A Fiduciary Review of Key Governance & Investment Functions of the Texas Permanent School Fund

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Disclaimer

The findings and conclusions contained herein are the responsibility of Cortex Applied Research Inc. The Texas State Auditor's Office has not audited the contents of this report.

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APPENDIX 1
THE MATHEMATICS OF ENDOWMENT FUND MANAGEMENT

The distributions from an endowment fund such as the PSF are affected by a number of factors:

- Investment return,
- Contributions,
- Inflation, and the
- Increase in the number of schoolchildren (that is, the beneficiaries)

The relationship among all of the above factors can be expressed in a series of equations to illustrate the fundamental concepts underlying the management of the PSF.

The principle of inter-generational equity requires that the PSF provide the same level of support to current and future generations of beneficiaries. Given that the cost of providing public education generally increases with inflation and with the number of beneficiaries, providing "the same level of support" means that distributions from the PSF have to increase over time to keep pace with inflation and the growth in the number of beneficiaries. The level of distributions, however, should not be so high as to deplete the value of the PSF and impair its ability to generate the required distributions in the future. In other words, the value of the PSF must also increase over time at the rate of inflation plus the rate of growth in the number of beneficiaries. *What is the level of distributions that will support the principle of inter-generational equity?* This is the question we try to answer in this appendix.

We start with the requirement that the rate of growth in the assets of the PSF, expressed in percentage terms, must be equal to inflation plus the growth in the number beneficiaries:

(1) Growth in Assets = Inflation + Growth in Beneficiaries

Next, the PSF can grow in only two ways – through investment return or through new contributions. Similarly, the PSF is reduced by the amount of distributions. In other words:

(2) Growth in Assets = Investment Return + Contributions - Distributions

We express investment return, contributions and distributions as a percentage of assets. Substituting for "Growth in Assets" from equation (1) into equation (2) we get:

(3) Inflation + Growth in Beneficiaries = Investment Return + Contributions – Distributions

By rearranging the terms in equation (3) we can isolate Distributions as follows:

(4) Distributions = Investment Return + Contributions – Inflation – Growth in Beneficiaries

This means that the level of distributions expressed as a percentage of the assets of the PSF must in the long run equal the investment return plus contributions less inflation and less the growth in the number of beneficiaries. In other words, an endowment fund should retain a portion of its investment return plus contributions to cover inflation and the increase in beneficiaries, and only

distribute the balance, no more and no less. If the amount of distributions is more than that allowed by equation (4), the value of the PSF will be eroded. If distributions are less than that allowed by equation (4), future beneficiaries will gain at the expense of current beneficiaries.

Another important implication of equation (4) is that the fiduciaries of an endowment fund can only provide increased distributions if they can generate a higher rate of return on the assets of the fund, since the other factors – inflation, future growth in the number of beneficiaries, and even the rate of contributions – are outside their control.

We can also use these equations to illustrate the implications of an "income-only" spending policy. Note that investment return by definition is:

(5) Investment Return = Capital Gain + Investment Income

Substituting for "Investment Return" in equation (2), we get:

(6) Growth in Assets = Capital Gain + Investment Income + Contributions - Distributions

Because under an "income-only" spending policy investment income is equal to distributions, we can eliminate Investment Income and Distributions from (6) and the result is:

(7) Growth In Assets = Capital Gain + Contributions

In other words, the assets of the PSF can only grow through capital gains on investments or through new contributions since all of the income must be distributed. Substituting for "Growth In Assets" in equation (1) and re-arranging terms, we get:

(8) Capital Gain = Inflation + Growth in Beneficiaries - Contributions

This means that under an "income-only" spending policy, the endowment fund must adopt an asset allocation policy that provides growth in assets or capital gains equal to the rate of inflation plus growth in the number of beneficiaries less the rate of new contributions. It cannot choose from a range of different asset allocation policies. It must adopt a specific asset allocation that generates the required rate of capital gain regardless of the investment risk that it may involve.

APPENDIX 2
IS UMPERSA APPLICABLE TO THE PSF?

The Uniform Management of Public Employee Retirement Systems Act (UMPERSA), a model act recommended for enactment in all States, takes the position that a sponsor should grant trustees considerable authority. Specifically, the model act recommends that a trustee should have exclusive authority, consistent with the trustees' duties under UMPERSA, to:

1. Establish an administrative budget sufficient to perform the trustee's duties and, as appropriate and reasonable, draw upon assets of the fund to fund the budget;

2. Obtain [by employment] or contract the services necessary to exercise the trustee's powers and perform the trustee's duties, including actuarial, auditing, custodial, investment and legal services; and

3. Procure and dispose of goods and property necessary to exercise the trustee's powers and perform the trustee's duties.

UMPERSA argues that trustees require independence because it allows them to perform their duties in the face of pressure from others who may not be subject to fiduciary obligations. In the absence of independence, trustees may be forced to decide between fulfilling their fiduciary obligations to beneficiaries or complying with directions of others who are responding to a more wide-ranging and possibly conflicting set of interests.

UMPERSA further argues that independence is justified for two reasons:

1. Considerable constraints are imposed on Trustees, in that they must comply with their fiduciary obligations when exercising judgment. In effect, the UMPERSA argues that trustees require more independence than other State actors, but in exercising that independence the trustees are subject to a more extensive and stringent set of fiduciary obligations.

2. Trustee independence aligns well with the interests of the sponsor. The sponsor has a strong interest in effective and efficient management of the trust fund, as mismanagement presents obvious political hazards and may ultimately result in higher costs or lower revenue for the sponsor. Given that the trustee is under a duty to act effectively and efficiently, eliminating any constraints that may interfere with the fulfillment of the duty is in the direct interest of the sponsor.

In summary, UMPERSA appears to suggest that the fiduciary duties imposed on trustees under trust law should provide sponsors with sufficient assurance that, if fiduciaries are granted considerable authority, the sponsor's interests will nevertheless be adequately protected. We believe that UMPERSA overestimates the degree of accountability and therefore the assurance that trust law alone can provide.

Industry Practice

While, under ideal circumstances, the position put forward by UMPERSA may be reasonable, it is not consistent with actual industry practice. A recent survey of the governance structures of 50 large public funds indicates that sponsors generally also expect to have direct influence in the fiduciary decision-making process. The boards of all 50 funds surveyed included at least one ex-officio member of the sponsoring government entity, or at least one individual appointed by an official within the sponsoring government entity.

An understanding of where the ultimate legal liability resides may help to explain why sponsors may be skeptical of the protections offered by UMPERSA. If individuals serving as fiduciaries on public investment boards believed there was a high probability that they might in fact be sued for breach of fiduciary duty, they would be unwilling to serve unless they were fully indemnified by the sponsor or unless adequate insurance provisions were in place. Because the State would have to bear the costs of indemnification and insurance coverage, the State essentially bears the risks associated with any shortfalls in fiduciary conduct. That is, in order to take advantage of the protections offered by trust law, the State must incur the indemnification costs.

The above suggests that fiduciary duty and its associated legal liability alone are insufficient to provide sponsors the assurances they need to grant trustees independent authority over the administration of large public investment funds. It further explains why it is extremely rare that sponsors grant the boards of public investment funds complete independence. Rather, sponsors usually ensure that they are represented to some extent on the fiduciary board and/or retain some degree of authority, such as budget appropriations.

APPENDIX 3
GENERALLY ACCEPTED PRINCIPLES AND STANDARDS OF FIDUCIARY CONDUCT IN MANAGING THE INVESTMENTS OF A PUBLIC FUND

In this appendix we present a detailed exposition as to what, in our professional opinion, constitutes generally accepted principles and standards of fiduciary conduct as regards managing investment matters in a public setting.

Sources of Best Practice

Our exposition is based in part on the review of fiduciary standards and principles presented in Appendix 8 and the application of these standards and principles to the management of the investments of large public funds. It draws upon the following sources of information for guidance as to what would be considered generally accepted fiduciary standards and principles in regard to investment matters:

- *Employee Retirement Income Security Act (ERISA)* which is the federal law regulating the management of private retirement plans.

- *Uniform Management of Public Employee Retirement Systems Act, 1997 (UMPERSA),* drafted by the National Conference of Commissioners of Uniform State Laws to facilitate the incorporation of modern investment practices into State law regulating the management of public retirement systems.

- *Uniform Prudent Investor Act, 1994 (UPIA),* drafted by the same body as above, and concerned primarily with the investment responsibilities of trustees of private gratuitous trusts, but with some bearing on charitable and pension trusts, among others.

- *Uniform Management of Institutional Funds Act, 1972 (UMIFA)*, also drafted by the National Conference of Commissioners of Uniform State Laws to establish guidelines for the management and use of investments held by colleges, universities, hospitals, religious organizations and other institutions of an eleemosynary nature. UMIFA is also intended to apply to a governmental organization that holds funds for eleemosynary purposes, e.g., a public school which has an endowment fund.

- *Restatement of Trusts 3d: Prudent Investor Rule*, which is the leading authority on U.S trust law.

Our exposition also draws upon our experience in consulting to more than 75 large pension funds, endowments and foundations across North America over the past ten years and observing their governance and decision-making practices in managing investment assets.

Fiduciary Standards and Principles

It is our professional opinion that the following standards and principles of fiduciary conduct as identified below would be generally accepted or considered best practice with respect to the management of investment matters for a public fund:

1. ***Loyalty – The fiduciary shall act solely in the interest of the beneficiaries of the fund, and for the exclusive purpose of providing benefits and paying appropriate and reasonable expenses of managing the fund.***

   The duty of loyalty is a widely accepted standard of fiduciary conduct. It does not simply mean that the fiduciary must avoid situations of self-dealing or conflict of interest in which the fiduciary would benefit personally. It also requires that the fiduciary not be guided or influenced by the interests of any third party. The fiduciary must keep the purpose of the fund in mind in taking any action and not act out of any motive other than achieving the purpose of the fund.

   The obligation to incur only expenses that are appropriate and reasonable is an important aspect of the duty of loyalty. The fiduciary must not incur expenses that are excessive or unreasonable since wasting money clearly harms the interests of the beneficiaries. Determining what costs are reasonable and appropriate will depend on the purpose of the fund, the types of assets held, and the knowledge and skill of the fiduciary. For example, fiduciaries who are unfamiliar with or inexperienced in investment matters may be justified in spending more for investment advice and counsel than fiduciaries who are knowledgeable.

   One implication of the duty of loyalty is that no "social" or "ethical" investments should be undertaken which sacrifice or harm the interests of the beneficiaries of the fund. This would be the case, for example, if such investments provide a lower rate of return than other comparable investments, or are undertaken at a higher cost, since that would favor the interests of those who benefit from the particular social or ethical cause at the expense of the beneficiaries of the fund. The Department of Labor issued an Interpretative Bulletin in 1994, which states that fiduciaries of private pension plans may invest only in accordance with the prudence and loyalty standards of ERISA. The Bulletin reminds fiduciaries that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives." We believe that it would be generally acceptable for this standard to apply equally to fiduciaries of public and other private funds.

2. ***Impartiality – The fiduciary shall act impartially, taking into account any differing interests of the beneficiaries of the fund.***

   The duty of impartiality follows from the duty of loyalty. If the fund has different groups or classes of beneficiaries, the fiduciary is required to be impartial in acting with respect to the potentially differing interests of the beneficiaries. In the case of the PSF, which is an endowment fund required to exist in perpetuity, the beneficiaries can be broadly divided among the current and future generations of students of the public education system of Texas. The duty of impartiality requires that the fund be managed to provide an equal

measure of support over time to current and future generations of students. This in turn requires that in managing the investments of the fund, fiduciaries must balance the demand for current income or distributions against the need to ensure that future growth in the assets of the fund is sufficient to cover inflation and growth in student population.

