations. However, UTIMCO should consider revising its performance bonus plan to ensure that it bases employee bonuses on objective, rather than discretionary, criteria.

Since 1996, UTIMCO has improved its ethics policies and procedures, increased public accessibility to investment decisions, obtained independent reviews of investment operations, and implemented better investment policy compliance monitoring. The UT System Board of Regents (Board) chose not to retain an independent consultant on an ongoing basis to assist it in overseeing the activities of UTIMCO. Management previously indicated that the Board did not believe such action was necessary.

Section 1:

Actions by the Legislature, Voters, the Board of Regents, and UTIMCO Strengthened Controls Over Investment Practices

A variety of actions have strengthened controls over investment practices since our prior audit (see Section 3). The most notable are as follows:

- A constitutional amendment approved by the Legislature and voters in 1999 permits the Board of Regents and UTIMCO to manage the Permanent University Fund (PUF) the way most endowments are managed. The Board can now base distributions on a prudent portion of the long-term expected total investment return to provide a more stable annual payout that keeps pace with inflation.⁵ UTIMCO can now adopt investment strategies for the PUF that are more likely to produce higher long-term return, in closer alignment with its investment strategies for the other endowment funds under the Board's control (see also Legislative Issues, Section 1-A).
- UTIMCO's Code of Ethics now requires UTIMCO directors to file annual financial disclosure statements with the Chief Compliance Officer and/or the Texas Ethics Commission. Before approving private investments, all directors and officers must now certify in writing whether they have a personal or private interest in the proposed transaction or the business entity.

⁵ A major bond rating agency indicated that passage of the constitutional amendment and UTIMCO's professional management would help ensure that bonds guaranteed by the PUF continue to receive the highest possible credit rating.

- If the UTIMCO staff identifies an actual or potential conflict of interest, investment files now document management's resolution of the issue. We reviewed three investment decisions from among several that some outside parties alleged involved conflicts of interest. We found no evidence that any of the directors had a prohibited financial interest in the proposed investments at the time of their investment decisions.
- The Board of Regents and UTIMCO increased the public's access to investment decisions with the following actions:
 - Disclosing the names of the principals managing UTIMCO's private investments and reporting the performance of those investments.
 - Providing non-confidential information, including UTIMCO's board of directors meeting minutes, to the public upon request. Attorney General Open Records rulings permit UTIMCO to withhold certain information (such as business plans and investment strategies) for private investments to protect the competitive advantage of those investments.
 - Adopting an open meeting policy for UTIMCO.
- An independent consultant concluded that UTIMCO's private investment program represented a successful and prudent execution of an alternative investment strategy.
- UTIMCO hired an independent firm to measure and evaluate investment performance against UTIMCO's investment objectives and against the performance of other funds.

Section 2:

UTIMCO Should Improve its Employee Bonus Plan to Base More Bonuses on Objective Criteria

UTIMCO's performance compensation (bonus) plan for employees has not consistently used predefined, measurable goals to determine annual awards. We noted UTIMCO's previous efforts to blend various bonus plan recommendations in order to improve its plan. However, in 1998, it awarded many employee performance bonuses using either subjective criteria, or it used different criteria than those stated in its written plan. Under the plan, several investment employees who received bonus payments in 1998 would have been ineligible for bonuses that year.

In 1998, UTIMCO's board of directors approved almost \$533,000 in bonuses, representing almost 31 percent of those employees' \$1.73 million base salaries. As much as half of the 1998 bonus awards may have been based on board- or management-recommended overrides of the plan's calculated amounts. In 1997, the board also made discretionary bonus decisions.

For 1998 bonuses, the most significant overrides to the plan occurred for some of the portfolio managers, whose performance is usually relatively easy to assess

objectively. For them, a redesigned plan might reduce the need for large overrides and better align the employees' goals with UTIMCO's long-term investment goals.

Some of the 1998 plan overrides for investment portfolio managers included:

- Basing the bonus calculation on three-year performance although the plan called for assessing only the current year's performance.
- Paying the withheld bonus amounts earned in the prior year, when the current year's underperformance would have caused the employee to forfeit those withheld amounts.
- Eliminating any withholding on current year bonuses and instead paying out the full amount in the year it was earned.

The plan permits the board to override its calculated results. Allowing some bonuses to be awarded at management's discretion appears reasonable, especially if the board or management determines that unexpected circumstances prevented achievement of the original goals or if the plan did not include important measures of success. However, revisions to the bonus plan might reduce the necessity for such intervention.

Since UTIMCO's major investment funds have a long-term focus, basing bonuses at least in part on portfolio managers' performance over longer periods should better align those employees' goals with UTIMCO's. The 1998 and 1999 plans only measured one-year performance, although one of the overrides listed above was to ignore the one-year calculations in favor of three-year performance. UTIMCO might find that using a combination of measurement periods, including both short- and long-term performance, but weighted more heavily toward long-term periods, would be more effective than the current plan.

In addition, the plan measured portfolio manager performance against a stated benchmark but not against the performance of a peer group of outside managers with similar portfolios. The current method would not reward a manager who does well against his peers in a period when all or most of the peer group underperforms the benchmark. Conversely, the existing method might award a bonus if the manager barely met the benchmark while most of his peers significantly exceeded it. Therefore, UTIMCO might require fewer overrides if it based bonuses on both performance versus the benchmark and performance versus a manager's peers.

Recommendation:

UTIMCO should consider revising its bonus plan in the following ways:

- Measure performance results over a variety of time periods, reflecting both short-term (one year) and long-term (two, three, and five years) performance. UTIMCO should consider placing more weight on the long-term periods, especially for portfolios in its long-term investment funds.
- For each time period, assess managers based on achievement of predefined benchmarks and on comparative performance versus their peer groups.

UTIMCO should determine the relative weightings of these two criteria to best reward their portfolio managers for demonstrated good performance.

