



Lawrence F. Alwin, CPA
State Auditor

An Independent Review of the Teacher Retirement System Investment Program

Conducted by Independent Fiduciary Services, Inc.
Under Contract to the State Auditor's Office

February 13, 2002

Members of the Legislative Audit Committee:

The State Auditor's Office contracted with Independent Fiduciary Services, Inc. (IFS) to perform an independent evaluation of the Teacher Retirement System's (TRS) investment program and practices on behalf of the Legislative Audit Committee. IFS finds that, based on current requirements of state law, TRS investment program and practices are:

. . . well structured and managed in an effective and professional manner. TRS is a leader in the pension fund industry, and in many respects its investment program and processes are emblematic of "best practices" used by other large public pension funds. Compared to [IFS's previous 1996 report] the increased professionalism and preparedness of both the members of the Board of Trustees and the investment staff are impressive.

However, IFS believes that developments in the securities markets and accepted pension industry best practices are becoming increasingly out of sync with current Texas statutory and constitutional provisions. IFS does not identify any legal constraints that are harmful to TRS's investment program, but it does identify legal constraints that inhibit TRS's efforts to maximize investment returns, minimize risk, and operate efficiently. IFS's recommendations are built around the principle that the TRS Board of Trustees (Board), as the fiduciary responsible for the effective management of the TRS Trust Fund, should be given the freedom to manage its responsibility prudently according to its best judgment. This freedom of prudent action should be counterbalanced by a high degree of accountability.

IFS's key legislative recommendations are summarized as follows:

IFS's key legislative recommendations are summarized as follows:

- Make explicit the TRS Board's ability to delegate investment authority to internal staff.
- Allow the Board to delegate investment authority to external managers when warranted, subject to strict fiduciary standards.

Plan of Work

The plan of work in the request for proposal developed by the State Auditor's Office for this project set forth the objectives and scope of IFS's report. The plan of work is included in IFS's report as Appendix 5. The summarized objectives are as follows:

- Determine if the TRS Board has the necessary authority required to manage TRS's investments optimally.
- Review the adequacy of the Board's investment policy, asset allocation, and monitoring processes.
- Address the status of key recommendations made in IFS's report on its 1996 investment review of TRS.
- Determine the sufficiency of information provided to the Board to support its consideration of investment issues.
- Address the use of qualified historically underutilized businesses for investment contracting and brokerage.
- Assess the adequacy of TRS's soft dollar policies and compliance with best industry practices.
- Review the current procedures used by TRS to assess trade execution and market impact.
- Assess TRS's alternative assets program and practices.
- Review TRS's implementation and utilization of its trade order management system.
- Assess the effectiveness of TRS's investment services department.

- Allow the Board to invest in any asset class, instrument, or strategy it deems prudent.
- Grant the Board budgetary, personnel, and procurement autonomy as it pertains to the investment program, while maintaining strict reporting and accountability to the Legislature.
- Offset increased Board autonomy by imposing the modern, prudent person standard of care.
- Use the principles imbedded in the Uniform Prudent Investor Act and the Uniform Management of Public Employees Retirement Systems Act.

Specifically, IFS states:

. . . TRS could further optimize its management effectiveness if legal constraints on Board authority regarding the investment program, budgetary process, procurement, and personnel matters were significantly eased or removed. . . . Reducing these constraints—while still retaining essential safeguards—could make an already well run and well organized pension fund even stronger, thus facilitating TRS’s ability to meet the retirement needs of its beneficiaries while minimizing TRS’s reliance on general revenue appropriations.

We appreciate the full support and diligent cooperation of TRS’s Board, management, advisors, and service providers throughout this project. TRS’s management has committed to fully exploring and considering all recommendations IFS offered. Please contact Carol Smith, Audit Manager, at (512) 936-9500 if you have any questions.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Enclosure: Independent Fiduciary Services, Inc.,
Report to the Legislative Audit Committee
Regarding the Investment Program and Practices
of the Teacher Retirement System of Texas

Purpose, Scope, and Presentation

Texas Government Code, Section 825.512(a), specifies that:

The legislative audit committee biennially shall select an independent firm with substantial experience in evaluating institutional investment practices and performance to evaluate the retirement system’s investment practices and performance.

The State Auditor’s Office managed the report process on behalf of the Legislative Audit Committee.

The plan of work developed by the State Auditor’s Office for the IFS report placed primary emphasis on reviewing investment practices and following up on the previous independent review of TRS conducted in 1996. The State Auditor’s Office placed less emphasis on investment performance because this area is included within the scope of a separate report that reviews the comparative investment performance of five large state investment funds. The comparative report will be prepared jointly by a consultant and the State Auditor’s Office and will cover the Teacher Retirement System, the Employees Retirement System, the Permanent School Fund, the Permanent University Fund, and the Long Term Fund (which is now known as the General Endowment Fund).

IFS’s report is organized into three major sections to facilitate the consideration of issues and recommendations by the Legislature, the Board of Trustees, and management. The report is available in two versions:

- The **unabridged version** contains the master executive summary; the legislative, Board of Trustees, and the management sections; and all six appendices.
- The **abridged version** contains the master executive summary and the legislative section of the report and does not contain any exhibits.



INDEPENDENT FIDUCIARY SERVICES, INC.

Report to the Legislative Audit Committee
Regarding the
Investment Program and Practices
of the
Teacher Retirement System of Texas

Prepared Under Contract to the Texas State Auditor's Office
And Released as Part of SAO Report No. 02-021

February 2002

Abridged

Disclaimer

The findings and conclusions contained herein are the responsibility of Independent Fiduciary Services, Inc. The State Auditor's Office has not audited the contents of this report.



February 12, 2002

Legislative Audit Committee
1501 N. Congress Avenue
Austin, Texas 78701

Dear Committee Members:

This is to comment on the recently completed *Report to the Legislative Audit Committee Regarding the Investment Program and Practices of the Teacher Retirement System of Texas* by Independent Fiduciary Services, Inc. The report's coverage includes virtually all aspects of TRS investment management. We appreciate the manner in which the study was conducted by IFSI and the coordination provided by the State Auditor's Office during the course of the review.

Trustees and management strive to maintain a clear and continuous focus on matters that drive investment results--effective oversight and policies; sound methodology in establishing asset allocation; effective execution; cost efficiency; and performance measurement against well-defined standards. The report's favorable conclusions regarding these areas are noted.

The pension trust fund is quite large and serves over one million members and annuitants. IFSI provides information and recommendations regarding core trustee issues. These include authority to delegate investment management; investment selection options that promote performance and risk management through diversification; reporting, accountability and compliance; and broad budgetary management authority intended to optimize portfolio management, including compensation programs for investment professional staff. We believe that you will find IFSI's work to be of value when considering authority that you may grant to trustees to facilitate their prudent management of the pension trust fund.

The report's recommendations will be useful as a guide for further enhancement of the TRS investment function. We look forward to evaluating each recommendation in the report and tracking consideration and implementation efforts. TRS trustees and staff understand their role in managing the pension trust fund, who it is intended to serve, and believe that it is worthwhile for the legislature to periodically receive independent

assessments such as the one before you. The legislature has already taken significant positive steps to address some of the issues raised in the report. We look forward to working with the legislature to continue to develop the best possible management and oversight of the pension trust fund.

We appreciate the opportunity to comment on the final report and would be pleased to respond in more detail at the Committee's request.