3. ***Prudence – The fiduciary shall act with the care, skill and diligence under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an activity of like character and purpose.***

The duty to act prudently is by now a well-recognized fiduciary obligation dating back in case law to *Harvard College vs. Amory* in 1830. For a large institutional fund it is also now generally accepted that the standard should be more stringent that that of just ordinary care and prudence. Instead, fiduciaries will be held to a standard of others "acting in a like capacity and familiar with such matters", or in other words the level of care exercised by fiduciaries of other funds of a comparable size and purpose. Lack of familiarity with investment matters cannot be used to excuse fiduciary conduct, which does not meet this standard of prudence.

The "prudent man rule" replaces the previous restrictions, which were common in most jurisdictions, the so-called "legal list" of approved investments. It is generally accepted now that no particular investment or asset on its own can be considered prudent or imprudent *per se*. The fiduciary may invest in any type of investment consistent with the purpose of the fund. The appropriateness of an investment should be judged in the context of the fund as a whole, and in terms of the potential impact of that investment on the risk and return of the total fund.

There are four principles of fiduciary conduct which derive directly from this overall standard of prudence:

(a) ***Diversification*** – The fiduciary shall diversify the investments of a fund unless he or she reasonably determines that, because of special circumstances, it is clearly prudent not to do so. This principle is strongly supported by modern portfolio theory, which distinguishes between "specific" and "systematic" risk of an investment. Specific risk is the risk which is directly associated with a particular asset or security. It can be reduced by investing in different assets or securities whose prices or values are not perfectly correlated, i.e., they do not change or move exactly together. It has been well demonstrated through many research studies that investors are not compensated for bearing specific risk. Systematic risk is the risk associated with changes in the general economy and capital markets that affect all investments, and therefore cannot be reduced through diversification.

For private trusts, a number of circumstances may exist, such as tax considerations or the interest in retaining a family business, which may make it prudent not to diversify. For institutional funds, both private and public, it will very rarely, if ever, be the case that

broad diversification of the fund across a number of different asset class and individual securities would not be considered prudent.

(b) ***Use of Appreciation*** – The fiduciary may appropriate for expenditure for purposes for which an endowment fund has been established, as much of the net appreciation, realized and unrealized, in the fair value of the assets of the fund as is prudent.

This principle applies specifically to an endowment fund. The underlying rationale has been most clearly stated by Professors William L. Cary and Craig B. Bright who were commissioned by the Ford Foundation in the late 1960's to examine the legal restrictions on the powers of trustees and managers of colleges and universities to invest endowment funds to achieve growth, to maintain purchasing power, and to expend a prudent portion of appreciation in endowment funds. In their report, *The Law and the Lore of Endowment Funds,* (1969), Cary and Bright state:

> [T]oo often the desperate need of some institutions for funds to meet current operating expenses has led managers, contrary to their best long-term judgment, to forego investments with favorable growth prospects if they have a low current yield.
>
> [I]t would be far wiser to take capital gains as well as dividends and interest into account in investing for the highest return consistent with the safety and preservation of the funds invested. If the current return is insufficient for the institution's needs, the difference between that return and what it would have been under a more restrictive policy can be made up by the use of a prudent portion of capital gains.

We see no reason why this principle, if it is applicable for the endowment funds of colleges and universities, should not also apply to the management of endowment funds in the public sector.

(c) ***Delegation*** – The fiduciary may delegate investment and management functions to an agent that a prudent person acting in a like capacity and familiar with such matters would delegate under the circumstances. In doing so the fiduciary shall exercise reasonable care, skill and diligence in:

i) Selecting an agent;
ii) Establishing the scope and terms of the delegation, consistent with the purpose of the fund; and
iii) Periodically reviewing the agent's performance and compliance with the terms of the delegation.

For an institutional fund, both private and public, the investment functions that would generally be considered as appropriate to delegate would be those with respect to the actual investment of assets, including selection of securities, construction of portfolios, custody of assets, undertaking of transactions, and in general the day-to-day operation of the fund. It would not be considered prudent for fiduciaries to delegate their

responsibility to establish the overall investment objectives, policies and guidelines for the fund, to select the broad asset classes in which the fund should be invested, and to choose the appropriate long-term allocation of the fund among these asset classes.

Both UMPERSA and UPIA recognize that there is an inherent tension between granting fiduciaries broad powers – including delegation – that facilitate efficient management and administration on the one hand, and protecting beneficiaries from the misuse of such powers on the other. The authors of the Acts observe that the principle of delegation, as framed, strikes the appropriate balance between the benefits and risks of delegation. They maintain that requiring fiduciaries to delegate only those functions that can be prudently delegated, and imposing the duties of care, skill and diligence in doing so, should protect the beneficiaries against excessive delegation.

We should point out that the principle of delegation as discussed here applies to the delegation by a board of trustees of investment and management functions to staff, investment managers and consultants. It should not be taken to apply to the establishment of a trust or fund, the appointment of trustees, and the delegation by the trust sponsor or settlor to the trustees of responsibilities for the management of the fund.

(d) ***Decision-Making*** – In making decisions with respect to the management of the investments of the fund, the fiduciary shall consider, among other circumstances, the following:

i) The purpose of the fund;
ii) General economic conditions;
iii) The potential impact of inflation or deflation on the value of the fund and the interests of beneficiaries;
iv) The role that each type of investment, asset class or investment strategy plays in determining the risk and return characteristics of the overall fund;
v) The expected total return on the assets of the fund, from income as well as capital gain; and
vi) The requirements of liquidity, of stability and regularity of income, and preservation or appreciation of capital.

The above is a list of factors, by no means exclusive, which reflect by and large the principles of modern portfolio theory, and constitute generally accepted investment practice for large institutional funds.

The fiduciary shall follow a prudent process for making and implementing decisions:

i) Decisions should be based on information that is objective, relevant and appropriate.

ii) Decisions should, after due deliberation and consideration, be consistent with the importance of the decision and its impact on the fund.

iii) For matters which require specialized knowledge and expertise:

- Decisions should be made after taking into consideration the advice of service providers with demonstrated knowledge and expertise on such matters;
- Service providers should be selected following established procedures and due diligence;
- Where the fiduciary is a board of trustees, the service provider should be duly appointed by the board;
- The information or advice should be made available to all members of the board.

iv) Where the board has established a committee to conduct appropriate due appropriate due diligence and deliberation on a matter, and make a recommendation to the board:
- The decision should be based on the recommendation to the board from the committee;
- The board should either accept the recommendation or send the matter back to the committee for further deliberation and review;
- The board should not take any decision contrary to or independent of the recommendation of the committee.

v) Decisions should be fully and completely implemented, and in a timely manner as would be prudent under the circumstances.

APPENDIX 4
REVIEW OF THE SBOE'S MANAGEMENT PROCESS FOR THE INVESTMENTS OF THE PSF

We have reviewed the SBOE's management process for the investments of the PSF against the principles and standards of fiduciary conduct identified in Appendix 3. Our review covers the period from January 1997 to date. For the purposes of the review, we defined management process to include:

1. Decisions that are:
   a) Consistent with the purpose of the PSF, and the interests of the beneficiaries;
   b) Based on objective, relevant and appropriate information;
   c) In accordance with a prudent decision-making process; and
   d) Not subject to potentially deleterious influences.
2. Implementation of decisions on a timely basis.
3. Monitoring compliance with and results of the decisions made.

We reviewed the SBOE's management process with respect to the following investment matters:

A. Asset allocation

B. Portfolio rebalancing

C. Evaluation, selection, monitoring, and retention of service providers

D. Allocation between internal and external investment management

E. Use of active versus passive investment styles

F. Transaction cost minimization

G. Securities lending

H. Soft dollars

I. Policies for investment initiatives such as historically underutilized business (HUB) and emerging managers

General Finding

The SBOE's management process may not have been in accordance with generally accepted standards and principles of fiduciary conduct, particularly in the following areas:

- Asset allocation policy and implementation;
- Selection of investment managers and consultants;
- Appointment of the securities lending agent; and
- Management of the HUB program.

Many of the actions and decisions of the SBOE: (a) may not have been consistent with the purpose of the PSF, (b) favored the current beneficiaries at the expense of future beneficiaries, (c) did not follow an appropriate decision-making process, or (d) failed to place sufficient emphasis on minimizing costs.

Our specific findings with respect to each of the investment matters listed above are presented in Appendices 4(A) through 4(I).

APPENDIX 4(A)
THE SBOE'S MANAGEMENT PROCESS FOR ASSET ALLOCATION

We have reviewed the SBOE's management process with respect to long-term asset allocation policy decisions taken at the following times: (1) July 1997; (2) July 2000; and (3) May 2001.

1. July 1997

The SBOE approved a revised long-term asset allocation policy for the PSF of 65% stocks (with 20% small and mid-cap stocks and 7.9% international stocks) and 35% bonds assets (including 5% in high-yield bonds). The decision was based on an asset allocation study by Insurance Advisory Services (IAS) in February 1997, which recommended an asset allocation very close to the one approved by the SBOE except that it proposed a 10% allocation to high-yield bonds.

Decision-Making

The IAS study employed what appears to be a standard and generally accepted approach, using assumptions of expected return, volatility and correlation for various asset classes to develop an "efficient" or optimal portfolio which would provide roughly the same current income as PSF's current asset allocation. The IAS study then examined the impact of the optimal portfolio, the current allocation and the previous asset allocation policy (approved by the SBOE in October 1994 but not fully implemented) on income and asset growth.

This decision by the SBOE could, however, be considered contrary to generally accepted principles and standards of fiduciary conduct for the following reasons.

(a) The IAS study's methodology, in our opinion, was flawed in at least two ways:

i) The IAS study derived assumptions with respect to future expected returns, volatility and correlation of returns for the various asset classes based on actual historical return over the period 1975 to 1996. While it did adjust the income component of return for each asset class by taking into account current dividend yield and interest rates and future expectations, total returns, volatility and correlation were based solely on the historical period. We feel the use of historical returns is particularly problematic since capital market returns, even when measured over twenty years, can vary significantly from one period to another. As the IAS study itself pointed out in adjusting the income return, "the sole use of historical data without taking into account current capital markets or future expectations can lead to erroneous results." Asset allocation studies should be based on expectations of future returns, volatility and correlations, for which historical data should be used only as a guide.

ii) The IAS study imposed a minimum allocation of 10% in high-yield bonds when running the model on the grounds that "the 10% level was the minimum allocation in which high-yield would have both an income and risk/reward impact

on the PSF. Less than 10% would not affect results over the long-term, while increasing minimum exposure could skew results away from an optimal allocation." We did not find this argument persuasive. We could understand the need for a maximum limit on the allocation to high-yield bonds, given that they are generally considered to be substantially riskier than conventional investment-grade[1] bonds. But imposing a minimum allocation of 10%, we feel, did skew the results, since the optimal asset allocation recommended by the model included the minimum 10% in high-yield bonds.

The decision of the SBOE was based on a study whose methodology was not relevant or appropriate and could indeed have biased the results of the study. It was probably not consistent with the purpose of the PSF and thus not in the interests of the beneficiaries. It could, therefore, be deemed contrary to the principle of prudence in decision-making by fiduciaries.

(b) The IAS study also failed to consider the effects of inflation as well as growth in student population when analyzing the impact of the proposed asset allocation on future distributions and growth in assets. The PSF is an endowment fund required to exist in perpetuity. Its purpose should be to achieve a rate of growth in distributions and assets which not only keeps pace with inflation but also with the growth in student population over time. Otherwise, the level of distributions per student, adjusted for inflation, will decline (even if the total distributions grows in nominal terms), the amount spent will provide less and less support to each student, and the role of the PSF and its contribution towards public education in Texas will dwindle over time. An asset allocation policy decision which does not take into consideration whether or not future growth in distributions and assets is likely to be sufficient to keep pace with inflation and growth in student population could potentially harm the interests of future generations of students. The SBOE's decision may, therefore, have been contrary to the fiduciary standard of impartially in the treatment of the differing interests of the beneficiaries of the PSF.