These revisions would reflect UTIMCO's long-term goals and would reduce the subjectivity of award amounts for portfolio managers. They should also increase the likelihood that the plan's calculations would result in good performers earning at least part of the maximum possible bonus each year. In that case, the board of directors might not feel the need to override the plan's results. On the other hand, the directors might feel such a need when the current plan's single calculation results in that employee earning no bonus.

Management's Response:

UTIMCO management supports the use of longer term benchmarks against which to award performance based compensation. It uses such longer term benchmarks in calculating performance based fees for external managers. The use of longer term benchmarks for internal managers has been difficult to implement in practice because of the restructuring of portfolios that has occurred during recent performance periods. With the restructuring of the endowment funds mostly complete and the internal portfolios expected to be stable, UTIMCO expects to use 3-year periods against which to measure and award performance compensation.

Furthermore the UTIMCO Compensation Committee has insisted on the use of subjective overrides in order to:

- a) recognize the impact of certain factors on the management of portfolios. Examples are the introduction of new asset classes, the absorption of the Permanent Health Funds and the restructuring of the PUF (approx. 2/3rds of assets under management) to a total return structure, and,*
- b) retain key employees and to encourage them to remain with UTIMCO as provided for in the first paragraph of the Plan.*

State Auditor's Follow-Up Comment:

UTIMCO's management response did not address our suggestion to also include peer group comparisons in the calculation of bonuses for portfolio managers. Management later told us that it does not intend to formally incorporate such comparisons into the bonus plan's design.

Management cited several reasons for this decision, including timing issues and the possibility that a truly comparable peer universe might not be available. We believe that UTIMCO could resolve the timing issues by returning to its prior practice of computing bonuses for a time period ending on a calendar quarter, the same cutoff dates used to collect peer universe performance. Furthermore, although the time required to collect and compile the peer universe data would delay the calculation and award of the bonuses, we do not consider that an overriding obstacle.

We do agree that, if a presumed peer group is not composed of managers subject to substantially similar investment constraints as the UTIMCO portfolio manager, basing that manager's bonus in part on the performance of the peer group would be inappropriate. However, if management can identify reasonably comparable peer universes against which to compare its internal managers, we continue to believe this comparison adds validity to the determination of performance bonus awards. Manager peer group comparisons are routinely included in external performance measurement firms' reports, and investing entities often use such information in deciding whether to hire or retain external portfolio managers.

Management told us that it would sometimes use peer universe comparisons on a more informal basis as one of the subjective factors when it considers whether to override the plan's computed bonuses. We believe this approach increases the possibility that peer group comparisons might be applied inconsistently, only to justify awarding a bonus when a manager underperforms the stated benchmark but does well in relation to a peer group. If bonuses calculated by the plan are not similarly adjusted downward should a manager exceed the benchmark but perform poorly compared to the peer group, the plan would be biased toward awarding more bonuses than appropriate.

We continue to support the use of performance-based compensation plans to help state investing entities attract and retain high performing investment professionals. Bonus plans are common in the investment business, although perhaps they are less likely to be used by government investing entities. However, our support for such compensation incentives remains contingent on the proper design and consistent application of the plans' bonus award criteria.

Section 3:

UTIMCO Implemented Most of the Significant Prior Findings

Table 2 below summarizes the status of the most significant prior findings.

Table 2

Implementation Status of Significant Recommendations to the Board of Regents and UTIMCO		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
Section 1-A: The Board of Regents should consider hiring an independent consultant to enhance its ability to meet its fiduciary responsibilities.	N	Management indicated that the Board disagreed with this recommendation. The Board of Regents retains the right to take such action any time it considers it necessary, but it has not chosen to do so.

Table 2

Implementation Status of Significant Recommendations to the Board of Regents and UTIMCO		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 1-B:</p> <p>The UT Board of Regents and/or the UTIMCO Board of Directors should assess whether the investment corporation can provide greater public accessibility either to the decision-making process or to records documenting actual decisions.</p>	I	<p>UTIMCO increased the public's accessibility to its investment decision-making process as discussed above, by:</p> <p>Providing more information about the principals and performance of private investments; holding open meetings; and making meeting minutes available.</p>
<p>Section 1-C:</p> <p>Management should: 1) measure and report investment performance of the Permanent University Fund in terms of its stated investment objectives, 2) improve the content, clarity, and consistency of the <i>PUF Annual Investment Report</i> and <i>Long Term Fund Annual Report</i>, and 3) periodically provide the UT Board with peer group comparisons of external investment managers.</p>	I	<p>UTIMCO implemented most of our recommendations regarding investment performance measurement and other reporting issues.</p> <p>UTIMCO does not report to the Board of Regents peer group comparisons of external investment managers. This information is available to UTIMCO directors who more closely oversee these managers.</p>
<p>Section 1-D:</p> <p>Management should: 1) monitor and report compliance with investment policies to both The UT Board of Regents and its own Board of Directors periodically, and 2) formally review investment policies and strategies at least annually, and request approval from the UT Board of Regents for any necessary changes.</p>	I	<p>UTIMCO's quarterly reports to the Board of Regents include information on compliance with investment policies. Also, UTIMCO frequently reviews its investment policies, and the Board of Regents approves policy changes on an annual basis.</p>