Sincerely,



Charles L. Dunlap

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Independent Fiduciary Services, Inc.
Report to the Legislative Audit Committee
regarding the
Investment Program and Practices
of the
Teacher Retirement System of Texas

February 2002

I. INTRODUCTION

A. Reason for Study

The dual purpose of this Review is to (a) assess the current status of key investment issues, as identified collaboratively by the Texas State Auditor's Office (the "SAO") and the Teacher Retirement System of Texas ("TRS") and addressed in Independent Fiduciary Services, Inc.'s ("IFS") "Report to the Legislative Audit Committee Regarding the Investment Program and Practices of the Teacher Retirement System of Texas" (the "1996 Report"), and (b) evaluate additional, specific aspects of the TRS investment program also identified by the SAO.

B. Methodology

In completing this study, we proceeded through several steps.

First, was collection of information. We prepared an extensive set of requests for information, to which the TRS responded in detail. This included, for instance, numerous policy and procedural documents, minutes of Trustee meetings, internal memoranda, actuarial data, contracts with service providers, statutory materials and a great deal of other information.



Additionally, we collected information through a series of on site personal interviews with Trustees, TRS staff and service providers.

Based on the information collected, we prepared initial lines of analysis and tentative conclusions across the range of subjects included in our contract with the SAO. We submitted to both the SAO and the TRS numerous drafts of our work, for their comment and extensive discussion. Although much of this discussion was over the telephone, some was face to face in Austin. In light of comments and questions from the SAO and TRS, we revised and refined our drafts over time.

The process of draft, comment and redrafts enabled the parties to point out matters which, in their view, were either factually or conceptually inaccurate, incomplete or misleading. The process also enabled us to obtain additional information and prepare a final report that took into account all comments. Nevertheless, the final form and content of this Report reflects our final, independent judgment.

This Report is subject to several caveats. First, many of the subjects addressed are judgmental and not susceptible to definitive or absolute conclusions. Second, we relied on information provided to us, including, to some extent, oral and written representations. Thus, our conclusions are based on the information we considered as of the time we performed our work. While we sought to cross-verify certain information, the process of cross-verification was limited. Third, although the report considers various legal matters, it does not purport to provide or supplant the need for legal advice on such matters.

C. Explanation of Report Format

In light of the multiplicity of issues and the complex nature of this review, this Report has been divided into the Master Executive Summary (intended for all readers), this Introduction and three distinct “Parts.” Part I designed especially for the Legislature, Part II for the TRS Board of



Trustees and Part III for TRS Executive Management. Each Part begins with an “Executive Summary” directed to the specialized audience and each is designed to be a standalone document. Accordingly, a reader of all Parts will find some repetition. This format has been used in an effort to afford members of the Legislature, the TRS Board, and TRS Executive Management the option of selectively focusing on issues of greatest concern to them.

The Report is presented in two versions. The abridged version contains the Master Executive Summary and the legislative portion (Part I) of the Report only and does not contain any appendices. The unabridged version contains all three parts, Part I – Legislative Issues, Part II – Key Investment Issues Requiring the Consideration and Judgment of the TRS Board of Trustees and Part III – Key Issues Within the Purview of TRS Executive Management, as well as various appendices.

D. Independent Fiduciary Services, Inc.

Independent Fiduciary Services, Inc. (“IFS”) specializes in evaluating the organization, administration, and investment programs of pension systems with dual expertise regarding fund operations and fiduciary responsibility. Prior to completing this assignment, we have completed similar evaluations of numerous other public and private pension funds. A more extensive description of IFS is provided in Appendix 4, page 223.



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Master Executive Summary

The primary purposes of this review are:

- To assess the status of the key recommendations Independent Fiduciary Services (“IFS”) made five years ago in its first report concerning the investment program and practices of the Teacher Retirement System (the “1996 report”); and
- To evaluate the Teacher Retirement System’s (“TRS”) current investment practices.

Most Prior Recommendations Have Been Implemented

TRS has implemented most of the key recommendations contained in the 1996 report, and of those it has not, nearly all involve matters outside the agency’s control. Appendix 1 on page 189 contains an assessment of the status of each key recommendation from the 1996 report.

TRS’s Pension Fund Is Well-Managed Given Constitutional and Statutory Limitations

Considering the requirements imposed by governing law, TRS’s current investment program and practices are well structured and managed in an effective and professional manner. TRS is a leader in the pension fund industry, and in many respects its investment program and processes are emblematic of “best practices” used by other large public pension funds. Compared to 1996, the increased professionalism and preparedness of both the members of the Board of Trustees (Board) and the investment staff are impressive.

The 1996 report identified several provisions of law¹ limiting TRS’s ability to effectively manage its investment portfolio. Since then, the Legislature has eased some constraints by



allowing TRS to manage its assets according to what investment professionals call “modern portfolio theory.”² This approach facilitates diversification by allowing the Board and staff to evaluate each investment within the context of the whole portfolio, rather than in isolation. The Legislature also expanded the definition of “securities” to allow a broader range of investments, such as interests in various types of limited partnerships.³ These changes help TRS enhance earnings and manage risk. The Legislature, however, has further opportunities to help TRS achieve its potential as one of the nation’s largest public pension funds.

Certain constitutional and statutory provisions continue to constrain TRS’s operations, resources and investment program in ways that impair performance, risk control and operating efficiency. Specifically, (1) as noted in the 1996 report, the Board may not delegate investment authority to external investment managers⁴ and (2) state statutes limit the Board’s and management’s authority over budget, procurement and personnel.⁵ This report analyzes the impact of these limits and recommends amendments to address them.

The Prohibition Against Delegating Investment Authority Restricts Options that May Benefit the Trust Fund

As the complexity and range of generally acceptable asset classes and investment strategies has proliferated, modern investment practice and law have evolved to permit pension fund boards to delegate discretionary management functions to external firms. Texas law, however, still forbids the TRS Board to delegate these functions. This limitation lessens TRS’s ability to diversify its investments and restricts the prudent and effective management of the TRS investment program. IFS has found no other statewide pension fund outside Texas that is completely prohibited by law from delegating authority to external investment managers.

TRS employees manage most of its assets internally. Although TRS investment staff is highly competent, it is difficult to maintain sufficient expertise in all the investment products and strategies required of a broadly diversified portfolio. Further, even the degree to which TRS trustees can delegate investment authority to internal TRS staff is uncertain. As a result, the



Board limits staff choices to items on an “Approved Universe” of investments. Creating and updating this list is an unwieldy function for a Board that meets approximately eight times per year.

Other Limitations on TRS Board Authority Hamper Effectiveness

In addition to precluding the TRS Board from delegating investment decisions, statutes also limit Board and management authority over permissible investment selection, budget, procurement and personnel. Several of these limits were not applicable at the time of the 1996 report. These limitations restrict management options that we believe trustees should have. Further, these options are consistent with the authority we observe at other very large systems. Combined with an inability to delegate investment authority, these limitations materially constrain the TRS investment program, in ways that may impair its long-term, risk-adjusted, net investment returns.

The current limitations on budget, procurement, and personnel have:

- Constrained the risk, return and operational characteristics of the investment portfolios;
- Hampered effective participation in alternative asset limited partnerships;
- Limited options to control investment staff turnover; and
- Unintentionally created the expensive necessity of procuring goods and services by placing trades with brokers that offer goods and services as promotions (known as “soft dollars”). Procuring goods and services through brokerage activity rather than directly (“hard dollars”) often results in inferior securities trades and/or higher than normal commission



costs. The excess costs TRS incurred by using soft rather than hard dollars totaled nearly \$13 million for fiscal years 1997 and 1998⁶. The soft dollar impact may increase in future years given the Board's recent decision to increase the cap on soft dollar utilization from 15% to 25% of all stock trades.

The Legislature has a strong interest in the safety, soundness, and efficiency of TRS's assets and operations. The Legislature can effectively oversee TRS's investment function without restricting the management of TRS's daily operations beyond the degree typical of other large public pension funds. Today, Texas statutes contain detailed prescriptions regarding many functions commonly within a Board's purview:

- Number of staff TRS employs;
- Amount employees may be paid (including base compensation and incentive compensation);
- Expenditure of trust fund assets, including per diem amounts and travel cost maximums;
- Permissible investments;
- Tools and research available for effective portfolio management; and
- Hiring of outside experts such as counsel and consultants.