(c) Furthermore, in making this decision, the SBOE did not follow a process that was completely appropriate in our view. The PSF Committee (Committee) reviewed the results of the IAS asset allocation study and, after what we presume was due deliberation and consideration, recommended to the SBOE the asset allocation as proposed in the IAS study which included a 10% investment in high-yield bonds. At the SBOE meeting on July 11, 1997 one member objected to the PSF investing in what were termed "junk bonds" (according to the minutes of the SBOE meeting). The SBOE agreed by a near unanimous decision (there was only one opposing vote) to limit the allocation to 5% in high-yield bonds "with an additional vote by the SBOE at some future date." The additional vote was never taken.

[1] The SBOE minutes generally refer to these investments as "high-grade" bonds. We shall use the term "investment-grade" because it is the generally accepted terminology, and it distinguishes these bonds very clearly from "high-yield" bonds.

We feel that this was not an appropriate process for arriving at this decision. If the SBOE did not agree with the Committee's recommendation, the appropriate course of action in our view would have been to send the matter back to the Committee for further deliberation and, if necessary, additional analysis by the consultant and/or staff. The Committee should have been asked to come back with either a revised recommendation based on further deliberation, or with stronger reasons and justifications for recommending a 10% allocation to high-yield bonds. The SBOE could have asked the Committee to recommend alternative asset allocations so that the SBOE could make a choice. For the SBOE to have simply approved on its own a 5% allocation was not good process.

The reason a board creates a committee of the board and authorizes it to deal with a particular matter – in this case the management of the PSF – and make recommendations on the matter to the board is so that the committee, consisting of a few members of the board, will be able to devote sufficient time and attention for proper due diligence and deliberation on the matter. When the matter then comes to the board for approval, the other members have not had the benefit of all the information, study and analysis, and advice from experts and staff that the committee has received. If, on the other hand, the board wants to review all this information itself, there is no reason to set up a committee. This is not to suggest by any means that the board should merely rubber-stamp the committee's recommendation. The board may indeed choose to disagree, if the majority of the board cannot be persuaded that the committee's recommendation is appropriate; but then it should send the matter back to the committee for further review. For a board to take a decision that is independent of, or in this case materially different from, a committee's recommendation is contrary to the very reason for the committee's existence.

The SBOE has taken a similar approach to making decisions in many other investment matters, an approach we believe could be considered contrary to the principle of prudence in decision-making.

Implementation

The asset allocation policy approved by the SBOE in July 1997 involved substantial changes to the investment management structure, including eliminating external management of domestic large cap core stocks and investment-grade bonds and transferring the assets to internal management, as well as a plan to hire six to eight new external managers for domestic large cap non-core stocks, small and mid-cap stocks and high-yield bonds assets. The SBOE approved the appointment of these managers in September 1997, but as result of a somewhat acrimonious dispute among SBOE members regarding the request for proposal (RFP) process and the appropriate allocation to manager portfolios (which we discuss more fully later in this appendix), the portfolios were not funded until some time following the SBOE meeting on January 16, 1998, more than six months after the asset allocation decision was made.

Not only was the implementation delayed but also the asset allocation policy was never fully implemented as far as we can tell, at least with respect to the allocation to small and mid-cap stocks, for no good reason that we can determine. In April 1999 the investment consultant IAS reviewed the asset allocation of the PSF and reported that while the actual mix of total stocks and bonds was close to the policy mix of 65% stocks and 35% bonds as of calendar year-end 1998, the actual allocation to small and mid cap stocks was less than 4% versus the 20% policy approved by the SBOE. (The allocation to domestic large cap stocks as a result was almost 19% above the policy allocation of 37.1%.) The consultant proposed three alternative ways of increasing the allocation to small and mid-cap stocks as required by the policy allocation. The PSF Committee and the SBOE reviewed the IAS report in July 1999 and decided to table the matter to the next SBOE meeting pending further study. At the next meeting in September 1999, the SBOE deferred action until the November meeting due to the prospective change in investment consultants. In June 2000, almost three years after the asset allocation policy was originally approved, when the new investment consultant, Callan Associates, undertook another asset allocation study, the actual allocation to small and mid-cap stocks was still only 4%. This delay, and eventual failure, to fully implement a policy decision previously taken was inconsistent with the principle of prudence in decision-making by fiduciaries.

2. July 2000

The SBOE unanimously approved a revised long-term asset allocation policy of 65% stocks (including 8% small and mid-cap stocks, and 22% international stocks) and 35% domestic bonds assets (with no allocation to international or high-yield bonds). The decision was based on an asset allocation study conducted by the investment consultant, Callan Associates, and a recommendation by the PSF Committee.

<u>Decision-Making</u>

The Callan study used the generally accepted mean-variance "efficient frontier" methodology to identify a set of optimal portfolios with different asset allocations, and to examine the impact of these asset allocation alternatives on the value of assets and distributions (equated with investment income) over a twenty-year period. The assumptions with respect to the rate of return, volatility and correlation for different asset classes – as best as we can determine – were forward-looking expectations and not simply historical values. The Callan study looked at the impact on both the nominal and real value of assets (i.e., adjusted for inflation), and the impact on nominal and real distributions, as well as real distributions per student. There was an explicit assumption about future growth in student population, unlike previous studies. In determining the risk-reward trade-off, the Callan study measured reward as the median or expected outcome for the real value of assets and real distributions per student in the 20th year; it measured risk as the worst case outcome in the 5th year, where the worst case was identified as the outcome with a 10% or less probability of occurrence.
The Callan study did not look at the impact on real assets per student, although our very rough calculation suggests that the asset growth, net of inflation, under the recommended asset allocation would have exceeded the assumed rate of growth in student population. The Callan study seems to have used the U.S. Consumer Price Index as the measure of inflation,

although an adjustment to reflect the cost of public education in Texas may have been more relevant. Also, we could quarrel slightly with the use of different periods to measure the risk-return trade-off. However, by and large, we believe that the decision of the SBOE was based on objective, relevant and appropriate information, and that it was consistent with the purpose of the PSF and in the interests of the beneficiaries of the PSF. Therefore, the decision would be considered in accordance with the standards of prudence and impartiality with respect to fiduciary conduct.

Implementation

The asset allocation policy approved by the SBOE in July 2000 – like the previous decision in July 1997 – involved major changes in the investment management structure of the portfolio, including: (a) the selection of three domestic large cap managers; (b) the selection of six small and mid-cap managers; (c) the selection of two managers of emerging managers; (d) the transition of domestic stock assets from the terminated investment managers to the new managers; (e) the transition of the externally managed high-yield bond portfolio to an internally managed investment-grade bond portfolio; and (f) the creation of an internally managed domestic large cap stock index fund. The implementation of the policy also involved a substantial increase in the allocation to the existing international stock managers from about 10% to 22% of total assets.

We discuss the selection of the investment managers later in this appendix. Here we confine our comments to three issues: (a) the transition of the domestic stock portfolio to the new investment managers; (b) the transition of the high-yield bond portfolio; and (c) the funding of the managers for international stocks.

(a) In September 2000, PSF staff presented a plan to the Committee for the transition of domestic stocks from the portfolios of the terminated managers to the new managers. The plan proposed a step-by-step process involving:
    i) Compiling a list of the portfolios to be liquidated and those to be funded;
    ii) Identifying the securities that could be transferred directly between the
    iii) Liquidated and new portfolios at no cost;
    iv) Identifying the characteristics of the remaining securities and developing optimal trading strategies for the various market segments;
    v) Identifying the firms which could execute the various strategies most effectively, and solicit competitive bids for each trade;
    vi) Evaluating bids and executing trades; and
    vii) Reconciliation and post-trade analysis.

    The total implementation cost was estimated at $118 million. Staff recommended that the services of the Plexus Group be used to assist in the transition process. The Committee directed staff to work with First Union Securities and Callan Associates to develop a transition plan. Callan Associates informed the Committee that it did not have any expertise in this area.

At the PSF Committee meeting on October 16, 2000, First Union suggested that using S&P 500 futures contracts to equitize cash could lower the transition cost. Staff indicated that they had consulted with Plexus on the most efficient manner to handle the transition and saw no need to utilize S&P 500 futures. At a subsequent meeting on October 26, staff indicated that they had also consulted further with First Union and Callan Associates, and that Callan Associates had recommended deferring to the advice of Plexus. At a later meeting in November 2000, the Committee decided to take no further action.

On February 1, 2001 staff informed the Committee that the transition had been completed. In March, Plexus presented a post-transition review indicating that the transactions involving assets worth $14.9 billion had cost $98.4 million (or 0.66% of assets), which was $47.6 million less than the benchmark and well below the original estimate.

We find that the transition of the domestic stock portfolio was executed efficiently, with proper monitoring and oversight. The use of the Plexus Group was appropriate, as they are well known for their expertise in the measurement of transaction costs and transition analysis. We find the Committee's direction to staff to use the services of First Union and Callan Associates without first determining if they had expertise in this area to be inappropriate. (The role of First Union in the transition process is discussed in more detail in the section below.) The transition of the domestic stock assets was implemented for the most part in accordance with the principle of prudence in delegation and decision-making by fiduciaries.

(b) Regarding the transition of the high-yield bond portfolio, PSF staff recommended to the Committee in September 2000 that the PSF should retain its current investment in high-yield bond securities because liquidating the assets and transferring the proceeds to an investment-grade bond portfolio would reduce income to the Available School Fund by $23 million, and further that the transition be deferred for 12 to 18 months. The performance measurement consultant, First Union Securities, opposed the idea. The investment consultant, Callan Associates, stated that timing of the liquidation is an important consideration, and if the SBOE decides to liquidate the high-yield bonds, it should wait for the market to improve. The Committee tabled the matter to the November 2000 meeting.

At the November meeting, First Union proposed that the portfolio managed by two of the three existing high-yield bond managers be transferred to the third manager, MacKay Shields, who should be directed to transition the securities to an investment-grade bond portfolio to be managed by MacKay Shields. The Committee decided unanimously to recommend this proposal to the SBOE, and further that MacKay Shields be directed to present a transition plan prior to implementing the transition. The SBOE subsequently voted unanimously to approve the recommendation of the Committee.

In December 2000, PSF staff advised the Committee that First Union had contacted MacKay Shields and informed the manager that the SBOE intended MacKay Shields to

begin investing in investment-grade bonds, although a transition plan had not yet been presented by the manager and approved by the SBOE. First Union admitted contacting the manager but disputed the nature of what was discussed. The Committee was also informed by PSF legal counsel that the State Auditor had raised a question whether high-yield and investment-grade bonds could be considered different asset classes, in which case Rider 40 of the current Appropriations Act may require a competitive RFP process before the payment of investment management fees for the new investment-grade bond portfolio could be authorized. The Committee directed staff to inquire of the Legislative Budget Board (LBB) whether an RFP process was required.

In February 2001, MacKay Shields presented a transition plan to the Committee. Staff advised the Committee that no response had yet been received from the LBB, that the SBOE had not received any information on the performance of the MacKay Shields investment-grade bond product, and whether or not the proposed management fee was competitive. Nevertheless, the Committee unanimously recommended to the SBOE that MacKay Shields be directed to transition the high-yield bonds to an investment-grade bond portfolio contingent upon affirmation by the LBB that management fees can be paid under Rider 40, or alternatively that an RFP for investment-grade bonds bond management be issued. The SBOE subsequently voted unanimously to approve the Committee's recommendation.