Table 2

Implementation Status of Significant Recommendations to the Board of Regents and UTIMCO		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 2:</p> <p>We recommend that: 1) UTIMCO strengthen procedures to ensure that all identified potential conflicts of interest in investment transactions are clearly resolved and adequately documented in investment files prior to the UTIMCO Board's approving the transactions, 2) the Code of Ethics require UTIMCO Directors to file financial disclosure statements with UTIMCO and with legal counsel, 3) UTIMCO's Code of Ethics be revised to limit to \$50 the value of gifts from interested outside parties that may be accepted by its Directors and employees, the level established by statute for state officials and employees, 4) the Code cite the most significant laws and regulations with which UTIMCO Directors and employees must comply to ensure personnel are aware of expectations, and 5) the UTIMCO Board should consider tape recording the meetings and retaining the tapes in case a question should later arise as to what was said at the meeting.</p>	I	<p>UTIMCO identifies, resolves, and documents possible conflicts of interest involving UTIMCO directors and key employees as part of its due diligence process, which management and the directors conduct prior to making investment decisions.</p> <p>UTIMCO revised its Code of Ethics as recommended.</p> <p>UTIMCO does not tape record its board meetings; however, more detailed documentation of these meetings is drafted by employees and maintained in investment files.</p>
<p>Section 3:</p> <p>The UT Board of Regents or UTIMCO's Board of Directors should periodically contract with an independent consulting firm to review private investment operations.</p>	I	<p>UTIMCO hired an independent consulting firm to review its private investment operations. This review covered most of the significant aspects of the program.</p>
<p>Section 5-A:</p> <p>We recommend that the selection process for hiring external investment advisors, managers, and consultants be consistently documented to ensure that the process is objective. In addition, performance evaluation criteria should be consistently included in contracts with external professionals.</p>	I	<p>UTIMCO developed and followed the selection process for hiring external investment managers. Performance evaluation criteria are included in contracts.</p>

Table 2

Implementation Status of Significant Recommendations to the Board of Regents and UTIMCO		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 6:</p> <p>We recommend that: 1) the amount of acceptable risk be quantified in terms of expected variability of rates of return and stated in all investment policies, 2) investment policies contain a restriction in the form of a dollar amount or percentage of investments allowed in Collateralized Mortgage Obligations (CMOs) including tranches, 3) wording be consistent across policies for similar policy expectations, 4) the "information memorandum" on the Short/Intermediate Term fund be rewritten to contain limitations on investment concentrations, 5) the benchmark for the fund be re-evaluated to ensure that it is an appropriate tool to measure the fund's performance, and 6) a formal investment policy be developed for the Short Term Fund.</p>	I	<p>Asset allocation policies address expected investment risk. UTIMCO revised investment policies to include consistent wording among funds, limitations on investment concentrations, and appropriate performance benchmarks. UTIMCO developed a formal investment policy for the Short Term Fund . However, investment policies do not contain dollar amount or percentage restrictions on investments in CMOs because UTIMCO considers them to be mortgage-backed securities.</p>
<p>Section 7:</p> <p>We recommend that: 1) UTIMCO ensure that a comprehensive policy addressing all aspects of the performance evaluation process is developed and enforced, 2) evaluation criteria should be developed that directly relate to an employee's specific job duties and evaluation results should support personnel actions, and 3) the UTIMCO Board of Directors should hire an independent consultant to review the existing performance incentive (bonus) plan to ensure that it is properly designed to fairly and objectively measure performance and to ensure that risks and rewards are appropriately balanced.</p>	P	<p>UTIMCO developed evaluation criteria that were directly related to each employee's specific job duties. Each section manager frequently conducts informal performance evaluations. In addition, the UTIMCO Board hired an independent consultant to review base salary structure and bonus plan. The consultant commented that the plan was somewhat subjective. We found that several bonuses for the 1998 plan year were determined in a discretionary manner by the UTIMCO Board and management (see Section 2).</p>

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Employees Retirement System

Overall Summary

We have previously reported on the status of all significant recommendations for the Employees Retirement System (ERS) from our prior review of controls over investment practices. We concluded in *An Audit Report on Management Controls at the Employees Retirement System of Texas* (SAO Report No. 98-024, February 1998) that ERS had made significant progress in implementing most of our recommendations except for an issue applicable to both ERS and the Teacher Retirement System (TRS). That prior crosscutting issue, revised and included in this report under Legislative Issues Section 1-C, relates to the authority of ERS and TRS to delegate investment decisions to external money managers.

ERS appears to rely on its external investment advisors to make important investment decisions that determine the performance of some investment portfolios. ERS does not consider its relationships with portfolio advisors to be a delegation of investment decisions. The Attorney General recently concluded that TRS lacks statutory authority to fully delegate these decisions. Because ERS's current authority to use external managers is identical to TRS's authority at the time of the Attorney General Opinion, the reasoning and conclusion of that Opinion appear to apply to ERS as well. Giving ERS explicit authority to delegate might help ERS prudently manage its investments. The extent to which ERS is currently able to rely on these outside parties without such delegation authority suggests that the State would not incur further risk if the Legislature chose to permit ERS to fully delegate these decisions.

Section 1:

ERS's External Portfolio Advisors Essentially Manage Certain Portfolios

ERS has previously indicated that it does not believe the Texas Constitution permits it to delegate investment decision making to outside money managers. In addition, a 1999 Attorney General Opinion concluded that TRS, which has the same relevant

ERS and TRS have the following statutory authority:

"The board of trustees may contract with private professional investment managers to assist the board in investing the assets of the retirement system."

The Attorney General concluded:

"[T]he TRS Board may seek advice from outside investment counselors to assist it in making its investment decisions, but the Board must retain final decision-making as to all investments and may not delegate to outside investment managers the power to decide which securities to purchase with assets of the retirement fund."

statute as ERS, lacks statutory authority to delegate such decisions (see text box at left). ERS believes its existing advisory relationships with external professional investment managers do not amount to a delegation of investment decision making. Although ERS uses these money managers differently from most entities that can delegate, in substance it is the advisors, not the ERS staff, who make the most important portfolio management decisions.

ERS's advisory contracts require the internal investment staff to review and approve most

of these investment decisions either immediately before or after the investment

transactions occur, unlike typical arrangements with external money managers. However, the ERS staff almost never rejects advisor decisions that comply with contractual restrictions, suggesting that the cost-benefit relationship of this process might be questionable if ERS had full authority to delegate. Furthermore, despite the extensive reviews, the long-term investment returns of the externally advised portfolios are probably no different than if ERS had fully delegated the management of those portfolios to the outside money managers.