Although the Board could make a "fiduciary finding" to justify expending assets of the trust beyond the legislative appropriation,⁷ IFS perceives an understandable reluctance on the part of TRS to do so. This report recommends re-balancing enabling law to maintain legislative



oversight, while at the same time giving TRS greater flexibility in budget, procurement, and human resources management, subject to rigorous fiduciary standards.

Primary Recommendation

TRS should be granted the authority to delegate investment authority, make any investment it deems prudent, establish its own budget, hire and compensate its staff, and procure such goods and services as it reasonably deems necessary. However, as a counterbalance to greater Board independence, the TRS Board and management should be subject to stricter fiduciary standards and remain accountable to the Legislature. As discussed on page 32 of this review, IFS recommends a somewhat more rigorous fiduciary standard of care for the TRS Board and management than current Texas law requires. Such accountability should include specified reporting to the Legislature and periodic independent evaluations of TRS on behalf of the Legislature.

Additional Recommendations

Various non-legislative opportunities for improvement are presented in Parts II and III for Board and management consideration.



¹ E.g., Tex. Const. art. 16, §67(a)(3) and Tex. Gov't. Code Ann. §825.301(a).

² Tex. Gov't. Code Ann. §825.301(a), governing TRS administration, was amended to provide that investment decisions are subject to the standard provided in Tex. Prop. Code Ann. §113.056(a). Acts 1997, 75th Leg., ch. 1416, §25, eff. September 1, 1997.

³ The Legislature amended Tex. Gov't Code Ann. §825.301 in 1997 to incorporate the standard of care contained in the Tex. Trust Code Ann, Tex. Prop. Code Ann. §113.056(a). Acts 1997, 75th Leg., ch. 1416, §25, eff. September 1, 1997. The section was further amended in 1999 to include within the definition of "securities" several asset classes: "any investment instrument defined as such by Art. 581-4, VTCS, 15 United States Code §77(b)(a)(1), or 15 USC §78c(a)(10), an interest in a limited partnership or investment contract, and any instrument or contract intended to manage transaction or currency exchange risk..." Acts 1999, 76th Leg, ch. 1540, § 17, eff. Sept. 1, 1999.

⁴ Op. Tex. Att'y. Gen. No. JC-0043 (1999).

⁵ Tex. Gov't. Code Ann §821.003 makes TRS an agency of the State. §660.003 imposes travel restrictions on all state agencies. The 2002-2003 General Appropriations Act contains the biennial appropriation for all state agencies and higher education institutions. As stated in the bill's caption, the Appropriations Act authorizes and prescribed "conditions, limitations, rules and procedures for allocating and expending the appropriated funds." [of the State]. Art. III-40-42 contains the appropriation for TRS. At III-40, it imposes a cap on the number of full time equivalent employees TRS may employ. III-41 lists key management positions with allowed maximum salaries.

⁶ The cost assumptions for commission rates came from TRS's actual experience for full service trades and execution-only program trades. The market impact assumptions are incremental for each type of trade, and were based on academic studies by professors at Emery University and the University of North Carolina, regarding trading in general, not actual trades on behalf of TRS. We believe that the base assumptions were, at the time, reasonable for the market as a whole, but may have been more expensive than TRS's actual experience at the time.

⁷ Tex. Gov't. Code Ann §825.314(b)



PART I - Legislative Issues

Executive Summary

We have evaluated TRS's current investment practices to determine whether TRS has the necessary legal authority and operating autonomy to manage its investment program optimally. In our opinion, the System would benefit from additional authority. Consequently, we recommend that the Legislature consider giving the TRS Board of Trustees ("Board") greater discretionary authority, accompanied by strict fiduciary standards and accountability to the Legislature.

After allowing for the requirements of its governing laws, the current investment program and practices of TRS are proficiently run, comparatively sound (relative to other large public pension funds across the country) and in many respects representative of "best practices" utilized by such funds. In our view, TRS could further optimize its management effectiveness if legal constraints on Board authority regarding the investment program, budgetary process, procurement and personnel matters were significantly eased or removed. Such constraints are not consistent with "best practices" across the country for comparable funds. Reducing these constraints – while still retaining essential safeguards – could make an already well run and well organized pension fund even stronger, thus facilitating TRS's ability to meet the retirement needs of its beneficiaries while minimizing TRS's reliance on general revenue appropriations.

In order to facilitate optimal investment performance, we recommend that the Legislature allow additional flexibility for TRS in the management of its investment program, subject, however, to rigorous fiduciary standards and accountability to the Legislature. Specifically we recommend that TRS be granted:

- **Authority to delegate investment discretion to external investment management firms, subject to strict fiduciary standards and continuing**



legislative oversight. Implementing this recommendation will remove one of the most significant restrictions on TRS’s ability to optimally manage the pension fund. Most public pension funds (statewide and local) outside of Texas are permitted to delegate at least some investment discretion to external investment firms.¹ However, TRS is precluded from doing so. TRS need not delegate its entire investment program to external firms to benefit from this approach. Indeed, TRS’s internal investment program is impressive. However, in today’s increasingly complex investment environment, it is difficult to hire and retain qualified investment staff expert in all the forms of investment required to prudently diversify an \$80 billion portfolio. The ban on delegation both unduly burdens the Board and management and precludes selective use of external management when warranted. **Additionally, the Board’s ability to delegate to internal management should be clarified.** Uncertainty as to the permissibility of internal delegation causes the Board and management to devote unproductive time to maintaining an “Approved Universe” list of eligible securities – an administrative burden with no commensurate added value.

- **Broad authority to invest in any investments, strategies and instruments which, based on prudent analysis and strict fiduciary standards, the Board deems suitable,** rather than limiting TRS (as under current law) to whatever fits within the prevailing, static definition of “securities.” The current definition of securities arguably breeds uncertainty about what investments are permissible, limits TRS’s ability to construct a fully diversified investment portfolio, and as a result, restricts its ability to pursue maximum, long term, net investment returns at minimized risk.
- **Independent budgetary, personnel, and procurement authority, subject to strict fiduciary standards and accountability to the Legislature.** Granting TRS enhanced autonomy in these respects is consistent with “best practice” principles and the trend in the public pension fund industry to provide boards



sufficient tools to effectively and efficiently fulfill their fiduciary obligations. In particular, undue constraints on authority over budget, personnel and procurement will likely prove increasingly counterproductive as TRS continues to prudently diversify its portfolio by building out its “alternatives” investment program (e.g., private equity, venture capital, strategically traded securities). This recommendation is not intended to apply to the expenditure of general revenue funds, but rather only to TRS investment-related budgetary, personnel, and procurement expenditures made from the TRS Trust Fund.

Insufficient Authority and Autonomy Constrains Optimal Management of the TRS Investment Program

State law limitations on authority and autonomy unduly constrain the ability of TRS to optimize its investment management program. We believe that, the Board should be granted considerable autonomy, subject to ongoing legislative oversight and rigorous fiduciary standards.

Industry Legal Standards Exist for the Management of Public Pension Funds

Unlike private retirement systems that are governed principally by the federal Employee Retirement Income Security Act (“ERISA”), public pension funds are governed by their respective state laws. Many of these state laws have not kept pace with and do not reflect modern investment practices. As a result, although boards are required to prudently invest the assets of a pension fund, they may be unable to optimize returns at an appropriate level of risk because of outdated statutory requirements that do not reflect changed capital market conditions.