Finally, in May 2001, following the decision to adopt a new asset allocation policy which included a 10% allocation to high-yield bonds, the SBOE approved the Committee's recommendation to rescind the decision to transition the portfolio from high-yield to investment-grade bonds.

The process undertaken to implement the transition of the high-yield bond portfolio would probably be considered to be contrary to generally accepted principles and standards of fiduciary conduct for the following reasons:

i) In a memo to the Committee dated September 13, 2000, staff indicated their view that the Callan asset allocation study did not recommend divesting high-yield bonds but instead was "ambivalent regarding the inclusion of the asset class". We reviewed the Callan study closely. None of the efficient asset allocation alternatives that it analyzed included an allocation to high-yield bonds. Instead, the Callan study included "domestic bonds" a term most investment consultants would use to describe investment-grade bonds. In fact, an earlier presentation on asset allocation by Callan Associates in May 2000 shows the Lehman Aggregate Bond Index (an index which excludes high-yield bonds) as a proxy for domestic bonds. Later in May 2001, the Callan Associates representative himself told the Committee that the recommended asset allocation did not include high-yield bonds. As further analysis, the Callan study did look at the impact of allocating 10% of the bonds portfolio (3.5% of total assets) to high-yield bonds. It concluded that the impact would be relatively small and wouldn't "materially help or hurt the PSF". The Committee, in recommending the asset allocation policy to the SBOE in July, directed staff to bring forward a plan to eliminate high-yield

bonds. In this case, the staff's recommendation to maintain the current investment in high-yield bonds does not appear to have been an objective interpretation of the results of the asset allocation Callan study. It may not have been consistent with the interests of the beneficiaries of the PSF, and, therefore, would probably be considered to be contrary to the standard of loyalty in fiduciary conduct.

ii) We agree that liquidity should be a consideration in any transition of assets, particularly in the case of high-yield bonds that are normally less liquid than investment-grade bonds. Delaying the process for a reasonable period of time to allow market conditions to improve may be prudent, but has to be balanced against the risk of deviating from the approved policy allocation. However, to delay or defer the implementation of the policy allocation simply because it would otherwise reduce current income was not a proper basis for fiduciary decision-making. If the need to maintain income was an important consideration, it should have been addressed in the asset allocation decision taken just two months earlier, in July 2000. Assuming that decision was based on an appropriate consideration of the interests of current and future beneficiaries of the PSF (and we find that it was), delaying the implementation of the decision in order not to reduce income unduly would have benefited the current generations at the expense of future generations. As such, it could be deemed to be contrary to the standard of impartiality in fiduciary conduct.

iii) It appears that the desire not to reduce income was motivated by the need to pay service provider fees. We recognize that the SBOE is required by law to provide all interest and dividend income to the Available School PSF, and that Rider 40 of the Appropriations Act restricts the ability of the SBOE to pay fees to external service providers in excess of the appropriated amount, unless total PSF income covers the Biennial Revenue Estimate (BRE). However, our review of the minutes of the September 2000 Committee and SBOE meetings does not indicate that Rider 40 was mentioned as an issue, or that it was suggested by anyone that the reduction in income would unduly jeopardize the SBOE's ability to pay service provider fees. Even if that were the case, and recognizing the practical reality that the SBOE needs to pay its service providers as per signed contracts, other actions – more internal management, passive investment strategies, etc. – would have been better than delaying the implementation of the approved asset allocation. There is considerable empirical evidence to suggest that asset allocation policy has the greatest impact on the long-term performance of a fund. Deviating from the long-term asset allocation for short-term considerations would, therefore, be likely to do the most damage. It would be considered inconsistent with the purpose of the PSF and thus contrary to the generally accepted standard of loyalty in fiduciary conduct.

iv) We find the role of the performance measurement consultant, First Union Securities, in providing advice and recommendations to the SBOE on the transition of stock and bond portfolios to be disturbing. While prudent decision-

making by fiduciaries requires that they take counsel from knowledgeable service providers on technical matters, the service providers should have demonstrated their expertise through an appropriate due diligence process, and been chosen by the SBOE specifically for that purpose. The SBOE should not simply accept whatever advice is offered by anyone on anything. The role of the performance consultant is to measure and analyze the investment performance of the PSF, asset classes and manager portfolios, and to advise on issues related to manager evaluation and termination, not to make recommendations with respect to the implementation of an asset allocation policy decision. We find it strange that the SBOE did not ask for or receive advice on the transition of high-yield bonds from the general investment consultant, Callan Associates, except once very early in the process. It was Callan Associates after all who conducted the asset allocation study and recommended the asset allocation policy approved by the SBOE. It seems particularly troublesome to us that First Union contacted the investment manager MacKay Shields on a matter unrelated to the performance measurement of the portfolio. It did not appear that the SBOE took any steps to determine whether the advice it received - from someone who was not mandated to provide that type of advice – was objective and appropriate. Instead, the SBOE and Committee voted unanimously to accept the recommendations made. To the extent that the SBOE acted on the advice of the performance measurement consultant, its decision could be considered contrary to the principle of prudence in decision-making by fiduciaries.

v) Finally, we believe that most investment managers and consultants would consider high-yield and investment-grade bonds to be significantly different in their risk-return characteristics as to constitute separate asset classes. In fact, the PSF's previous asset allocation approved in July 1997 considered high-yield bonds as a distinct asset class with a specific allocation separate from investment-grade bonds. Price changes on investment-grade bonds are driven to a large extent by macroeconomic factors, which result in changes in the yield curve (i.e., interest rates) and sector spreads (Treasuries versus corporates). For high-yield bonds, the risk specific to an individual security, particularly the financial strength of the issuer, has a great impact on price. The risk of default is much bigger factor for high-yield as opposed to investment-grade bonds. High-yield bond research, in fact, resembles more closely the type of company-level due diligence and analysis common in stock markets. The skill set required to manage a portfolio of high-yield bonds is quite different from that for a conventional bond portfolio. Most investment consultants would look at a very different universe of candidates for selecting a high-yield bond manager versus an investment-grade bond manager. Asking an existing high-yield bond manager to transition the portfolio and then manage it as a portfolio of investment-grade bonds without going through a competitive RFP process for an investment-grade bond manager was not an appropriate decision. It would probably be considered inconsistent with the principle of prudence with respect to delegation of investment matters to an agent by fiduciaries.

(c) With respect to the funding of the international stock managers, the Committee reviewed a presentation by the investment consultant, Callan Associates in September 2000. The consultant made a number of observations which included the following:
   i) The average number of managers for an allocation of this size was 4 to 5.
   ii) It was unusual for the allocation to an individual manager's portfolio to make up more than 25% of the total investment in that asset class. 100% was extremely unusual. This increased both business and maverick risk (the risk of being wrong and different).
   iii) Even weightings across managers mitigated business and maverick risk.

Callan Associates then reviewed three alternative international stock manager structures consisting of four managers, the three existing managers plus one new manager with one of the following mandates: (a) the same as the current managers; (b) an emerging markets mandate; or (c) an all-cap international mandate. The Committee did not take any action at the meeting.

The Committee discussed the matter further at a subsequent meeting in October 2000, and in November recommended to the SBOE that the amount allocated to international stocks in the asset allocation policy be divided equally among the three managers. The recommendation was based on a unanimous vote of the Committee. At the SBOE meeting the next day, the Committee chairman made a motion in accordance with the Committee's recommendation. The motion was not seconded and it died. The chairman then made a revised motion to award 50% of the international stock allocation to one manager, and 25% to each of the other two managers. This motion was seconded and carried unanimously.

The minutes show very little discussion on this item at the SBOE meeting. One SBOE member inquired whether the revised motion was being made because the one manager was "performing well" and the chairman agreed. It could be argued – since numerous empirical studies show that portfolio performance is subject to "reversion to the mean" so that a manager who has performed well in the recent past is not likely to do as well in the future – that this decision was not in the best interests of the beneficiaries of the fund. Our concern, however, is with the process. Although the Committee's recommendation was contrary to the advise of the consultant, that would be appropriate if the matter had been duly deliberated and discussed. However, when the Committee's recommendation went to the SBOE for approval, the SBOE should have sent the matter back to the Committee for further deliberation, instead of simply approving a different decision. The process for funding the international stock portfolios may have been inconsistent with the principle of prudence in decision-making by fiduciaries.

3. May 2001

The SBOE unanimously approved a change in the asset allocation policy of the PSF to 60% stocks (including 8% small and mid-cap stocks and 17% international stocks) and 40% bonds assets (including 10% in high-yield bonds). The decision was based on a presentation by

staff, supported by analysis by the investment consultant, and a unanimous recommendation by the PSF Committee.

Decision-Making

Staff made a presentation to the Committee in which it projected a shortfall in investment income of $44 million relative to the Biennial Revenue Estimate (BRE) for the 2002-2003 biennium. It also estimated that professional service fees for external investment management and custodial services would be $17 million higher than the appropriated amount. Under a rider to the current appropriations act, many believed at the time that the SBOE could not pay excess service fees unless income was greater than the BRE by the required amount[2]. Staff outlined three alternatives to cover the income shortfall:

i) Index more of the stock portfolio to reduce investment management fees, and combine custody and securities lending to reduce custody expenses. This would eliminate the projected shortfall in fees but still leave income $44 million less than the BRE.
ii) Retain the current high-yield bond portfolio. This would increase income above the BRE enough to cover all but $4 million of the expected professional fees.
iii) Change the asset allocation policy as indicated. This would not only cover the expected fees, but also produce additional income of $147 million beyond the BRE.

Callan Associates reviewed for the Committee their analysis of the proposed asset allocation using the same capital market assumptions as the asset allocation study in 2000. The analysis showed that the allocation would increase income but reduce the expected total return slightly. It would also reduce the volatility of the PSF, resulting in a more favorable return-to-risk profile.

The SBOE's decision to change the asset allocation policy was not just to cover the higher expected service fees, which could have been achieved under the first alternative, or even to meet the 2002-2003 BRE, which could have been achieved under the second alternative, but rather to generate additional income over and above the BRE. We understand that in April 2001, two members of the SBOE met with members of the State Legislature and reached an informal understanding to change the asset allocation policy of the PSF in order to generate additional income to fund health insurance for public education employees.

A letter dated May 1, 2001 from the two members to the Chairman of the Senate Committee on Education outlined a proposed change in asset allocation from 65% stocks, 35% bonds to 60% stocks, 40% bonds in order to raise additional income from the PSF. The letter went on to mention the further understanding that any legislation to remove oversight of the PSF from the SBOE to an appointed board and/or change to a total return strategy would be removed from further consideration. Another letter from the Chair of the SBOE to the Chairman of

[2] The Attorney General's office issued an opinion on January 29, 2003 in favor of the SBOE's ability to pay the PSF's financial services providers regardless of whether or not the PSF is producing the extra revenue mandated by Rider 90 to the TEA's appropriation.

the Senate Education Committee dated April 30, 2001 stated that an item had been added to the agenda of the forthcoming SBOE meeting to consider ways of modifying the asset allocation of the PSF in order to provide more funds to the Available School Fund.

Although this agreement with the Legislature was not explicitly mentioned in staff's presentation or discussed during the SBOE meeting in May, our review of the minutes of subsequent meetings indicates that it was understood by most, if not all, members of the SBOE that when it decided to change the asset allocation policy of the PSF, it was doing so in order to generate the additional income required by the Legislature. There seemed to be some confusion, however, among the members as to how much additional income.