ERS's use of its advisors also includes other notable differences from traditional full-delegation contracts with external managers:

- ERS has the right to reject or reverse any trade recommended or initiated by its advisors.
- ERS staff initiates all stock trades through brokers, whereas external money managers customarily handle this function in fully delegated relationships.
- ERS contends that its advisory relationships result in lower portfolio management fees than if it delegated full discretion and fiduciary responsibility to the external advisors. Another large state investment fund that fully delegates management of some portfolios appears to pay its external managers higher fees than ERS pays for portfolios of comparable size and investment style. Some, but probably not all, of ERS's lower advisory fees are explained by ERS's in-house performance of the investment trading functions discussed above.

However, as discussed below, ERS's advisors appear to function as the de facto portfolio managers for their particular portfolios rather than being used to provide general investment advice.

ERS's Advisors Function Differently for Different Investment Types But Initiate the Most Important Decisions for Each Type

At the time of our review, ERS used investment advisors for its domestic equity, international equity, and fixed income portfolios. The advisors functioned differently for each type of portfolio; however, the advisors, not ERS, appeared to initiate the material investment decisions. ERS generally expects that these decisions will result in its externally advised portfolios *outperforming* the underlying benchmarks against which performance is assessed ("active" management). For other portfolios, managed entirely by the internal staff, ERS generally expects that performance will closely match the performance of the underlying benchmark ("passive" management).

The following procedures in place in 1999 further suggest that ERS's advisors have the primary responsibility for managing the portfolios:

- The domestic equity advisors for the actively managed portfolios, not the ERS staff, initiate the buy and sell recommendations on individual stocks for these portfolios. Their recommendations include the specific stocks, number of shares, price range, and timing of trades. ERS does require internal investment staff member approval of recommendations before trades are made. However, ERS staff members almost always accept advisor

recommendations, suggesting that ERS's additional reviews have negligible impact on long-term portfolio performance (returns and risk).

- Transaction reports indicate that combined, ERS's two externally advised domestic equity portfolios traded almost \$1.8 billion in stock, or 40 million shares, in fiscal year 1998. This trading volume appears to be representative of other years.
- In July 1999 we requested examples of advisor-recommended trades for which the ERS staff did not grant approval. The most recent example ERS provided to us was from 1994. ERS does not specifically track the advisors' recommendations that the internal staff rejects. However, if ERS's internal reviews routinely resulted in rejecting some of the advisor's recommendations, ERS probably would have located several 1998 or 1999 rejections. In September 2000, ERS told us it had recently rejected one trade an advisor recommended.
- The international equity advisor was responsible for the active portion of that portfolio's strategy. The ERS investment policy indicated that this portfolio was to be managed using an active/passive strategy. The advisor was expected to initiate the continuous active decisions by recommending how much ERS's percentage of each foreign country's stocks should differ from that country's percentage in the international benchmark. These decisions were intended to result in the portfolio's overall performance exceeding the benchmark's performance over the long term.

The policy also required that ERS consider terminating the advisor for continued portfolio underperformance versus the benchmark. ERS has told us it did not always choose to fully implement the outside advisor's country allocations for a variety of reasons. We do not have sufficient evidence to assess whether ERS's departures from the advisor's recommendations materially affected overall portfolio performance. However, if the portfolio underperformed the benchmark, and if ERS could not accurately determine whether its overrides of the advisor's decisions were the primary cause of the underperformance, ERS might have difficulty making the most appropriate advisor retention or termination decisions.

The policy further suggested that the ERS staff would passively construct the stock portfolio for each country to implement the approved allocation percentages. The specific stock selections made by the ERS staff, although considered a passive strategy, could also cause performance to differ somewhat from the benchmark. However, the policy does not establish the same expectation placed on the advisor to outperform the benchmark. Instead of mandating outperformance of the benchmark, as it does for the advisor's decisions, the policy establishes an allowable range above or below the benchmark's performance for the passive strategy.

- The fixed income advisor's contract permitted that firm to exercise discretion to vary two key components (sector weightings and duration) of their bond portfolio versus ERS's approved targets. The contract also permitted the advisor to initiate and execute bond transactions without prior ERS approval.

- The advisor's "active" decisions to vary the portfolio's duration (a measure of the portfolio's sensitivity to interest rate changes), the amounts invested in each bond sector, and specific bond selection could all cause the portfolio's performance to differ from the related benchmark's performance.
- ERS performed post-transaction reviews on each bond trade and had the right to require the advisor to reverse any noncompliant trades at the advisor's expense. For trades that complied with ERS's policy restrictions, ERS could also require reversal, although we are not aware that any such reversal has ever occurred. For reversals of compliant trades, however, ERS would bear any risk of loss incurred from the time of the advisor's initial trade until the advisor's reversal.

ERS Advisory Fees, While Possibly Lower for Equivalent Portfolios When Compared to Entities That Can Fully Delegate, Far Exceed the Advisory Fees Paid by TRS

ERS has paid investment advisory fees far in excess of those paid by TRS. In 1998 and 1999, ERS paid advisory fees of \$10.9 million and \$6.4 million, respectively. In contrast, TRS paid less than \$0.5 million in investment advisory fees in 1999 although its investment portfolio was approximately four times larger than ERS's. TRS typically uses its advisors to provide general market advice, performance reports, and to review technical issues.

Table 3

1999 Investment Advisory/Management Fees Suggest that ERS Uses Advisors As Other Entities Use External Money Managers in Full-Delegation Relationships

Entity	Reported Investments (As of 8/31/99)	Assets Subject to Advisory or Management Relationships (As of 8/31/99)	Reported Investment Advisory and Management Fees (Fiscal Year 1999)
TRS	\$79.6 billion	\$79.6 billion	\$0.5 million
ERS	\$18.9 billion	\$7.9 billion	\$6.4 million
UTIMCO (Permanent University Fund and Long Term Fund)	\$10.1 billion	\$6.0 billion	\$6.7 million
TEA (Permanent School Fund)	\$19.6 billion	\$6.7 billion	\$19.3 million

Source: Fiscal year 1999 TRS audited financial statements and unaudited information provided by investing entities

Table 3 compares the investment advisory or management expenses and investment balances reported by the four largest long-term investing entities. Two of those entities, the University of Texas Investment Management Company (UTIMCO) and the Texas Education Agency (TEA), are statutorily permitted

to delegate investment management decisions. Direct comparison of fees is difficult because differences in asset class, portfolio size, and investment style significantly affect fees. However, the table indicates that ERS and TRS use advisors significantly differently from one another, although both have identical statutory authority.