In recognition of the changing environment faced by public retirement systems, the National Conference of Commissioners on Uniform Laws (“NCCUL”) has developed two uniform laws² – The Uniform Prudent Investor Act (“UPIA”) was approved and recommended to all states August 5, 1994 and the Uniform Management of Public Employees Retirement Systems Act (“UMPERSA”) was approved and recommended to all states August 1, 1997.



UPIA and UMPERSA are collectively referred to as the “Acts.” We agree with the conclusions of the NCCUL that these two uniform laws effectively incorporate the major principles of portfolio management developed by the past 50 years of financial research.

The State of Texas has adopted neither of these Acts. A 1999 report issued by the Texas House Committee on Pensions and Investments expressed uncertainty regarding whether anything would be gained by adopting either UMPERSA or UPIA. Full adoption of these Acts may not be necessary for Texas. Nevertheless, we believe that the legislative enactment of certain relevant principles embodied in these Acts – namely, authorizing boards to delegate investment authority; permitting investments in any instruments and strategies deemed prudent; and greater operating autonomy – is consistent with “best practices” and would promote the ability of the TRS Board to fulfill its investment mission.

The relevant principles of the two uniform laws are set forth below.

Principles of the Uniform Prudent Investor Act (UPIA)

UPIA reverses common law rules that historically restricted the investment powers of trustees. UPIA has been adopted in 72% of the states and is endorsed by the American Bar Association and the American Bankers Association.³ Legislative adoption of UPIA principles would remove most of the current restrictions imposed by Texas law on the TRS Board’s investment authority. Additionally, it would allow the Board to delegate investment decisions to staff and qualified agents (e.g., external money managers), eliminate the legal concerns that we were advised led the Board’s fiduciary counsel to recommend the Board’s adoption of the “Approved Universe” list several years ago, and expand the range of permissible investments.



Principles of the Uniform Management of Public Employees Retirement Systems Act (UMPERSA)

The intent of UMPERSA is to modernize, standardize, and clarify the rules governing the management of public employee retirement systems. Like UPIA, UMPERSA was developed as a uniform law designed to replace laws that inhibit or prevent the use of modern investment practices – all restrictions on types of investment are abrogated and replaced by general but rigorous fiduciary standards of prudence and loyalty. Also like UPIA, UMPERSA affirms the power of a board of trustees to delegate investment and management functions.⁴ It also advocates independent management of a pension fund as a fundamental principle necessary to ensure that boards are able to perform their duties effectively and efficiently, subject, however, to strict fiduciary standards, clear reporting and legislative oversight. Thus, UMPERSA provides for independent procurement, contracting, budgetary, and personnel authority (e.g., the ability to hire, evaluate and compensate staff).

In exchange for this needed independence, boards are subjected to high fiduciary standards and held accountable pursuant to stringent reporting and disclosure requirements. UMPERSA imposes strict liabilities on fiduciaries for breaching their duties, including personal financial exposure and reporting and disclosure requirements. However, UMPERSA allows boards to use trust fund assets to purchase fiduciary liability insurance to protect them from such exposure. (To the extent that TRS Board members may already run some risk of similar exposure, TRS has, pursuant to statutory authority, purchased liability insurance coverage for the Board and specified employees.⁵)

UMPERSA also has been endorsed by the American Bar Association, and according to the National Conference on Public Employee Retirement Systems, has been introduced in 16 states. Only South Carolina has enacted specific portions of the Act (the fiduciary sections), although other jurisdictions have adopted many UMPERSA principles, e.g., Indiana recently enacted statutes governing that state's statewide teacher retirement system that contain UMPERSA principles.



The Trend Among Public Pension Plans is Toward Greater Autonomy

A survey recently conducted by IFS for the Iowa Governor’s Task Force on public pensions fund structure and governance found that increasing numbers of public pension funds are being granted enhanced levels of independence from the appropriation process. The survey respondents consisted of 50 public pension funds, principally state pension funds. The survey reflected that 90% of the respondent systems had independent budgetary authority or were not subject to the jurisdiction’s appropriations process. Numerous teacher retirement system boards have independent budgetary authority, pursuant to state statutes, including Indiana State Teacher Retirement System, Teachers’ Retirement System of Alabama, New York State Teachers’ Retirement System, North Dakota Teachers’ Retirement Fund, Teachers’ Retirement of Oklahoma, Ohio State Teachers Retirement System and Montana Teachers’ Retirement System.⁶

Clarify Authority to Delegate

The current provisions of Texas law governing the authority of the TRS Board to delegate investment discretion are contradictory, or at least confusing. On the one hand, constitutional provisions⁷ can be construed to prevent delegation. On the other hand, some statutory provisions⁸ expressly permit delegation (e.g., cash management by the custody bank and securities lending) and as a practical matter delegations to staff do occur (e.g., rebalancing portfolio investment allocations). In addition, playing “devil’s advocate” one may argue that investment in a limited partnership constitutes a “delegation” of investment discretion to the general partner. However, since TRS’s interest in such a partnership is by definition a “security”⁹ this argument illustrates the needless confusion that can arise between a permissible private investment and an impermissible delegation of investment discretion. These contradictions create an underlying theme of legal uncertainty that unduly limits TRS’s ability to optimally manage its investment program. In response to this uncertainty, TRS has foregone the benefits that delegation to external management may offer and has led to the unproductive “Approved Universe” mechanism.



Specific Authority for External Delegation is Needed

Most public pension funds outside of Texas have legal authority to delegate at least some investment discretion to external investment firms. TRS is precluded from doing so based on interpretation of Texas law by the Texas Attorney General. However, TRS need not delegate its entire investment program to external firms to benefit from this approach. In fact, among large public funds, internal asset management is common. Funds that manage assets internally typically manage more than half of their assets themselves.

In determining whether and to what extent a public fund's assets are better managed internally or externally, analysts consider four issues: (1) relative costs; (2) practical ability to attract and retain qualified investment professionals; (3) control over the investment process by appropriate parties; and (4) expected investment performance. These considerations apply with different results regarding the different types of assets and strategies TRS currently employs or may employ in the future.

For the bulk of its investments, we believe that TRS's use of internal management is a sound approach. The vast majority of TRS's internally managed assets consist of publicly-traded domestic stocks and bonds, relatively traditional and straightforward assets, traded in relatively efficient markets. By contrast, strategies or assets that require more esoteric expertise or research, with substantial prospects of materially outperforming (or under-performing) the relevant targeted return benchmark are often better managed externally. One example is a portfolio of international emerging market stocks, which may require unusual research, including knowledge of a range of local markets, laws and social conditions. Another example is a stock portfolio comprised of fast growing, newly formed companies with low capitalization ("small-cap growth" stocks), where very prompt, specialized information may be essential to success. In that instance, purchased research may not be sufficiently prompt, detailed or insightful, and the cost of maintaining a capable, in-house research staff may be prohibitive.



In some situations, another possible hazard of exclusively internal management is homogenization, i.e., dominance of a single investment style running across all parts of a fund's portfolio. By contrast, outside management by distinct firms may help distribute a fund's overall investment program across a true diversity of investment disciplines. Diversification is widely accepted in the industry as a primary method of decreasing investment risk.

Delegation in Substance with Limited Control

As reviewed above, recent changes in Texas law clarify that TRS may invest in limited partnerships and similar limited liability vehicles. Some observers could argue that in some cases a TRS limited partnership investment is a de facto delegation, since the outside general partner manages the partnership's investments on behalf of all limited partners (including TRS). This argument carries little weight with investments in private equity, where the limited partnership interest is the accepted industry-standard investment vehicle, and where there are numerous passive investor limited partners along side TRS. However, this argument is of greater weight where a real choice exists between a passive investment in a limited-liability vehicle such as a limited partnership and a contractual delegation to an external manager with a duty over a separate account devoted exclusively to TRS. For example, TRS currently invests in some private equity limited partnerships comprised of many passive investors, and in others - such as strategic securities trading and high yield bond limited partnerships (or other limited-liability entities) - in which TRS is the sole or largest investor. In order to minimize the risk that the latter situation could be challenged as a de facto delegation, TRS seeks to ensure that the limited partnerships are organized in strict compliance with applicable law, which by definition restricts the investor's degree of control over its assets.