The Legislature subsequently passed the 2002-2003 Appropriations Act with a rider attached (Rider 90) that required the SBOE to provide to the Comptroller of Public Accounts a memorandum of commitment indicating that changes in the PSF's investment strategy will result in an additional $150 million of investment income in the 2002-2003 biennium. The SBOE, after much discussion and debate, voted to approve the memorandum of commitment in September 2001.

We believe that changing the asset allocation policy of the PSF based on short-term considerations, simply to increase the level of current income, is inconsistent with the long-term objectives of the PSF. The decision itself, the events surrounding the decision, and the process by which it was reached would be considered contrary to generally accepted principles and standards of fiduciary conduct for the following reasons:

a) The previous policy was adopted only ten months earlier, in July 2000, based on a very thorough and detailed asset allocation study. The study considered the impact of inflation and growth in student population and recommended an asset allocation policy in which (a) the level of distributions in real terms, net of inflation, per student would be maintained, and would in fact increase slightly, and (b) the real value of assets would keep pace with the growth in student population. There was no evidence presented to suggest that there had been a change in the purpose of the PSF or in the expectation of future return or risk in capital markets. In fact, the analysis presented in support of the change in asset allocation policy used the same capital market assumptions as the previous study. If the current policy reflected an appropriate balancing of the needs of current and future generations of beneficiaries, then changing the policy simply to increase the level of income – when nothing else had changed – tilts the balance unfairly in favor of the current generation of beneficiaries at the expense of future generations. Moreover, the decision was taken without a study to examine the impact on future distributions and growth in assets net of inflation and growth in student population. The decision did not take into consideration the interests of the future beneficiaries of the PSF and, therefore, would probably not be deemed consistent with the standard of impartiality in fiduciary conduct.

b) The asset allocation policy approved in May 2001 was not supported by a proper asset allocation study, although it proposed a significant change from the policy adopted in July 2000 – a reduction in the stock allocation from 65% to 60%, and a new 10%

allocation to high-yield bonds. The investment consultant did some analysis of expected return and volatility but there was no determination of the impact of the proposed policy on future level of distributions and the value of assets over the long run. It was not demonstrated that that the policy was consistent with the purpose of the PSF or in the long-term interests of the beneficiaries. The decision was not based on information that was completely appropriate or relevant and could, therefore, be considered contrary to the principle of prudence in fiduciary decision-making.

c) We recognize that the SBOE has to provide the funds to pay professional service fees, and that it is constrained by the requirement that fees be paid out of a budget appropriation rather than from the assets of the PSF. However, the projected shortfall in fees could have been met by the first of the three alternatives presented by staff, namely indexing more of the externally managed stock assets and combining securities lending with custodial services. While it may be argued that this would reduce the potential value added by active investment managers and thus adversely impact the long-term growth of the PSF, PSF's actual experience with external management of domestic stocks has been the opposite. In any case, since it is well recognized that asset allocation is the major determinant of the long-term performance of a fund, it is far more prudent and appropriate to explore alternative solutions to the very real need to pay service fees – such as negotiating lower fees with investment managers, moving assets from external to internal management, and increasing the use of passive or indexed strategies – instead of changing the asset allocation policy of the fund. Therefore, to the extent the decision was made to cover a projected shortfall in professional service fees, it was not necessarily consistent with the purpose of the PSF, and thus may have been contrary to the standard of prudence in fiduciary decision-making.

d) There is no reference that we can find in any of the minutes of SBOE meetings or any other documentation indicating that the two members were duly authorized by the SBOE to approach the Legislature as representatives of the SBOE, let alone reach an understanding on a matter that required a decision on the part of the whole SBOE. This is not appropriate conduct by members of any board, particularly one that has fiduciary responsibilities. To reach an agreement or understanding, however informal, on changing the asset allocation policy without proper analysis and due diligence on whether the change would be consistent with the purpose of the PSF or in the best interests of the beneficiaries is also contrary to the principle of prudence in making decisions. Finally, it appears that the undertaking to change the asset allocation was provided in exchange for an understanding that there would not be further action by the Legislature to remove the responsibility for managing the PSF to an appointed board. This would seem to put the interests of the current members of the SBOE ahead of those of the beneficiaries of the PSF. The decision would, therefore, probably be considered contrary to the most widely recognized standard of fiduciary conduct, that of loyalty.

Implementation

The asset allocation policy approved by the SBOE in May 2001 as it turned out was never implemented. The policy re-instated a 10% allocation to high-yield bonds and, therefore,

required the selection of external high-yield bond managers. In July, the SBOE approved the issuance of a request for proposal (RFP) for high-yield bond management services. At the September 2001 meeting of the SBOE, some members expressed concern at the 10% allocation in what they termed "junk bonds". In approving the appointment of the high-yield bond managers in November 2001, the SBOE, on the recommendation of the Committee, decided that the managers should be funded at 5% of total assets, contrary to the policy allocation of 10% in high-yield bonds approved by the SBOE in May. The 5% allocation to high-yield bonds was to "be sourced first from stocks, to the extent that stocks represent more than 60% of the value of the total portfolio, and second from high grade bonds." Our reading of this somewhat convoluted motion is that what the SBOE approved for implementation was an asset allocation policy of 60% stocks and 40% bonds assets, which in terms of the overall stock/bonds split was the same as the allocation approved in May, except that the 40% in bonds would now be split 35% in high grade (or what we have chosen to call investment-grade) bonds, and 5% in high-yield bonds.

This decision was based on analysis by the investment consultant, Callan Associates, of four alternative asset allocations ranging from 52% stocks, 48% bonds to 60% stocks, 40% bonds – with high-yield bond allocations ranging from 0% to 10%. Each of these alternatives, according to staff, would meet the income expected of the PSF during the current biennium. One of these alternative allocations – 60% stocks and 40% bonds (with 10% in high-yield bonds) – was, in fact, the one approved by the SBOE in May. The analysis looked at the impact of the various asset allocations on total income and year-end market value of assets for the years 1, 2, 5 and 10. It did not look at the impact adjusted for inflation or expected growth in student population. None of the alternative allocations, however, was the one approved in November. In other words, the Callan study did not specifically look at the impact of the allocation, which the SBOE then approved for implementation.

In January 2002, the Committee recommended another change in the asset allocation policy to 55% stocks (with 8% small and mid-cap stocks and 15% international stocks) and 45% bonds assets (with 5% in high-yield bonds). This was one of the alternative asset allocations included in the analysis by the investment consultant. Staff provided the Committee with copies of the presentation that the consultant had made in November, and reviewed the results of the analysis. The SBOE approved the Committee's recommendation without discussion.

The process of implementation of the asset allocation policy approved in May 2001, which ultimately resulted in a different policy being implemented in January 2002, could be considered contrary to generally accepted principles and standards of fiduciary conduct in the following ways:

a) The allocation approved for implementation in November 2001 was, in our view, materially different from the one approved in May. While the overall stock/bonds split may have been the same, that does not fully describe a fund's asset allocation policy. As we have argued earlier, most investments consultants and advisors would consider high-yield bonds to be a different asset class than conventional investment-grade bonds, with significantly different return and risk characteristics. A 5% difference in allocation could have a substantial impact on the PSF in the long run. While the SBOE may have thought

it was just changing slightly the allocation to its high-yield bond managers, it was in fact adopting a different asset allocation policy. To the extent that the SBOE did not realize the implication of what it was doing, its decision may have been inconsistent with the standard of prudence in fiduciary conduct.

b) If the SBOE did realize what it was doing, i.e., approving an asset allocation policy that was materially different from the one it approved in May 2001, the decision was based on information and analysis that was not relevant to the decision. The analysis by the investment consultant presented in support of the change in asset allocation policy did not examine the impact on the PSF of the policy approved in November. The decision may not have been consistent with the purpose of the PSF, and could, therefore, be considered contrary to the principle of prudent decision-making.

c) The asset allocation policy that the SBOE ultimately approved in January 2002 was not supported by a proper asset allocation study. The four asset allocation alternatives examined under the analysis by the investment consultant were not necessarily "efficient" or optimal portfolios, based on the generally accepted methodology for determining such portfolios, according to the consultant's own report. In other words, it is possible that another asset allocation policy could have reasonably been expected to provide a higher return at the same risk, or the same return at lower risk. The decision may not have been in the best interests of the beneficiaries of the PSF and, therefore, would probably not be deemed consistent with the principle of prudence in fiduciary decision-making.

d) Finally, the analysis that was done did not take into consideration the impact of inflation or growth in student population. The decision thus did not ensure that the interest of the future beneficiaries of the PSF was protected. Therefore, the decision may not have been consistent with the standard of impartiality in fiduciary conduct.

Monitoring

Our review of various minutes of SBOE and PSF Committee meetings since January 1997 shows that there was a standing item on the agenda of the Committee, which provided for "Review of Permanent School Fund Securities Transactions and the Investment Portfolio". The material accompanying this review included a report that compared the current asset allocation against the asset allocation policy approved by the SBOE. The Committee met at least as often as the SBOE, which met at least six times a year, and prior to every SBOE meeting. In addition, since May 1999, there has been an additional standing item on the agendas of both the SBOE and the Committee on "Review of the Allocation of the Permanent School Fund Assets to Internal and External Investment Managers". The report provided for this review compared the current allocation to asset classes, sub-asset classes and individual portfolios against the asset allocation policy and target manager allocations approved by the SBOE. This provided, in our opinion, sufficient information and opportunity for the SBOE to ensure compliance with the various asset allocation decisions that were made.

APPENDIX 4(B)
THE SBOE'S MANAGEMENT PROCESS FOR PORTFOLIO REBALANCING

The SBOE has had, as part of its Investment Procedures Manual, a policy established and in place since at least 1998 which calls for the rebalancing of the asset allocation of the PSF when the actual allocation to asset classes, sub-asset classes and individual portfolios moves outside a specified minimum-maximum range around the PSF's long-term asset allocation policy. The policy requires the PSF staff to recommend rebalancing of sub-asset classes and individual portfolios to the SBOE for approval. The policy was not clear until recently on whether SBOE approval was required for rebalancing the overall stock/bond income allocation. In March 2002, the SBOE amended the policy giving staff the authority to rebalance the stock/bond income mix, when the stock allocation moves outside a 4% plus/minus range around the policy mix.

Most large institutional funds that are well managed monitor their asset allocation on a regular basis and follow a policy of systematically rebalancing the asset allocation. Rebalancing becomes necessary because as capital markets move relative to each other, a fund's actual allocation changes. If the allocation is allowed to drift too far from the long-term asset allocation policy, it could significantly change the fund's risk-return profile from what was considered appropriate by the fund's fiduciaries. Rebalancing the asset allocation as necessary from time to time is an important part of prudent risk management for a fund.

The SBOE made a number of decisions with respect to rebalancing the PSF's asset allocation during the period under review, some of which could be considered contrary to or inconsistent with generally accepted standards of fiduciary conduct.

1. November 1999

At a meeting of the PSF Committee in August 1999, staff informed the Committee that the PSF's current allocation to stocks was above the maximum limit established in the SBOE's rebalancing policy. In order to comply with the policy, staff recommended that the PSF be rebalanced by moving $400 million from the four externally managed domestic large cap stock portfolios to the internally managed bond income portfolio.

One SBOE member noted that rebalancing would simply increase investment income, which was already projected to be above the Comptroller's estimate for the current biennium, and was, therefore, unnecessary. Staff explained that the increase would be only $18 million versus the total estimated income of $1.35 billion, and that the purpose for rebalancing was not to raise income but to control the overall risk of the PSF. Since the policy required staff to rebalance, staff would need direction from the SBOE not to rebalance. The Committee voted unanimously to recommend to the SBOE that staff be directed not to do any rebalancing until after the November 1999 SBOE meeting.