Accountability for Portfolio Performance Resides With the Advisor

As further evidence that external advisors manage ERS portfolios, it appears that the advisors are held accountable, or take credit for, investment performance.

- ERS holds the advisors, not the internal investment staff, accountable for their portfolio's performance. ERS compares the advisor's portfolio performance to a peer group of managers responsible for similar portfolios, as is routinely done by entities that delegate full discretion to external managers. Board minutes reflect that trustees cite poor portfolio performance as a reason to consider terminating an advisor. If the internal staff were making the significant investment decisions, it would share blame for poor performance.
- ERS board minutes typically attribute portfolio performance to the advisor's specific decisions or strategies, and sometimes even refer to the advisor as a manager.
- ERS's four advisors told us that they include their performance for ERS with the results of their other clients' portfolios for which they have full investment discretion. Investment reporting standards require money managers to report performance for portfolios for which they have discretion separately from portfolios with substantial client-imposed restrictions. Although ERS restricts its equity advisors to a list of Board-approved stocks, the advisors we spoke to did not consider this or ERS's transaction approval requirements a significant restriction of their investment discretion.

The Current Advisory Relationships Enhance ERS's Ability to Diversify

These advisors provide an important investment function by permitting ERS to implement a more diversified overall portfolio. Diversification among asset classes and investment styles can provide important long-term benefits to ERS by permitting better control of the risk and return relationship. We do not believe that the ERS internal staff could continue the current level of portfolio diversification without the services of these external advisors. Furthermore, the externally advised portfolios are all referred to as active portfolios and are expected to outperform their benchmarks. The internal staff, however, has typically been responsible for managing portfolios on a more passive basis, to perform more as the benchmarks perform. As a result, the advisors might provide access to more profitable strategies than ERS could achieve on its own.

On the other hand, ERS indicated that many money managers are not willing to do business with ERS under the existing advisory structure. Therefore, ERS's access to top performing or extremely specialized outside firms might be limited by its inability to enter into the type of relationship that is standard for most institutional investors. ERS's close monitoring of the advisor's decisions provides assurance that investments will continue to comply with the Board's investment policy. If ERS had full delegation authority, ERS could reduce its current level of monitoring and permit its investment staff to devote more time to internally managed portfolios, without significantly increasing the risk of relying on outside experts.

Recommendation:

As discussed further under Legislative Issues Section 1-C, the Legislature should consider expanding ERS's (and TRS's) delegation authority so that ERS (and TRS) could, if it (they) chose, fully delegate some investment decisions to private professional investment managers.

Comments From the Employees Retirement System:

The Board of Trustees of the ERS has never delegated its authority in investing the assets of the retirement system. The ERS Board of Trustees maintains the responsibility and liability for all investment decisions and the obligation to invest the assets in portfolios being advised by external managers. The ERS staff has done an excellent job of selecting its investment advisors and, thus, does not often find the need to reject their advice. However, it should be noted that because it has an advisory relationship with these managers, that the ERS can reject the advice should it choose to do so and in fact has at times done so.

The ERS has sufficient authority to meet its mission and provide retirement benefits to the state's employees. The ERS could support a statute providing for the delegation of the Board's authority given the additional flexibility that would be provided its investment activities. However, the ERS does not feel a constitutional amendment is necessary as noted in Legislative Issues, Section 1-C.

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Texas A&M University System

Section 1:

Texas A&M University Implemented Prior Recommendations

The Texas A&M System (TAMUS) Board of Regents (Board) and management further strengthened controls over investment practices by implementing our most significant prior recommendations. TAMUS hired an external investment consultant who provides the Board and internal investment staff with additional, independent investment information. Although the Board remains the fiduciary for TAMUS' investments, it delegates some investment functions, such as the hiring of consultants and money managers, to its Committee on Finance and/or to TAMUS' investment staff. We believe such delegation is reasonable, particularly in a university system environment in which the Board is responsible for making decisions on a variety of high-profile issues. Accordingly, we have characterized recommendations as implemented where management acted on our recommendations to the Board. Table 4 summarizes the status of the most significant prior findings.

Table 4

Implementation Status of Significant Recommendations		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 1-A:</p> <p>The Board should establish a formal relationship with an independent investment consultant to assist with its investment oversight responsibilities. The outside consultant should report directly to the Board and be available to perform specific tasks for the Board, such as analyzing investment policies and strategies, evaluating investment performance, assisting with external money manager searches, and providing the Board with formal or informal investment training.</p>	I	An independent investment consultant periodically reports to the Board's Committee on Finance. The consultant appears to have provided most of the recommended services, working more directly with the investment staff and the Committee on Finance. The Board does not receive formal investment training.
<p>Section 1-B:</p> <p>Management should periodically provide additional investment-related information to the Board.</p>	I	Management has included the recommended information in their periodic investment reports.

Table 4

Implementation Status of Significant Recommendations		
STATUS: I = fully or substantially implemented; P = partially implemented; N = not implemented		
Prior Recommendation	Status	Follow-Up Results/Comments
<p>Section 2-A:</p> <p>Management should monitor and report on investment compliance, and should document its due diligence reviews of external managers and its supervisory reviews of internally prepared quarterly investment performance reports.</p>	I	The external consultant's quarterly reports to the Board include information on compliance with investment policies for each portfolio. Management documents results of periodic due diligence reviews. The Board receives independent performance information from the outside consultant. Management performs reviews to ensure that its internal reports reconcile with the independent consultant's information.
<p>Section 3-A:</p> <p>Investment policy should establish limits on investment concentration to ensure sufficient diversification and should specify the benchmark for the short-term portfolio.</p>	I	The policy now contains sector and industry limits for each stock portfolio and describes the benchmark for the short-term portfolio.
<p>Section 3-B:</p> <p>TAMUS investment staff who exercise discretion over investment decisions should file annual financial disclosure statements.</p>	I	The appropriate employees appear to be filing the required financial disclosure statements.