In short, to the extent that TRS invests in "securities" in order to achieve diversification with necessary specialized investment expertise, but also observes the prohibition against delegation, it may needlessly surrender control over its assets. By contrast, if TRS were allowed to directly delegate authority to invest TRS assets to an external investment manager, it would be



better positioned to control the investment of TRS assets and impose on the external manager fiduciary duties and liabilities running exclusively and directly in favor of TRS. Better control can be achieved by TRS through a variety of means including maintaining the externally managed assets at TRS's custody bank, customized reporting requirements and investment guidelines, audit requirements, contractual fiduciary duty and liability provisions, and frequent oversight (e.g., through "management of managers").¹⁰

The issue is essentially the distinction between "passively investing" and "actively delegating." Which approach is more prudent depends on the circumstances of each case. Thus, the prohibition on delegation to external managers unduly hampers the Board. The Board should have reasonable discretion to employ both methods of investing TRS's assets.

Clarify the Authority to Delegate Internally

The "Approved Universe" is a list of securities the Board has pre-approved, from which staff must select the investments it purchases. Insofar as delegation to staff is not expressly authorized, the conservative view is that only the Board can legally make investment decisions. However, it is neither feasible nor prudent for the Board to make every investment decision for an enormous, sophisticated fund like TRS. Realistically, an internally managed pension fund like TRS must use investment staff and must provide that staff considerable investment discretion, within the framework of policies and procedures adopted by the Board. This is implicit in the fact that the Board is a part-time, uncompensated body. Arguably, using the artifice of the Approved Universe exposes the Board members to needless liability for supposedly approving individual investments as to which they cannot possibly have actual detailed knowledge. The staff is the trained and qualified instrument through which the Board exercises its investment authority by adopting policies and exercising oversight.¹¹ Therefore, the Board should be able to give specific or general authority to the staff without concern over improper "delegation," thus eliminating the need for the Approved Universe.



TRS Should Have Broad Authority to Invest in All Asset Classes Deemed Prudent

The ability to properly diversify assets is a tenet of fiduciary responsibility. Diversification mitigates investment risk. Accordingly, trustee boards are required, under trust law, to diversify the assets of the pension fund, unless under the circumstances it is clearly prudent not to do so.¹² However, the TRS Board does not have sufficient authority to properly and prudently diversify its portfolio. For example, many other public pension funds across the country have concluded that direct or indirect investing in real estate can enhance overall portfolio diversification. Real estate returns – both up and down – tend to have a relatively low correlation with those of publicly-traded stocks and bonds. Thus, investing in equity real estate may help counterbalance the different cycles of investing in publicly traded securities. Yet, TRS is legally precluded from direct real estate equity ownership. The last two years (ending December 31, 2001) provide an excellent example of how real estate can contribute to a successful diversified portfolio. During this period, while NASDAQ stocks were down over 50% and S&P 500 stocks were down nearly 20%, the broad, national index for institutional real estate (NCREIF) generated a positive return of 20.4%.

TRS's Authority to Invest is Uncertain

The 1996 IFS report recommended granting TRS authority to invest in a broader range of asset classes than was then permitted. Subsequently, the Legislature took action to broaden the range of permitted investments (or at least help to alleviate doubts about the scope of permitted investments) to include interests in limited partnerships, investment contracts, and instruments or contracts intended to manage transactions or currency exchange risk. However, although the range of permitted investments has been expanded and clarified by the Legislature, the extent of the Board's investment authority remains unduly limited in terms of real estate and cloudy in terms of permissible investment instruments.¹³ Legal arguments can be made for narrowly interpreting the Board's investment authority or broadly interpreting it; in the final analysis, the "right" conclusion remains uncertain.



We believe uncertainty is a more serious impediment to structuring and operating the TRS investment program than even an unnecessarily limited, but clear set of rules. This is because, as a practical matter, the TRS Board and staff are unlikely to take actions that may be subject to legal challenge. For instance, given the authority to invest in limited partnerships, in all probability, the Board could legally buy a limited partnership interest in a professionally managed, high quality, nationally diversified real estate limited partnership. However, because real estate per se is not a permitted investment, and delegation to external managers has been interpreted by the Texas Attorney General as unlawful under existing law, even a prudently evaluated and structured investment of this sort may not be entirely free from legal challenge. Thus, as a practical matter, the Board and staff are unlikely, in our view, to make any such investment, even if they conclude, as a matter of investment practice, that it would help diversify the overall TRS portfolio.

Limited partnership investments also provide another example of contradictory authority and uncertainty, as discussed above. After TRS law was clarified regarding investments in limited partnerships, TRS invested in limited partnerships which, in turn, invest in high yield bonds. Notwithstanding this, TRS management has stated that it is uncertain whether TRS would be open to criticism on legal grounds if it purchased interests in limited partnerships that, for example, invest in certain traditional asset classes such as publicly traded stocks or bonds. Nevertheless, through its “strategically traded securities” investments – one component of the alternative asset program – TRS does invest in external fund vehicles that use publicly-traded stocks and related instruments (e.g., options) to implement specific trading strategies.

The uncertainties that surround TRS’s investment program impede the ability of the Board to optimally manage and diversify its portfolio. This is especially true because, as we understand the law, Board members run at least a theoretical risk of personal liability for losses TRS suffers as a result of their fiduciary breaches. If the Board were to invest in, for example, a limited partnership which appears lawful and the investment subsequently did poorly, the Board would risk, with the benefit of hindsight, a legal challenge to its authority to have made the



investment in the first place. On the other hand, because investing in such a partnership interest is probably lawful, if the Board decides not to proceed and the partnership subsequently does well, the Board may be second-guessed for being too conservative by not having pursued a successful investment opportunity. Either way, the Board is unduly influenced by the legal uncertainty, and constrained from focusing on the genuine investment merits.

TRS Investment Authority Compared to Other Statewide Public Pension Funds

Most statewide public pension funds are not subject to restrictions on permissible investments (often called “legal lists”). Most statewide public pension funds operate under some version of a prudent person standard, which permits boards to invest in any investment which, after following a diligent process of analysis, they have found prudent, within the context of the overall portfolio. On the other hand, several statewide pension funds still labor under some form of legal lists including, for example, the New York State and Local Fund, as well as the Louisiana Teachers Fund and the West Virginia Board of Investment. In the past five years, many legislatures, including those in South Carolina, Wisconsin, Minnesota, Florida, Michigan, Oregon, Washington, and Mississippi, have eliminated or diminished investment restrictions on public retirement systems.¹⁴

Enhance TRS’s Budgetary, Personnel, and Procurement Autonomy

TRS’s relative lack of operating autonomy impairs its ability to optimally manage its investment program so as to maximize returns, while minimizing risk and expense for the benefit of plan participants. The Legislature should grant greater autonomy to the TRS Board, allowing it to establish its own personnel policies, independent procurement authority, and budget which, taken together, allow expenditures for necessary investment-related goods and services to be made directly out of fund assets. This action would be consistent with the principles advocated by UMPERSA and the practice employed in numerous other states.



Today, TRS spending is in practice limited by the General Appropriations Act. TRS's enabling statute¹⁵ gives the TRS Board the authority to utilize a "fiduciary finding" to justify expending assets of the trust beyond its legislative appropriation. However, there appears to be a reluctance to exercise this authority for fear of impairing relations with the Legislature. Given this reluctance, the "fiduciary findings" option is of limited practical value.