At a subsequent meeting nine days later, the Committee reconsidered this decision. The external investment advisor to staff, Mr. David Hoener, strongly supported staff's recommendation to rebalance. The Committee decided to recommend to the SBOE that the

PSF be rebalanced as recommended by staff. At the SBOE meeting the next day, the Chairman of the Committee maintained that the appropriate course of action would be not to do any rebalancing until after the SBOE meeting in November, in order to avoid making any adjustment to the PSF until the new investment consultant had an opportunity to review the structure of the PSF. After some debate, the SBOE voted unanimously to direct staff not to rebalance until after the November meeting.

At the Committee meeting in November 1999, preceding the SBOE meeting, the Committee voted to recommend to the SBOE that $300 million be transferred from only one domestic large cap stock portfolio, the one managed by Davis Hamilton Jackson & Associates (DHJ) to the bond income portfolio. The minutes show no discussion of this item. At the SBOE meeting the next day, the Committee Chairman stated that the reason for moving assets from only one investment manager rather than all four as recommended by staff was because the PSF's portfolio was the manager's biggest account, about four times larger than the next biggest account. As a fiduciary he was uncomfortable that the portfolio represented such a substantial portion of the firm's assets under management. The SBOE voted to accept the Committee's recommendation.

The SBOE's decision could be considered as inconsistent with generally accepted principles and standards of fiduciary conduct for the following reasons:

a) The SBOE's decision in September 1999 to direct staff not to do any rebalancing until after the November meeting was contrary to the recommendation of the Committee. As we have said before, we do not believe it is good fiduciary practice on the part of the SBOE to take a decision that is independent of the recommendation of the Committee. If the SBOE disagreed with the Committee's decision, it should have sent the matter back to the Committee for further review. To do otherwise, we believe, could be considered inconsistent with the principle of prudence in decision-making by fiduciaries.

b) The Committee's recommendation was based on the recommendation by staff, which was strongly supported by the staff's external investment advisor. The SBOE should not have acted contrary to that recommendation unless it was clearly prudent to do so. We do not find the SBOE's argument – to allow the new investment consultant an opportunity to review the structure of the PSF – provides sufficient reason. The selection of the new consultant was approved by the SBOE at the same meeting; a contract with the consultant had not yet been drafted and executed. It would not have been reasonable to expect a new consultant to undertake an asset allocation study and review the investment management structure of the PSF in less than two months. The SBOE's decision to direct staff not to rebalance the asset allocation for two months exposed the PSF to higher risk than allowed by its asset allocation policy without sufficient cause. The decision may not have been in the best interests of the PSF's beneficiaries and could, therefore, be deemed to be contrary to the standard of loyalty in fiduciary.

c) Finally, we do not believe that the SBOE's decision in November to transfer assets from only one investment manager, rather than all four as recommended by staff, and supported by the external investment advisor, was justified. The fact that the PSF's

portfolio was the manager's largest account and four times bigger than the next largest account, is not enough reason. For example, the PSF's portfolio could have been 4% of the manager's assets under management and the next largest account could have been 1%. The manager may have had more than a hundred accounts. It is the absolute size of the account (as a percent of the manager's total assets under management) that should be of concern, not the size relative to the manager's other accounts. In any case, this concern should have been raised two years ago when the manager was hired – we do not find that it was. (It is highly unlikely that the PSF's portfolio simply grew much faster than the manager's other similarly managed accounts to become the largest account by a factor of four.) The SBOE's decision to transfer assets from one investment manager only may not have been in the best interests of the PSF's beneficiaries and, therefore, would probably be considered contrary to the standard of loyalty in fiduciary conduct.

2. March-May 2000

At meetings of the PSF Committee in March 2000 and again in May 2000, staff informed the Committee that the PSF's current allocation to stocks was above the maximum limit established in the SBOE's rebalancing policy. In order to comply with the policy, staff recommended that the PSF be rebalanced by moving $500 million from the internally managed domestic stock portfolios to the internally managed bond income portfolio. The staff's external investment advisor supported the recommendation. The Committee voted on both occasions to recommend to the SBOE the rebalancing as recommended by staff. The SBOE then approved the recommendations of the Committee.

In making these rebalancing decisions, one SBOE member observed in the March meeting that there were many compelling arguments for selling stocks, but that was only one decision. The other decision was what to do with the proceeds, what was the most attractive or the most undervalued asset in the market, what was a good buy. The question was whether the proceeds should be invested in small and mid-cap stocks, high-yield bonds, income securities, or international stocks. He was convinced that bonds were the most attractive assets at that time. The same member had stated in September 1999 that moving assets from stocks to bonds would only result in higher investment income that was unnecessary. Another member asked in the May 2000 meeting whether moving from stocks to bonds would increase income and was told it would.

These rebalancing decisions, we believe, would generally be regarded as consistent with the principle of prudence in fiduciary conduct. However, the comments made during discussions at the SBOE meetings lead us to believe that some SBOE members do not really understand the nature of rebalancing and why a fund needs to rebalance its asset allocation.

Moving from large cap stocks to small and mid-cap stocks or international stocks would still leave the total stock allocation above the maximum limit under the PSF's rebalancing policy. It is only by moving from stocks to bonds that the allocation would again be in compliance with policy.

The objective of rebalancing is not necessarily to move from unattractive overvalued assets to attractive, undervalued assets. That generally tends to be the result, but it is not the objective. Nor is it to raise investment income. Instead, the objective is simply to move from assets that have become over-weighted relative to the PSF's long-term asset allocation policy to asset classes that have become correspondingly under-weighted in order to control the risk exposure of the total PSF.

Most large well-managed funds, in our experience, regard rebalancing as a fairly mechanical exercise in risk management, with policies and guidelines set by the board and implementation delegated to staff. The decisions involved are mainly operational in nature, dealing with timing, speed of execution and minimization of transaction costs.

3. March 2002

The Committee recommended to the SBOE that the PSF staff be authorized to rebalance the total stock/bond income allocation of the PSF whenever the stock allocation exceeds the long-term policy allocation by more than 1% in order to maximize income produced by the PSF for the current biennium. Staff would not be required to rebalance if the stock allocation fell below the policy allocation.

One SBOE member commented that it would not be prudent to rebalance only from stocks to bonds but not the other way, that if the stock allocation dropped below the minimum limit, the PSF would not be in compliance with its asset allocation policy, and that if the SBOE did not require the PSF to be rebalanced from bonds to stocks, it would not be acting responsibly as fiduciaries. Another SBOE member observed that it would be prudent in the long-term to rebalance both ways. Staff stated that the intent of the proposed change in rebalancing policy was to ensure that the PSF was able to produce the income expected over the biennium. Staff explained that the PSF has conflicting objectives because it has to be managed to a short-term income target as well as long-term return, and that the SBOE needs to decide which objective has priority. The investment consultant, Callan Associates, advised that if the SBOE wanted to rebalance both ways from stocks to bonds, as well as bonds to stocks, the maximum-minimum range should be plus-minus 4% to reflect the volatility of the asset classes. The SBOE rejected the recommendation of the Committee and approved a rebalancing policy which authorized staff to rebalance the total stock/bond income mix whenever the stock allocation deviated more than 4% from the long-term policy of the PSF.

While the decision of the SBOE may have been prudent, the process was probably not in accordance with generally accepted principles and standards of fiduciary conduct for the following reasons:

a) We believe that recommendation of staff and the Committee was not consistent with the purpose of the PSF or in the interests of the beneficiaries. Rebalancing the PSF only from stocks to bonds and not vice versa would increase current income only at the risk of reducing future growth in the value of assets – and hence reducing the level of distributions for future generations of students. It would allow the asset allocation of the PSF to deviate significantly from the long-term policy, and thus change the risk-return

tradeoff from what was approved as appropriate and acceptable by the SBOE. The recommendation to rebalance only one way could be considered contrary to the standards of prudence and impartiality in fiduciary conduct.

We have not found in any of the laws and statutes governing the PSF that the SBOE is required to change the asset allocation of the PSF or its rebalancing policy to meet a specific income target. There is an issue, however, with respect to the payment of professional fees.[3] The SBOE cannot simply pay the fees out of the assets of the PSF; it must pay out of the amount budgeted for that purpose by the Legislature under the Appropriations Act. A rider attached to the Act requires that any excess fees over the appropriated amount can only be paid if the income of the PSF exceeds the amount in the Biennial Revenue Estimate prepared by the Comptroller. This is a significant constraint and a very real problem. However, as we have stated before, we do not think it would be considered prudent to address this by changes in the asset allocation or the rebalancing policy of the PSF. Other measures – such as negotiating lower fees with investment managers, moving assets from external to internal management, and increasing the use of passive or indexed strategies – would have less impact on the expected return and risk of the PSF.

b) While we believe that the SBOE acted prudently in rejecting the recommendation of the Committee, it should have sent the matter back to the Committee for further review. The Committee has been established for the very purpose for allowing sufficient time and attention to be devoted to proper due diligence and deliberation on matters concerning the PSF. For the SBOE to act contrary to the Committee's recommendation, in our view, could be seen as inconsistent with the principle of prudence in delegation and decision-making on fiduciary matters.

[3] The Attorney General's office issued an opinion on January 29, 2003 in favor of the SBOE's ability to pay the PSF's financial services providers regardless of whether or not the PSF is producing the extra revenue mandated by Rider 90 to the TEA's appropriation.

Appendix 4(C)
The SBOE's Management Process for the Selection and Retention of Service Providers

The SBOE made a number of decisions with respect to the selection and retention of service providers during the period under review.

1. September 1997 – Selection of Investment Managers

The SBOE, on the recommendation of the PSF Committee (the Committee), approved the appointment of nine external investment managers to manage domestic large cap stocks, small and mid-cap stocks, and high-yield bonds assets of the PSF.

Decision-Making

In May 1997, the PSF Committee directed staff to issue a request for proposal (RFP) for the selection of a number of external investment managers for the PSF. The RFP was sent to over 150 firms, of which 95 responded. The investment consultant, IAS, and staff reviewed responses and recommended 13 firms to be interviewed by the Committee. Three of these were Texas firms, as the Committee had wanted to consider some Texas firms. The investment consultant recommended a final list of ten firms, which the Committee in turn recommended to the SBOE for approval. The Committee also recommended the allocations to the managers' portfolios. The SBOE approved the appointment of nine of the ten firms, including the allocations recommended by the Committee, by an almost unanimous vote, with only one member opposing.

One SBOE member commented about the tenth firm that only 11% of their assets under management were in stocks, and that he was concerned about recommending such a large amount of money to a firm of that size. The investment consultant advised the SBOE that the firm in question had been founded 33 years ago and had $5.3 billion in total assets, of which $1.1 billion (i.e., more than 20%) was in stocks. The SBOE rejected the appointment of the manager by a narrow vote of 8 to 6 with one member declaring a conflict and not voting.

The SBOE followed an overall process that we believe was appropriate. Its decision appears to have been in the interests of the beneficiaries, and would, therefore, be considered in accordance with the standard of prudence in delegation and decision-making by fiduciaries. However, we do have some concerns with respect to two issues:

a) One is with the requirement by the Committee to include some Texas firms in the list of managers to be interviewed. We are not sure whether there was sufficient due diligence undertaken to ensure that these firms could provide an equivalent level of service at a competitive fee as other non-Texas firms.

b) The other is with the decision by the SBOE not to appoint the tenth manager recommended by the Committee, on the basis of information provided by one SBOE member at the meeting which was contradicted by the information provided by the

investment consultant. We believe that the SBOE did not give due weight and consideration to the advice of the expert on the matter.