Other Investing Entities

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Other Investing Entities

Section 1:

The General Land Office and Veterans Land Board Further Strengthened Their Investment Oversight

The General Land Office and the Veterans Land Board substantially implemented our recommendation to further improve investment oversight controls. The Veterans Land Board receives quarterly investment reports in a more timely manner, and its investment staff has improved the reports' contents to provide more information.

Section 2:

The Department of Housing and Community Affairs Improved the Timeliness of Investment Reports

Management at the Department of Housing and Community Affairs implemented our recommendation to provide quarterly investment reports to the Board and its Finance Committee in a more timely manner.

Section 3:

Other State Auditor's Office Reports Discuss the Status of Prior Recommendations for the Comptroller of Public Accounts' Treasury Operations and Texas Tech University

A separate State Auditor's Office report will discuss the status of our prior recommendations related to controls over investment practices at the Comptroller of Public Accounts' Treasury Operations.

An Audit Report on Management Controls At Texas Tech University System (SAO Report No. 00-012, February 2000) discussed the status of prior recommendations related to controls over investment practices at Texas Tech University.

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Appendix 1:

Objectives, Scope, and Methodology

Objectives

The primary objective of this follow-up audit was to determine whether the Legislature and several major state investing entities had implemented the most significant recommendations from two prior State Auditor's Office reports. We previously reported recommendations to improve investment practices in *A Review of Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996), and *A Review of Controls Over Investment Practices at Five State Investing Entities* (SAO Report No. 97-036, February 1997). Our secondary objective was to perform additional audit procedures if we became aware of significant new investment practice issues at any of the entities covered by our follow-up procedures.

Scope

The scope of this audit included follow-up procedures related to prior recommendations that required legislative action to implement. We also performed follow-up audit procedures at the entities we judged to have the most significant prior recommendations. We excluded entities at which our significant prior recommendations would be addressed in another State Auditor's Office report.

We performed follow-up procedures at the following six entities:

- Texas Education Agency
- The University of Texas System
- Employees Retirement System
- Texas A&M University
- General Land Office and Veterans Land Board
- Department of Housing and Community Affairs

We also performed audit procedures at the Texas Education Agency to address significant new issues related to the State Board of Education's oversight controls over the Permanent School Fund. In connection with that work, we simultaneously assisted the House Committee on General Investigating in fulfilling its interim charge to investigate recent actions of the State Board of Education relating to its management of the Permanent School Fund.

A separate State Auditor's Office report will report the status of prior recommendations related to controls over investment practices at the Comptroller of Public Accounts' Treasury Operations.

The State Auditor's Office reported on the status of the most significant prior investment practices control recommendations at Texas Tech University in *An Audit*

Methodology

The methodology used for this audit included collecting and analyzing information, performing audit tests and procedures, and evaluating the information against established criteria.

Information collected to accomplish the audit objectives included the following:

- Interviews with the following:
 - Management and staff of the entities' investment and/or accounting divisions
 - Selected State Board of Education members
 - Representatives of vendors or bidders involved with Permanent School Fund business
- Applicable constitutional and statutory provisions
- Attorney General Opinions
- Agency internal audit reports
- Reports issued by the Office of the Attorney General
- Reports by outside consultants
- Surveys of investing entities by outside parties
- Board and investment committee meeting minutes and tape recordings
- Board member correspondence
- Financial disclosure statements
- Tapes of legislative committee hearings
- Investment and operating policies and procedures manuals
- Ethics policies
- Contracts with consultants, advisors, external portfolio managers, investment custodians, and securities lending administrators
- Investment division organizational charts
- Personnel files
- Investment compliance reports
- Various investment reports generated for internal and/or external users
- Business filings obtained from state agencies and self-regulatory organizations
- Documents and recordings provided by the House Committee on General Investigating

Tests and procedures conducted included the following:

- Inquiries of entity staff members
- Observation of board or investment committee meetings and review of prior meeting minutes and tapes
- Review of investment policies for appropriateness and comprehensiveness
- Observation of documents or reports to determine that appropriate procedures were performed
- Recalculation of information in entity documents

- Review of contractor selection and evaluation procedures and review of selected contracts for appropriateness of terminology
- Comparison of selected contractor service fees and contractual rates
- Review of selected investment personnel files for evidence of adequate job descriptions, periodic performance evaluations, and ongoing job-related training
- Review of investment reports for timeliness, adequacy of content, and clarity
- Review of financial disclosure and “no conflict” statements

Criteria used to evaluate information received included the following:

- Constitutional and statutory restrictions and requirements
- Attorney General Opinions
- Public Funds Investment Act (as general guidance, although most entities reviewed are exempt from the Act’s major provisions)
- Entity investment policy and operating policies and procedures
- Contractual provisions
- Opinions of independent outside investment experts
- Requirements of investment-related self-regulatory organizations
- Standard audit criteria

Other Information

Fieldwork at most of the entities was conducted from June 1999 to August 1999. Procedures related to the State Board of Education’s oversight of the Permanent School Fund were extended through September 2000. The audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor’s staff performed the work:

- Roger Ferris, CPA (Project Manager)
- Hugh Ohn, CPA
- Robert Sahm, CPA
- Robin Smith, CPA
- Worth Ferguson, CPA (Quality Control Reviewer)
- William J. Morris, CPA (Quality Control Reviewer)
- Carol Smith, CPA (Audit Manager)
- Craig Kinton, CPA (Audit Director)

Transcripts Suggest That a State Board of Education Member Made Erroneous Allegations That Undermined the Decision-Making Process for the Award of Two Contracts

A State Board of Education (SBOE) member's allegation that a firm violated SBOE's "no contact" rule affected the award of two contracts. However, the evidence he cited, which the Advisor produced only recently, does not appear to support his allegation (see TEA Section 3-A).