The following specific examples demonstrate how TRS's lack of autonomy impairs its ability to optimally manage its investment program:

Budgetary Process Creates Potential for Conflicting Objectives

A pension fund's trustees are different from the leaders of other state entities. This is due to the extensive and stringent fiduciary duties and responsibilities that govern operations, including, most significantly, the obligation to manage fund activities solely in the interest of the participants and beneficiaries, and not for other interested parties. These duties and responsibilities both necessitate and validate autonomy. In the absence of autonomy, boards may be forced to decide between fulfilling their fiduciary duties and responsibilities or making decisions based on more wide-ranging, and possibly conflicting, sets of interests, such as requirements to invest in economically targeted investments at below market rates of return.



Budgetary Process Encourages Costly Use of Soft Dollars

When a compelling need has arisen in the face of an insufficient appropriation, the Board's lack of budget autonomy has led to use of soft dollars to pay for certain otherwise ordinary expenses such as the fees of the consultant that helps implement the Alternative Assets program. Soft dollars are payments to a brokerage firm in exchange for credits (similar to frequent flier miles) for the client/investor. The client can use these credits to pay third-party firms for goods and services like investment research, subscriptions, and consulting services. The potential risk to the client (TRS) is that brokers will be selected, not on the strength of trade quality and lowest cost, but rather because of the availability of their soft dollar programs.

Subjecting the TRS to legislative appropriation creates a risk that budgetary pressures will lead to excessive levels of soft dollar brokerage that impair securities execution, indirectly increasing (and hiding) overall costs. In other words, if TRS lacks sufficient appropriated monies to pay for essential services in "hard dollars" (direct, conventional payment), then TRS must direct securities transactions to soft dollar brokers to generate the soft dollars needed to pay for these required services. However, soft dollar payments are typically more costly than direct hard dollar payments for equivalent services. Soft dollar payments can also create undue commission costs and produce poor securities execution (buying stocks and bonds at unduly high prices, selling at unduly low prices).

An analysis of TRS's soft dollar transactions for 1997 and 1998 demonstrates that for 1997, TRS paid approximately \$5.1 million more using soft dollars than if it had used hard dollars. The corresponding excess cost for 1998 soft dollar program approximates \$7.8 million.¹⁶ The Board recently authorized an increase in the soft dollar transaction maximum from 15% to 25% of transactions. Future excess costs may continue to grow as the soft dollar program increases in size.



While the use of soft dollars may be inefficient, the goods and services purchased with soft dollars provided important resources to TRS's investment program. Lack of access to these resources (i.e., loss of the soft dollar program without a corresponding increase in the ability to pay hard dollars) may cost TRS far more in terms of lost investment performance than the inefficiencies identified above.

The Board's Ability to Attract and Retain Qualified Staff is Constrained

The Board's lack of authority to delegate investment management authority to external managers (discussed above) makes the limitations that exist on its authority over compensation for the investment staff especially problematic. The inability to delegate to external managers increases TRS's required reliance on internal asset management. The ability to attract and retain top-notch investment staff is therefore critical.

The primary tools employers use to attract and retain qualified employees are providing a conducive work environment and compensation. Yet, TRS's ability to offer competitive compensation is inhibited by state budgetary and personnel processes. Turnover among investment personnel at the TRS is relatively low compared to other parts of state government, but quite high compared to other statewide pension funds across the country. [Turnover comparison charts are included in Appendix 2, page 199 of this Report.] The latter suggests TRS's ability to attract and retain necessary investment professionals, in the context of the regional and national market for such professionals sought by both public and private institutional investment organizations, is impaired. In our experience, at public pension funds, while non-competitive compensation is generally a contributing factor, other factors such as complications and frustrations with the bureaucratic process also add to turnover.

High turnover exposes TRS to undue "governance risk" – risk of disrupting the investment program because of loss of personnel and need for time to train new personnel.¹⁷ TRS has designed its internal asset management program in light of this risk – meaning that it utilizes only tightly constrained, highly quantitative investment techniques. The idea is to run



only those investment strategies that can survive the loss of key personnel. However, in at least some portions of the financial markets, a measure of more active and flexible investment management may be preferable. In short, constraints on compensation to investment staff and operating practices translate into troublesome constraints on the investment program.

In recent years, TRS has been allowed to increase base pay for many of its investment staff. In seeking to attract and retain qualified investment personnel, one possible further approach increasingly used among other public pension funds with significant internal asset management programs is to use incentive compensation. In a well-constructed incentive compensation program, the interests of staff and the fund are aligned: higher pay is earned only in exchange for genuinely improved investment performance. In a fund as massive as TRS, this can be a very attractive trade-off. However, under current law, TRS's flexibility in designing and implementing a well conceived incentive compensation program is constrained and subject to uncertainty.¹⁸ Accordingly, we recommend that the Legislature clarify the Board's authority to design and adopt a well designed and soundly monitored incentive compensation program for investment staff. The funding for the program should exist outside the state legislative appropriations process. To the extent incentive compensation is earned through generating sufficiently favorable returns for TRS, payment should come from trust assets.

The empirical support and more detailed analysis regarding all these compensation issues are set forth in Appendix 2 on page 199 of this Report.

State Travel Limitations Constrain TRS's Ability to Optimally Manage its Investment Program

Currently TRS is subject to both per diem and budgetary maximum travel expense limitations that restrict opportunities to attend training and educational conferences, investigate investment opportunities, and participate in advisory board meetings. TRS is limited to the state per diem for employee travel. For FY02, the state per diem for in-state travel is \$80 for lodging



and \$30 for meals. The out-of-state maximum reimbursement rates are set by the State Comptroller based upon the particular travel destination.

In addition to the per diem limitation, there is a state-imposed agency cap on aggregate travel expenses. For FY02, the aggregate travel cap for TRS was increased to \$425,000, an increase from the prior year's \$337,472. The budget allocated to the investment division, while increased, is still believed inadequate. In our opinion, the limitation impedes TRS's ability to effectively operate its investment program, particularly its private equity, international and emerging markets investment programs, and unduly restricts the ability to attend worthwhile educational conferences.

The impact of the travel limitations on the private equity program illustrates the problem. TRS allocated approximately \$3.5 billion to alternative investments (as of March 31, 2001) and is actively seeking to meet that target. Once it meets that target, TRS will likely be a limited partner in as many as 30 to 40 partnerships, in which TRS may often be the largest investor. The travel expense limitation hinders the alternative investment staff's ability to conduct on-site investigative visits and to sit on the advisory boards of the limited partnerships in which TRS participates. Advisory boards are generally composed of three to nine representatives of the largest limited partners. Participation on such boards is highly desirable to insure that the interests of the limited and general partners are appropriately aligned.

Partnership advisory boards provide limited partners with a means to exchange views and important information about partnership investments. For purposes of Texas law, we were advised that although advisory boards may have some limited authority, such as determining whether the general partner has a conflict of interest, they arguably do not involve official acts by state employees. We also understand that although most private equity partnerships in which TRS has invested will pay for travel or reimburse the advisory board members for their actual expenses, various restrictions arguably prohibit TRS employees from directly accepting such payments beyond the per diem limitation.¹⁹ We were advised that these restrictions include the



statutory prohibition against state employees' acceptance of travel reimbursements from certain persons, requirements relating to state agency use of state travel contracts, Texas Penal Code chapter 36, state ethics laws, and the TRS Ethics Policy adopted by the Board.²⁰

Texas Government Code §660.016 provides that a state employee may not accept travel expense reimbursement from a person that the employee's employing agency intends to audit, examine, or investigate, or is auditing, examining or investigating. We have been advised that this statute was probably not intended to apply to a public pension fund's monitoring of its partnership investments through attendance at advisory board meetings, but that it arguably creates uncertainty whether TRS employees may accept reimbursement of actual advisory board travel expenses. This is because such partnerships could be audited, examined, or investigated by TRS or on its behalf. It is also arguable that the state travel regulatory scheme deems any third party reimbursement in excess of per diems allowed under Texas rules to be a gift *to the employee* to that extent.