Implementation

Although the SBOE approved the appointment of the investment managers in September 1997 and approved their allocations, the managers' portfolios were not funded – i.e., the decision was not fully implemented – until January 1998. This unusual delay was due to concerns raised by some SBOE members at the next meeting of the Committee in November regarding the RFP process. The RFP was not formally approved by the SBOE prior to its issuance. The Chief Counsel of the Texas Education Agency reviewed the matter and concluded that this did not invalidate the selection process since staff was acting with the SBOE's general direction and knowledge in issuing the RFP. We note that the Investment Procedures Manual of the PSF is not very clear as to whether an RFP should be approved by the Committee or by the SBOE. At the request of the Chairman of the SBOE the Commissioner of Education deferred the execution of any contracts with the new investment managers pending further action by the SBOE.

At the next meeting of the SBOE in January 1998, some members wanted an item placed on the agenda for the March meeting either to rescind the decision of the SBOE in September 1997 to hire the new investment managers, or to determine what amounts should be allocated to these managers. After extensive and fairly acrimonious debate, a vote was taken on the allocation question and it failed to pass.

The action of some SBOE members to delay the implementation of the decision to appointment the new investment managers would not be regarded as appropriate conduct for fiduciaries. The selection of investment managers was part of a review of the long-term asset allocation of the PSF, which began in February 1997 with an asset allocation study by the investment consultant. The RFP for investment managers was issued in May, the asset allocation policy was approved in July, and the appointment of investment managers and the allocation to their portfolios was approved in September by a near unanimous vote of the SBOE. There were ample opportunities during this time for SBOE members to review and satisfy themselves with respect to the provisions of the RFP and the manager selection process in general. Staff and the investment consultant provided a great deal of information to the SBOE and the Committee during the process. If some members felt that not enough information had been provided to them, it was their fiduciary duty to ask for more information. The State Auditor's Office reviewed the selection process and found it to have been "well-designed and effective". We concur. The delay in the implementation of the decision does not appear to have been justified. It was probably not in the best interests of the beneficiaries, and could be considered contrary to the principle of prudence in decision-making by fiduciaries.

2. September 1999 – Selection of Investment and Performance Measurement Consultants

The SBOE approved the appointment of Richards & Tierney to conduct an asset allocation study with an option to extend the contract for three years under a full retainer. It also

approved the appointment of Everen Securities to prepare a performance measurement report for the PSF for the quarter ending September 30, 1999.

The SBOE had authorized the issuance of an RFP in July for investment consulting services including asset allocation studies, performance measurement, investment manager searches and continuing education workshops. The RFP was sent out to 26 firms, of which 12 firms responded. Staff presented organization profiles on these firms to the Committee in August. One Committee member asked staff whether any of the firms was under investigation by the Securities and Exchange Commission (SEC). Staff said they had not had time to conduct that level of due diligence. Another member requested staff to investigate whether Everen Securities was involved in an investigation by the SEC. The Committee selected six firms, one of which was Everen Securities, for interview.

The Committee interviewed the six firms in September. They were each asked whether they or anybody on their behalf had tried to contact any SBOE member or staff, or whether anybody has approached them to assist in lobbying the SBOE or staff. Four of the firms said no to both questions. Richards & Tierney said that no efforts had been made on their part, but that the Chairman of the Committee had called them and asked them to meet with Mr. Brian Borowski, and they had. The principal of Everen Securities, Mr. Russell Stein, said that he had asked various individuals, including Brian Borowski, to speak on his behalf with six SBOE members as well as staff, to set the record straight regarding the allegations against him by the SEC. The Committee decided by unanimous vote to recommend to the SBOE that Asset Consulting Group be appointed to conduct an asset allocation study with an option to extend the contract for three years under a full retainer.

The Committee also decided that a number of firms would be asked to prepare performance measurement reports for the 3rd quarter ending September 30, 1999, following which one of the firms would be selected as the performance measurement consultant. The Chairman made a motion that Holbein Associates, Asset Consulting Group and Everen Securities be the firms. One member expressed his concern that Everen had not followed the no-contact rule in the RFP process. TEA legal counsel stated that the SBOE has the authority to disqualify a firm that violates the no contact rule, and advised that it would be in the best interests of the SBOE to do so. Another member said that Everen Securities acted out of a perceived need for Mr. Stein to defend himself against allegations made by the SEC, and that staff's distribution of a summary of the allegations to the SBOE created his need to respond. The Committee decided to recommend to the SBOE that only Holbein Associates and Asset Consulting Group prepare performance measurement reports for the 3rd quarter.

At the SBOE meeting the next day, the same member who had defended Everen Securities informed the SBOE that he had evidence that Asset Consulting Group had asked individuals to contact SBOE members on their behalf to secure the consulting engagement, contrary to their denial of having done so to the Committee, and that he could, if necessary, produce affidavits and recorded conversations to support his assertions. The member made a motion to substitute Richards & Tierney for the Committee's recommendation, which was Asset Consulting Group. Another SBOE member asked that the evidence be provided to TEA legal counsel, who could review it and advise the SBOE whether it justifies that Asset

Consulting Group be disqualified. After some further discussion, the SBOE approved the appointment of Richards & Tierney to conduct an asset allocation study with an option to extend the contract for three years under a full retainer.

Two members of the PSF Committee, including the Chairman, later paid a visit to the offices of Richards & Tierney in Chicago, presumably for purposes of due diligence purposes, accompanied by Mr. Brian Borowski. Following the visit, Richards and Tierney wrote a letter to the Chairman of the Committee, indicating that they were not prepared to work as an investment consultant for the PSF.

The same member who had made the previous motion to replace Asset Consulting Group with Richards and Tierney now moved that Everen Securities be appointed as the performance measurement consultant for the PSF. Another member noted that the SEC investigation of the principal, Russell Stein, of Everen Securities was still ongoing, that the individual was aware of the no contact rule, and yet had tried to get a number of people on his behalf to contact members of the SBOE in direct violation of the no contact rule. In response to a question, the member indicated (according to the minutes) that Mr. Stein had said that he had known Mr. Brian Borowski and that the two had been close personal friends for a number of years. Another member mentioned that Mr. Borowski had been an advisor to the Chairman of the PSF Committee and one other member for a number of meetings, and questioned whether that represented a conflict of interest. After further discussion the SBOE voted 8 to 7 to appoint Everen Securities to prepare a performance measurement report for the PSF for the quarter ending September 30, 1999.

These decisions of the SBOE, and the manner in which they were taken, would very likely be regarded as a violation of generally accepted principles and standards of fiduciary conduct for the following reasons:

a) The action of the Chairman of the PSF Committee in contacting one of the prospective bidders to an RFP and asking them to speak with his personal advisor could be deemed to be highly inappropriate conduct for a fiduciary. It was a clear breach of the spirit if not the letter of the SBOE's own RFP that stated that "any communication by a prospective bidder with any member of the SBOE must be in writing and filed with the Executive Administrator of the Texas Permanent School Fund."

b) The SBOE's decision to reject the unanimous recommendation of the PSF Committee to appoint Asset Consulting Group to conduct the asset allocation study was made entirely on the basis of information that one member claimed to possess. As best as we can determine, the information was not reviewed by TEA legal counsel, as requested by one SBOE member, nor was it shared with the rest of the SBOE. The SBOE did not verify the accuracy and objectivity of that information. Its decision may not have been in the best interest of the beneficiaries of the PSF and could, therefore, be deemed to be contrary to the standard of loyalty in fiduciary conduct.

c) The decision by the SBOE to appoint another candidate to conduct the asset allocation study, independent of the Committee's recommendation, did not follow an appropriate

process for fiduciary decision-making. If the SBOE did not want to accept the recommendation of the Committee, it should have sent the matter back to the Committee for further review. The Committee could then have reviewed the information that one SBOE member claimed to possess, or have it be reviewed by TEA legal counsel, determined if that information was reliable and accurate, and, if so, made an alternative recommendation to the SBOE. The SBOE's decision could, therefore, be considered contrary to the standard of prudence in decision-making by fiduciaries.

d) We do not find any reason why the SBOE should have rejected the Committee's recommendation to have two firms, Holbein Associates and Asset Consulting Group, prepare performance measurement reports for the 3rd quarter, and then select the performance measurement consultant after evaluating the reports. We have already commented why the rejection of Asset Consulting Group may have been unjustified. The SBOE should have sent the matter back to the Committee and asked them to verify the allegations, and if necessary recommend another firm. Instead, the SBOE appointed a third firm, Everen Securities, as the only firm to prepare a performance measurement report for the 3rd quarter. In doing so, it rejected the Committee's recommendation not only with respect to the two other firms but the selection process itself, which required that more than one firm prepare the 3rd quarter reports, and that these reports be evaluated prior to making a selection. The SBOE's action was entirely unjustified. It may not have been based on reliable information, did not follow an appropriate process, and, therefore, would probably be regarded as contrary to the principle of prudence in decision-making by fiduciaries.

e) The SBOE's action in appointing Everen Securities, whose principle, Russell Stein, was then currently under investigation by the SEC, the country's highest regulatory agency on investment matters, and who asked various individuals to contact on his behalf at least six SBOE members plus staff, in blatant disregard of the very clear and explicit prohibition in the RFP, we believe, would not be regarded as acceptable conduct for a fiduciary body. This decision was not in the interests of the beneficiaries of the PSF and could, therefore, be deemed to be contrary to the foremost standard of fiduciary conduct, that of loyalty.

3. January 2000 – Selection of Performance Measurement Consultant

The SBOE, on the recommendation of the PSF Committee, appointed First Union Securities (formerly Everen Securities) as the performance consultant for the PSF.

The SBOE authorized that the RFP issued in July 1999 for investment consulting services – including asset allocation studies, performance measurement, investment manager searches and continuing education workshops – be re-issued in November. This was prompted by a letter received by the SBOE from Richards & Tierney indicating that they were not prepared to work as an investment consultant for the PSF. The respondents to the original RFP were allowed to update their original response if necessary or simply indicate re-submission of their response. Ten responses were re-submitted and three new responses were received. Staff provided organization profiles of all thirteen firms to the Committee.

The Committee met in January 2000 to narrow the field to a list of candidates who would be invited to make presentations. At the meeting a motion was made to recommend to the SBOE the appointment of First Union Securities as the performance measurement consultant for the PSF. One member, noting that Mr. Russell Stein, representing First Union, had previously violated the no contact rule, asked him whether he had had any contacts with SBOE members since the re-issuance of the RFP. Mr. Stein said that he had breakfast with the Chairman of the Committee and two other SBOE members that morning. The Chairman and one of the two SBOE members said that they did not think that First Union was competing under the current RFP. The SBOE member (who was also a member of the Committee) went on to say the SBOE had made a mistake in November 1999 when it appointed First Union for a single project (the 3rd quarter report) rather than as the permanent performance measurement consultant for the PSF, which was the SBOE's intent.

Mr. Russell Stein – who was present at the meeting – said that First Union had not sent a letter re-submitting their previous bid, but rather their letter specifically stated that they were standing by their original contract and not re-submitting a bid for the current RFP. This was contradicted by the staff, who provided the Committee with a copy of a letter from First Union, dated December 17, 1999, which stated, "we wish to re-submit our initial response to the RFP." Mr. Stein said that he called Mr. Paul Ballard, the Executive Administrator of the PFS, on the phone and informed him that First Union did not want to be included in the current RFP. Mr. Ballard disagreed, saying that Mr. Stein had told him only that, consistent with the firm's previous position, First Union wanted to be considered solely for the performance measurement service.

Mr. Stein, in response to a question by a Committee member, indicated that First Union was a brokerage and investment banking firm. The member asked if Mr. Stein would have any objections if the SBOE prohibited First Union from acting as a broker in transactions involving the assets of the PSF, and required it to disclose any brokerage transactions with its investment managers involving other assets. Mr. Stein said he would not. The Committee then voted to recommend to the SBOE that First Union be appointed as the performance measurement consultant for the PSF.