SBOE's "no contact" rule prohibits bidders on a contract from contacting SBOE members to influence the contract award in their favor. SBOE has interpreted this rule to mean also that bidders must not ask others to contact SBOE members on their firms' behalf. The rule is in effect from the last date to submit responses to a Request for Proposals (RFP) until the date SBOE awards the contract.

An SBOE Member Alleged at the SBOE Meeting That the Recommended Firm Had Lied to the PSF Committee About Its Compliance With the "No Contact" Rule

SBOE decided to divide its RFP for consulting services into two separate contracts, the lead consultant role and the performance evaluation consultant role. On September 8, 1999, a PSF Committee member asked each finalist firm if they had violated the "no contact" rule. On September 9, 1999, the PSF Committee voted to recommend to SBOE that one firm receive both contracts. That firm's representative, a vice president and senior consultant, had apparently told the PSF Committee the day before that his firm had not violated the "no contact" rule.

On September 10, 1999, SBOE voted on the recommendations from the PSF Committee for both contracts. Prior to the first vote, an SBOE member alleged that he had recorded evidence that the recommended firm's representative had lied to the PSF Committee when stating that his firm had not violated the "no contact" rule. He told SBOE that both an owner of the firm and the firm's representative who spoke at the September 8 meeting had asked others to contact SBOE members on the firm's behalf. SBOE did not award either contract to the firm (referred to henceforth as the Rejected Firm).

The following excerpted transcripts from the September 10 meeting detail the SBOE member's allegations and some of the related discussion by other members. We have replaced the names of firms or individuals by the designations or explanations in parentheses. Brackets enclose our explanatory remarks. The first discussion and vote was to select the lead consultant.

SBOE Member 1 (the member who made the allegations): . . . The questions were asked consistently of each one, "Have you," to the respondent, "had any contact directly or indirectly with board members in the solicitation of support for your contract . . . ?" . . . The problem that I have is that [Rejected Firm] responded, to the direct question, "No, we have not." And I've discovered to my satisfaction—and there is evidence and if necessary we can provide some affidavits, and we can provide

some recorded conversations—that [Rejected Firm] did indeed contact individuals on behalf of their response to communicate with board members, their desired intent to seek the RFP. I find that disturbing. So on that basis, and applying our procedure and policy across the board, I have to reject them, and accept, and propose that we accept [another firm, which was then awarded the lead consultant contract but later rejected it after a Chicago meeting with SBOE Member 1, another SBOE member, and the unpaid Advisor]. . . That’s my motion.

SBOE Member 2: Is there discussion? Let me just ask [SBOE Member 1], your information is, therefore, that since the time we in the Committee voted unanimously for [Rejected Firm] that evidence has come to the fore that it also violated the no contact rule?

SBOE Member 1: Yes, sir.

SBOE Member 2: And would you say, absent that information, that you would be in favor of [Rejected Firm], the same as you voted, as we all voted yesterday?

SBOE Member 1: I would have voted in ignorance, and regret it. And I’m happy that the information became apparent.

[Discussion by others omitted.]

SBOE Member 3: To our knowledge, the only finalist that did not disclose actual efforts to contact board members was [Rejected Firm]. . . .

[Discussion by others omitted.]

SBOE Member 4: I find this a little bit disturbing because absolutely nobody contacted me from any of these groups, any of the finalists. And I feel like that we only have real proof that one person made contact because he admitted it [this refers to the Performance Consultant described in TEA Sections 2-B and 3-A who, after the second vote, was awarded the performance evaluation consultant contract in place of the Rejected Firm]. And I find it a little disturbing to have to take this without any real proof, that this happened, or when it happened, or who was contacted. I really don’t know, I just really don’t like not having more proof.

SBOE Member 1: Well, I’d be happy to respond and [SBOE Member 4], I am satisfied personally, and that I have that confidence in the information that it takes my vote.

SBOE Member 4: That doesn’t satisfy me.

SBOE Member 1: And you certainly have your vote, and so I simply submit the motion. And the core issue, and I’ll close and I’ll keep my peace, the core issue here is the fact that we have, we’re going to issue a contract proposed to a firm that lied in a meeting to an elected board.

SBOE Member 4: That’s only your word that they lied.

[Discussion by others omitted.]

SBOE Member 5 (the member who questioned each finalist on September 8): . . .
And [Rejected Firm] would have my vote except for some disqualification which you say, and you have heard, but which I haven't been apprised of. Apparently, only a few of us have been apprised of, and we get no confirmation from [TEA's Chief Counsel] that it constitutes a violation of the no contact rule.

SBOE Member 1: I don't even think the issue is where it violates the no contact rule. Well, I, in my judgment they did not answer your question honestly. There were contacts.

SBOE Member 5: Then tell us what they did that causes us to follow your vote. Other than your word on it.

SBOE Member 1: Because, I think then we're going to delve into some of the politics of who knows who, and who contacts who, and then that gets, and you understand that.

SBOE Member 5: My point, though, is, if they violated the no contact rule, I am perfectly willing to go against them. . . All I have that they otherwise violated, is what you, is you say that they did. You won't even tell me the facts that they did. That's a little disturbing.

SBOE Member 1: Contacts were made by [Rejected Firm's representative], directly, trying to seek support from SBOE, from a third party. Contacts were made by the principal in the firm to parties.

SBOE Member 5: To a board member?

SBOE Member 1: To parties to contact board members.

SBOE Member 5: They did contact a board member?

SBOE Member 1: I have it recorded.

[After further discussion, SBOE awarded the lead consultant contract to the firm nominated to replace the Rejected Firm.]

Next, SBOE discussed and voted on awarding the performance evaluation consultant contract. Excerpts from that discussion follow:

SBOE Member 6: [SBOE Member 1], would you have the same concerns there?