Under state travel regulations, TRS employees generally must travel using state contracts – making TRS business travel at the expense of a third party partnership difficult, if not unlawful.²¹ We understand that TRS does follow the state travel regulations and reimburses TRS employees attending partnership meetings up to the state per diem, and then in turn invoices the partnership for that amount. However, the expenses associated with many advisory board meetings exceed the state per diem in cost, especially for lodging, even at the higher out-of-state levels allowed. Thus, TRS employees attending advisory board meetings must make other arrangements (e.g., stay at a less expensive hotel remote from the meeting hotel and incur additional ground transportation costs) or pay out of their own pocket for any costs exceeding the per diem allowed under state law.

Under a conservative interpretation of the TRS Ethics Policy (at Section VIII A of the Ethics Policy) an employee's acceptance of travel and lodging expenses from entities in which TRS invests is deemed to be either an improper gift or economic benefit *to the employee* (as



opposed to a benefit to TRS), and is thus prohibited. In light of Texas statutes, regulations and ethics opinions relating to state employee travel, amendment of the TRS Ethics Policy to allow advisory board travel at partnership expense may not be possible unless the regulations are revised to provide TRS with greater flexibility in travel for investment management purposes.²²

The travel restrictions also limit TRS staff's ability to participate directly in key financial markets with individuals who have similar responsibilities, and conduct necessary due diligence particularly regarding the \$8.7 billion international investment portfolio (as of March 31, 2001). Since TRS is prohibited from using external managers, the international investment program is managed internally. International equity offers potential for enhanced returns and added diversification, but not without commensurately additional risk. In order to mitigate such risk, appropriate research and due diligence is essential. Such due diligence often necessitates international travel, particularly regarding emerging market investments. International travel is generally quite expensive and the Travel Regulations Act, Tex. Gov't Code §660,024, requires agency-head approval for international travel. However, the General Appropriations Act requires agency *governing board* approval prior to travel, which must be attached to the documentation provided to the Texas Comptroller. The TRS Board meets only eight times per year, sometimes making timely approvals cumbersome. Even more significantly, we believe that it is more appropriate for the Board to focus on policy making matters and allow decisions concerning travel by staff for investment-related matters to be handled by TRS management.

Specific examples of trips foregone for both domestic and international analysts and managers include:

- *Deutsche Banc Telecommunications and Technology Conference* – held annually in a European city, and viewed as one of the most important international conferences in the telecommunications and technology sector. More than 300 major institutional investors attend and more than 100 major telecommunications and technology companies attend and make presentations.



- *Bank of America Technology Conference* – held domestically. We were informed that the Director of Equities believes that participation in the conference could have assisted in managing the turn in technology stocks a month earlier.
- *Edison Electric Institute Conference* – considered by some to be the premier electric utility investment conference. Because of the sweeping changes going on in the utility industry as a result of deregulation, attendance could have enhanced the knowledge base of the investment staff relating to investor owned utilities.

It is essential that TRS staff have the opportunity to attend educational conferences to become more knowledgeable, receive ongoing training, and interact with their peers from other pension funds. This is particularly true when new complex programs, such as alternative investments and strategically traded securities, are being implemented. TRS saves investment management fees from internal investing, but these savings ultimately depend on the staff's ability to achieve investment results equal to that of external managers. Superior results are nearly impossible to achieve consistently over time without spending a reasonable amount of time and money on independent research, continuing education and exposure to industry developments. Staff is faced with the unfair dilemma of paying the difference between the per diem and the actual cost out of their personal funds or foregoing travel and risking negative portfolio performance.

Investment Division FTE Limitation Should be Eliminated

TRS is also subject to the State FTE (Full Time Equivalent) limitations. This requirement subjects TRS to statewide budget mandates which limit maximum staffing levels without any apparent recognition that the costs of TRS's operations are paid out of the pension trust fund, rather than from general revenue. As a result, to ensure effective administration of its operations, the Investment Division must compete with the agency as a whole for needed positions. At an investment division such as TRS, where almost all assets are managed



internally, the degree of portfolio earnings (or losses) at stake over time far overshadows the incremental differences in increased investment personnel costs needed to insure sufficient staffing.

Independent Procurement Authority Should be Expanded

Texas Government Code §825.207(b) is another constraint. It states that, “*The comptroller shall pay money from the accounts of the retirement system on warrants drawn by the comptroller*” This provision limits decisions by the Board insofar as the comptroller can – for reasons only indirectly related (or completely unrelated) to TRS – withhold certain payments to third party vendors who provide necessary services to TRS as well as certain payments of travel reimbursement or incentive compensation to employees. In fact, we understand that on occasion the Comptroller has in fact withheld such payments even when TRS believed payment was appropriate and necessary for the TRS mission.

Purview of the Attorney General

The Texas Attorney General is statutorily designated as the legal representative of TRS.²³ As in the case with other state agencies, TRS also employs its own internal legal staff. Although the TRS General Counsel’s office appears to be fairly independent of the Attorney General’s Office, and this relationship has worked in practice over the years, it poses an inherent potential for conflict. For example, even in the event of litigation where the Attorney General deems the interest of the State to differ from that of TRS, TRS does not have the authority to independently retain outside counsel unless the Attorney General agrees. The potential for conflict is increased since there is no formal understanding defining the relationship. We find it is best to address this type of relationship issue before a dispute occurs.

The designation of the Attorney General as the legal representative of TRS is a problem because the interest of the State, the TRS Board, and the TRS beneficiaries and participants may



not always be aligned. Examples could include a dispute regarding the interpretation of a statutory provision, a benefits dispute, or whether outside legal counsel is needed. The fact that the State Attorney General is the legally-designated representative of TRS can present questions of objectivity and an inherent potential for conflict of interest or the appearance thereof. While it may be possible to address this issue through a memorandum of understanding, we believe it is better to clarify statutorily and expand internal legal counsel's authority.

Increased Authority and Autonomy Should be Offset by Strict Fiduciary Standards and Continued Legislative Oversight

To the extent TRS is granted greater authority over the System's investment program, we recommend that the Board be subject to both continuing reporting requirements and the modern prudent person standard of care. In our opinion, rather than imposing overall budgetary and other legal limits, accountability can be ensured by requiring reasonable evidence that expenditures provide appropriate results.

The model statute most relevant to pension fund responsibility, UMPERSA, does not advocate independence (autonomy) without accountability. Rather, fiduciaries are subject to strict fiduciary standards and potential liability for breaching such standards, as well as reporting and disclosure requirements. Specifically, and at a minimum, in exchange for the autonomy we recommend, TRS should be required to provide periodic reports to the Legislature regarding costs and investment performance and/or undergo a periodic independent review of its investment program (i.e., whether its operations are effective and efficient).

Furthermore, in exchange for providing the Board greater authority over permissible investments, ability to delegate, broader budgetary authority and to hire and pay staff, the Legislature may also want to consider imposing a fiduciary standard on the Board that is more rigorous than the present common law standard. The Texas Constitution imposes an "ordinary" prudent person standard based on the common law long applicable to trusts in Britain and the U.S. That standard establishes that in making investments, a board shall exercise the judgment and care



under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs. This common law prudence standard appears less rigorous than either the modern prudent person standard, which requires the prudence of others “acting in a like capacity and *familiar with those matters*” [emphasis added] or the even more rigid “prudent expert” rule.