SBOE Member 1: Obviously. Looking for a performance consultant, let me just make my motion. I propose, my motion is that we adopt and extend a contract to [firm of the Performance Consultant] for the performance management services for the Permanent School Fund

[Discussion by others omitted.]

SBOE Member 1: The issue that I will say in defense of, well [Rejected Firm] obviously did not tell the truth in my opinion. [Performance Consultant] did answer

[SBOE Member 5's] question honestly. Some folks here may not like the answers to those questions, but they did answer the questions honestly and forthrightly. They are the only respondent who asked to do asset alloca- asset - [correcting himself] performance measurement exclusively.

SBOE Member 5: This discussion and voting pattern is one of the weirdest I have ever experienced. [Performance Consultant's firm] has one principal official who has action still pending against him at the Securities and Exchange Commission. He presented to us his own version of the SEC's proceedings, and presented as well documentation, which would appear to support his version of the current status of that investigation. But the truth of the matter is the investigation is not closed at the SEC; he has no clean bill of health at the SEC. He has neither been found guilty or not guilty by the SEC. It is pending. He indicated to us it would be a couple of years before the matter would be resolved.

But he also, very forthrightly and aggressively, acknowledged that he had made every effort he could to contact as many members of the board as he could through intermediaries, third party intermediaries. He obviously was aware of the no contact rule, so he got, tried to get other people on his behalf to contact at least a majority of this board on his behalf. That seems to me is a direct, open violation of your no contact rule. No communication is permitted with any board member from the response deadline date to the request for proposal, through and including the date of selection of outside professional expertise. Yes, he honestly admitted he violated your rule, and did so aggressively.

I find it very interesting, that clearly one of the most professional of the people who presented to us, I don't know anything about them at all, but [Rejected Firm] is suddenly disqualified, when apparently only one member of the board knows what the facts are related to that disqualification. And that this man [referring to the Performance Consultant] aggressively admits that he tried to manipulate his selection favorably. And yet the motion is to include him in a very sensitive role to be employed by this board. I find that astounding. The man is disqualified. The firm is disqualified. They have openly violated your rules.

[Discussion by others omitted.]

SBOE Member 7: I know [SBOE Member 8] was very concerned about the fact that [the unpaid Advisor] has been a constant advisor, has been here for a number of meetings, to [SBOE Member 3], and to [SBOE Member 1]. And I just, you know, wonder if that's a conflict of interest there. You know, and are we promoting a double standard? Are we knocking out [Rejected Firm] for the word of one board member, and then voting for [Performance Consultant's firm], based on the fact that they were honest, but they did contact most of the members?

[After further discussion, SBOE failed to approve an amended motion to retain the existing performance evaluation consultant, on a 7-8 vote. SBOE then awarded the contract to the Performance Consultant's firm on an 8-7 vote.]

Recordings That the SBOE Member's Unpaid Advisor Provided Later to a Legislative Committee Do Not Indicate That the Rejected Firm Asked Anyone to Contact SBOE Members on Its Behalf

In response to a request by the chair of a legislative committee, the Advisor provided the committee with copies of two tapes of conversations relevant to the SBOE member's allegations. The Advisor testified, when asked, that the first tape was unedited. These tapes, made public almost a year after the two SBOE votes, provide no evidence that either the representative or principal of the Rejected Firm asked the Advisor or anyone else to contact SBOE members on its behalf. Complete transcripts of those two tapes (neither has an identified date) are as follows:

Tape One - A recording of a message that a principal (an owner) of the Rejected Firm left on the Advisor's answering service.

Rejected Firm's Principal: This is [name of caller], a principal of [Rejected Firm] in [the firm's headquarters city]. Apologize calling you this late on your cell phone. Got your number. He said it would be OK to call after talking to [Performance Consultant]. What we'd like to do is leave you our home phone number. My home phone number, [first name of caller]'s home phone number, is [phone number]. If there's any chance to talk to you this evening, I'd love to spend a few minutes talking. [Unintelligible short word, possibly "I"] understand there might have been a miscommunication. I apologize for anything that took place there. I just want to assure you that the principals of our firm, if we need to be there in the morning for part of that presentation tomorrow, we can certainly do that. And want to make sure that you know that you've got commitment on our end from the people who own the firm to do whatever it takes to solve SBOE's needs, work with SBOE and/or its advisers to satisfy what you're looking for on the consulting side. And again, I encourage you to call me at home tonight, [phone number]. If I don't hear from you, I'm going to call you first thing in the morning as well and I hope to talk to you. Thank you, good night. [Sound of telephone hanging up.]

Tape Two - A recording of part of a conversation between the Rejected Firm's representative (who responded to questions about the no contact rule on September 8, 1999) and the Advisor

[The recording the Advisor provided omits the beginning of this conversation.]

Rejected Firm's Representative: I am concerned about, uh

Advisor: [Interrupts] When did you speak to [Advisor's Partner]?

Rejected Firm's Representative: What's that?

Advisor: When did you speak to [Advisor's Partner]?

Rejected Firm's Representative: This afternoon. And I didn't know that

Advisor: [Interrupts] You didn't speak to him on Saturday?

Rejected Firm's Representative: No.

Advisor: Hmmm.

Rejected Firm's Representative: I didn't, I didn't know that I had said something that, I didn't, that's being misunderstood, I believe. Let me just try to summarize this and then I'll let you go.

When I had this conversation with [PSF Executive Administrator], about this "white paper,"⁶ that was before you and I had even met, number one. Number two, please keep in mind that I'm sorry that I've created this impression that I may have created, but I told [PSF Executive Administrator] to come to you and to deal squarely with you. And that's before I met you, [Advisor's first name]. And the reason that I told him that, before I even knew you and met you, has nothing to do with politics or being, you know, chummy or a friend. It has to do with

[At this point, there is a loud pulsating noise and the recording ends.]

⁶ The "white paper" is a technical position paper that the Advisor apparently produced. The PSF Executive Administrator had a copy of this document.

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