UMPERSA stakes out a middle ground prudent person standard. The model law prescribes not “ordinary prudence...in the management of their own affairs,” as at common law, nor the most exacting “prudent expert” standard, but the standard of others “acting in a like capacity and familiar with those matters.” The comments to UMPERSA indicate that fiduciaries should not be evaluated against a prudent expert standard. Rather, fiduciaries should be evaluated in terms of the actions of prudent fiduciaries for other similar systems facing similar circumstances. The standard gives consideration to factors such as size, complexity, and the purpose of the pension fund. Case law under ERISA varies on this point. Some courts have described the standards of Section 404(a)(1) of ERISA as a prudent person standard, like UMPERSA, while others have considered and applied it as a prudent expert standard. While the exact meaning of the current Texas common law standard of care is not entirely clear, we believe that it is less rigorous than the modern prudent person standard (e.g., under UMPERSA) and certainly less rigorous than the prudent expert standard (which arguably applies under ERISA). In conclusion, raising the standard for the TRS Board from the present common law “prudent person” standard to the modern “prudent person in similar circumstances” will provide greater accountability without raising the legal liability bar so high that capable people will refuse to serve on the Board.



Summary of Legislative Recommendations

- 1) Make explicit the Board's ability to delegate investment authority to internal staff.
- 2) Allow the Board to delegate investment authority to external managers when warranted, subject to strict fiduciary standards.
- 3) Allow the Board to invest in any asset class, instrument, or strategy deemed prudent.
- 4) Grant the Board budgetary, personnel and procurement autonomy as it pertains to the investment program, while maintaining strict reporting and accountability to the Legislature.
- 5) Increased authority and autonomy should be offset by imposing the modern, prudent person standard of care.
- 6) Utilize the principles imbedded in UPIA and UMPERSA to accomplish the preceding recommendations.



¹ Some other Texas public retirement systems are permitted, under Tex. Gov't Code §802.204, to delegate investment discretion.

² “Uniform” designation indicates that there is a substantial reason to anticipate enactment in a large number of jurisdictions and standardization is the principal purpose. By contrast, a “model” designation means uniformity is not the principal objective and a significant number of jurisdictions are not expected to adopt the Act in its entirety since its purpose can be achieved by adoption of its principles.

³ Information source – The National Conference of Commissioners on Uniform Laws.

⁴ Id.

⁵ Tex. Gov't Code §825.112

⁶ Employee Retirement Income Security Act of 1974, Sec. 404(a)(1)(C); Uniform Prudent Investor Act, Sec 3; and Uniform Management of Public Employees Retirement Systems Act, Sec. 8(a)(2).

⁷ E.g. Tex. Const. art. XVI, §67(a)(3)

⁸ Tex. Gov't Code §825.302 (Custody and Investment of Assets Pending Transactions); §825.303 (Securities Custody and Securities Lending).

⁹ *See, e.g.*, Tex. Gov't Code §825.301(a) ((deeming a limited partnership interest to be a security for purposes of the Board's investment in "securities" under Tex. Const. art. 16, §67(a)(3)).

¹⁰ *See, e.g.*, Tex. Gov't Code §§ 802.204; .205 (authorizing other Texas public retirement systems to appoint investment managers and requiring a separate custody account for the assets under external management); ERISA §403(c)(3), 29 U.S.C.A. §1102(c)(3) (authorizing a plan fiduciary to appoint an investment manager for an ERISA plan); ERISA §405(d)(1), 29 U.S.C.A. §1105(d)(1) (providing that an ERISA plan trustee is not liable for the acts or omissions of an appointed investment manager).

¹¹ *See, e.g.*, Tex. Gov't Code §825.113(b) (stating that Board shall develop and implement policies and separate policy-making from management responsibilities of the staff); Tex. Gov't Code §825.212(a), (e) (requiring Board to adopt and enforce ethics policies for staff and external consultants).

¹² Employee Retirement Income Security Act of 1974, Sec. 404(a)(1)(C); Uniform Prudent Investor Act, Sec 3; and Uniform Management of Public Employees Retirement Systems Act, Sec. 8(a)(2).

¹³ The definition of “securities” as used in Article 16 §67(a)(3) of the Texas Constitution was last interpreted by the Attorney General. in Op. Tex. Att’y. Gen. No. JC-0043 (1999). The Opinion advised that the TRS may invest in instruments defined as securities under the UCC definition. Following the issuance of Opinion No. JC-0043, the Texas Legislature amended §825.301(a) to add a definition of “securities” and specified that the definition included interests in limited partnerships, investment contracts, and instruments or contracts intended to manage transactions or currency exchange risk. However, the A.G. has advised that direct ownership of real property is not a “security.” (JC-0043 reaffirmed Op. Tex. Att’y. Gen. MW-152 (1980).) Accordingly, direct ownership of real estate (rather than through a limited partnership) is still prohibited.

¹⁴ Information source – Survey conducted by IFS for the Iowa Governor’s Task Force on IPERS Structure and Governance.



¹⁵ Tex. Gov't. Code Ann. §§ 825.314(b) and 825.313(d).

¹⁶ The cost assumptions for commission rates came from TRS's actual experience for full service trades and execution-only program trades. The market impact assumptions are incremental for each type of trade, and were based on academic studies by professors at Emory University and the University of North Carolina, regarding trading in general, not actual trades on behalf of TRS. We believe that the base assumptions were, at the time, reasonable for the market as a whole, but may have been more expensive than TRS's actual experience at the time.

¹⁷ Public Pension Systems Statements of Key Risks and Common Practices to Address Those Risks, July 2000. Endorsed by the Association of Public Pension Fund Auditors (APPFA), the National Association of State Retirement Administrators (NASRA), and the National Council of Teachers Retirement (NCTR).

¹⁸ Tex. Gov't. Code §825.208 prescribes that TRS compensation rates "may not exceed those paid for similar services for the state." Section 825.210 can be read to limit TRS employees from having "a direct or indirect interest in the gains from investments," which can be read to require caution in creating an incentive-based compensation program. Finally, §825.213(b) appears to tie employee raises to "annual performance evaluations that are based on documented employee performance," and uses the term "merit pay," suggesting that base salary increases are already based on documented performance. Legislative action thus may be needed to relieve TRS from the salary limitations contained in these provisions if an incentive-based compensation structure were to be implemented.

[Please note that on this and certain other technical legal analyses regarding Texas law, IFS has necessarily considered -- but sought to critically evaluate -- guidance from TRS legal staff who are members of the Texas bar and SAO staff].

¹⁹ It is also uncertain whether TRS itself could incur travel expenses and accept reimbursements for them in excess of state per diems, even when expending pension trust funds.

²⁰ *See, e.g.*, Tex. Gov't Code §660.017 (Excess Reimbursements); Tex. Penal Code §36.08; .09 (Gift to Public Servant by Person Subject to His Jurisdiction); Tex. Penal Code §36.09 (Offering Gift to Public Servant); Tex. Gov't Code §572.051(1) (stating that a state employee should not accept gifts, favors or services that might reasonably tend to influence the employee in his official duties).

²¹ 1 Tex. Admin. Code §125.19 (requiring executive branch state agencies to use the travel agency, charge card, rental car, airline, hotel, and other travel services negotiated by the state travel management program, but expressly exempting higher education institutions and TRS sister fund Employee Retirement System of Texas).

²² Advisory board travel expenses come out of funds provided by limited partners as set forth in the partnership agreement. However, TRS is in the same position as any other limited partner in this respect. If TRS does not serve on the advisory board, other investors, including other public pension funds, will do so. TRS will still indirectly bear these expenses as a limited partner. If TRS is to diversify its portfolio, it should be in a position to fully monitor its investments without undue legal constraint.

²³ Tex. Gov't Code §825.203.