At the SBOE meeting the next day the same member made a motion – in the form of an amendment to the Committee's recommendation – which would require that: (a) the PSF's investment managers be prohibited from conducting any business with First Union involving the assets of the PSF other than required by its role as the performance measurement consultant; (b) investment managers and First Union disclose any transaction between them; and (c) investment managers disclose any contact by First Union to seek requests or favors other than information related to performance measurement. The SBOE, after considerable discussion, voted 8 to 7 to postpone consideration of the amendment until the SBOE meeting in March 2000. After some further discussion, the SBOE then voted 8 to 7 to appoint First Union as the performance measurement consultant for the PSF.

In March 2000, the SBOE adopted a new Code of Ethics[4], as part of the Statement of Investment Objectives, Policies and Guidelines, which: (a) prohibited all service providers, including investment managers, from engaging in transactions involving the assets of the PSF with consultants who provide advice to the SBOE on the investment and management of assets; and (b) required that service providers, including investment managers and consultants, disclose all investment transactions or trades between them, including any fees or compensation paid in connection with the transactions.

We find this decision of the SBOE, and the manner in which it was taken, to be contrary to generally accepted standards of fiduciary conduct for the following reasons:

a) The SBOE had clearly appointed First Union (then Everen Securities) to prepare the performance measurement report for 3rd quarter 1999 only. The RFP for investment consulting services – including performance measurement – had been re-issued. Ten of the original respondents re-submitted their bids, including First Union, although they later tried to deny it. (In fact, we find their attempt at denial reprehensible.) Three new responses had been received. Instead of reviewing and evaluating all responses, including the new ones, the Committee proceeded immediately towards recommending to the SBOE the appointment of First Union. The recommendation of the Committee, therefore, did not follow an appropriate process, and could be considered contrary to the principle of prudence in decision-making by fiduciaries.

b) The appointment of First Union Securities as a performance measurement consultant for the PSF was not appropriate for three reasons:

    i) First Union openly disregarded the no contact requirement of the RFP for the second time. They participated in the second RFP process as indicated by their letter, and as such were bound by the no contact requirement.

    ii) The principal of the firm, Russell Stein, was still under investigation by the SEC.

    iii) First Union was a brokerage firm that earned a substantial portion of its revenue from commissions on securities transactions by investment managers. In selecting the firm to monitor and evaluate the performance of its managers and provide advice and recommendations, the SBOE clearly opened the door to a potential conflict of interest. The fact that the SBOE chose very deliberately not to impose specific conditions on the appointment (above and beyond the general requirements of the Code of Ethics), which would limit the potential for conflict, was inconsistent with its responsibilities as a fiduciary.

The decision of the Committee to recommend, and for the SBOE to approve, the appointment of this firm as a service provider was, therefore, not in the best interests of the beneficiaries of the PSF, and could be regarded as a violation of the standard of loyalty in fiduciary conduct.

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[4] SBOE *Code of Ethics, Texas Administrative Code, Title 19, §33.5.*

4. March 2000 – Selection of Investment Consultant

The SBOE approved the appointment of Callan Associates as the investment consultant for the PSF.

The decision was based on the re-issuance in November 1999 of an RFP originally issued in July for investment consulting services – including asset allocation studies, performance measurement, investment manager searches and continuing education workshops. The re-issuance of the RFP was necessary, as the consultant initially selected by the SBOE, Richards & Tierney, had indicated that they would not accept the assignment to conduct an asset allocation study for the PSF. The respondents to the original RFP were allowed to update their original response if necessary or simply indicate re-submission of their response. Ten responses were re-submitted and three new responses were received. Staff provided organization profiles of all thirteen firms to the Committee.

The Committee reviewed the submissions and invited six firms to make presentations to the Committee in February 2000, after which the Committee selected two firms, Richards & Tierney and Callan Associates, for onsite due diligence visits by Committee members and PSF staff. Following the due diligence visit with Callan Associates (Richards & Tierney had already been visited back in October 1999), the Committee recommended to the SBOE the appointment of Richards & Tierney as the investment consultant for the PSF.

At the SBOE meeting in March 2000, two motions were made, one to appoint Richards & Tierney, and the other to appoint Callan Associates. One Committee member commented that in his view Callan Associates had more to offer, their strength was in money manager selection as well as asset allocation, and they could provide a broader range of services than Richards & Tierney. The SBOE, after some discussion, approved the appointment of Callan Associates.

While we find that the SBOE followed a generally acceptable process for the selection of the investment consultant for the most part, we do have the following concerns:

a) The minutes of the meeting do not show that any new information was provided to the SBOE that would justify the SBOE's rejection of the Committee's recommendation and its decision to appoint Callan Associates. In any case, as we have argued before in similar situations, if the SBOE did not agree with the Committee's recommendation, it should have sent the matter back to the Committee for further review and, if necessary a new recommendation. If the SBOE wanted to make the choice between two candidates, it should not have required the Committee to make a recommendation. Instead, all members of the SBOE should have been provided with enough information on the two candidates – including a presentation to the SBOE and an opportunity for the whole SBOE to question each candidate – and the SBOE could then have made an informed decision. Instead, it appears that the SBOE did not make its decision based on sufficient information provided to all SBOE members about the two candidates. This decision, therefore, would probably be considered as inconsistent with the principle of prudence in decision-making by fiduciaries.

b) Many investment consultants derive a substantial part of their revenue from affiliations with brokerage firms and business relationships with investment managers. At the time of its selection, Callan Associates, for example, had a broker/dealer affiliate, provided performance measurement and marketing advice to investment management firms, and conducted client conferences and seminars in which money managers pay to participate and make presentations to plan sponsors and trustees. This could lead to situations where the advice that the investment consultant provides to trustees with respect to the evaluation and selection of money managers may be subject to a potential conflict of interest. There are some investment consultants, however, who do not sell services to third party vendors, and do not have ties to broker/dealers, or interests in investment management firms. There were at least three such firms among the 13 who responded to the RFP. While the RFP did ask respondents to detail any financial relationship with affiliated organizations such as brokerage and money management firms, whether any fees were paid by money managers, and if so how much and for what purpose, to identify any potential conflicts of interest and how such conflicts would be resolved, we find it somewhat puzzling that none of the three firms were among the six in the short list who were invited to make presentations to the Committee. The minutes of a subsequent SBOE meeting in September 2000 indicate that the SBOE is well aware that Callan Associates may have a potential conflict of interest in the selection and evaluation of money managers. We are concerned that the SBOE, in selecting the investment consultant, may not have placed sufficient importance on the need for a fiduciary body to avoid such conflicts of interest.

c) There is growing concern among the fund management community that many investment consultants obtain substantial revenue either directly from investment managers or indirectly through broker/dealer affiliates, which could compromise the advice they provide to fund trustees. Most well managed funds now realize that in order to receive unbiased advice from their investment consultants, the interests of the consultant must be properly aligned with those of the fund. We would, therefore, strongly recommend that the SBOE require its investment consultant to disclose annually all revenue, including any fees and brokerage commissions, it has received – either directly or indirectly through affiliated companies – from each of the PSF's investment managers over, say, the past one, three and five years. This should ideally be the dollar amount of payments made by the investment managers, but if that cannot be disclosed on grounds of confidentiality, the Board should know at least in relative terms how much its investment managers are paying compared to the other investment management clients of the consultant. We also recommend that in any future investment manager search, the SBOE should require the consultant to disclose similar information on all respondents to the RFP.

5. May 2000 – Termination of Investment Manager

The SBOE, on the recommendation of the PSF Committee, approved the termination of the services of Loomis & Sayles, a small cap manager of the PSF. It also directed, again on the recommendation of the Committee, that the assets in their portfolio be transferred to another small cap manager, Harbor Capital.

The minutes of the Committee meeting do not mention that there was any discussion on this item. There was, however, considerable discussion at the SBOE meeting, mostly centered on why Loomis & Sayles were being terminated when other managers had worse performance. Staff explained that Loomis & Sayles had lost their two main portfolio managers. They had brought in a manager who was relatively new to the process and without an established track record with the firm.

The decision to terminate Loomis & Sayles appears to have been based on appropriate and relevant information and would, therefore, be considered prudent. The decision to transfer the assets to Harbor Capital, however, would not for the following reasons:

i) The SBOE was about to undertake significant changes in the investment manager structure of the PSF, so it may not have made sense to hire a new manager to replace Loomis Sayles. However, there was no information or explanation, at least in the minutes of the SBOE or Committee meetings, why the assets in the portfolio were transferred to one manager rather than split among the three remaining managers of the PSF who all had identical small/mid cap domestic stocks mandates. That would have been the appropriate course of action to take in order to maintain the existing – and presumably desired – diversification of these assets among the investment managers.

ii) In transferring the assets to Harbor Capital, the SBOE did not ensure whether that would be the most efficient and cost-effective way of transitioning the assets of the portfolio. Most large funds would have used a transition manager that specializes in such activity to liquidate the remaining assets in the portfolio after letting Harbor Capital choose which securities to retain. We comment further on the transition of the portfolio in Appendix 4(I).

We find that the SBOE's decision to transfer the assets in the terminated portfolio to one manager and to have that manager handle the transition of assets may not necessarily have been in the best interests of the beneficiaries of the PSF. It could, therefore, be regarded as inconsistent with the standard of loyalty in fiduciary conduct.

6. September-November 2000 – Selection of Domestic Stocks Managers

The SBOE, on the recommendation of the PFS Committee, appointed the following domestic stocks managers of the PSF, with the mandates as shown below:

September 2000		November 2000	
Harbor Capital	- large cap core	Harbor Capital	- small/mid cap core
Capital Guardian	- large cap value	Capital Guardian	- small/mid cap core
Dresdner RCM	- large cap growth	Gabelli Asset Mgmt.	- small/mid cap value
		NWQ Inv. Mgmt.	- small/mid cap value
		MFS Inst. Advisors	- small/mid cap value
		J.W. Seligman	- small/mid cap value

Decision-Making

The decision was based on a review by the investment consultant, Callan Associates, in May 2000 of the investment manager structure of the PSF, which examined a number of alternative structures with different proportions under active and passive management, and with the active component having separate portfolios for large cap and small/mid cap stocks, further differentiated by investment styles into core, value and growth portfolios. The Committee recommended, and the SBOE approved, a structure with 51% of the total domestic stocks assets to be passively managed by internal staff in large cap stocks, and 49% actively managed by external investment managers. The externally managed assets would be split 85/15 between large cap and small/mid cap stocks, with two managers each in the core, value and growth styles, and 5% of the actively managed assets to be allocated to emerging or minority managers. There was considerable discussion on whether or not the PSF's current managers who were performing well should be exempt from the RFP process, with the SBOE finally voting against exemption.

In July 2000, the SBOE, on the recommendation of the Committee, approved the issuance of six separate RFPs for large cap and small/mid cap managers for the three style mandates. The RFPs for large cap managers were issued in July. In August, the Committee met to select four firms to be interviewed for each style mandate. Staff provided the Committee with an RFP response summary sheet that also indicated which of the respondents were Callan Associates clients. The Committee heard presentations by the managers in September, and decided by unanimous vote to recommend that the three large cap managers listed above be appointed as investment managers of the PSF. The SBOE approved the appointment of the first two managers without much discussion as they were already managing assets for the PSF. The recommendation to appoint Dresdner RCM was approved after considerable debate, and only after an alternate motion to appoint Davis, Hamilton, Jackson, one of the existing managers of the PSF, failed.

The RFPs for small/mid cap managers were issued in September 2000. The Committee met in October to select four firms to be interviewed for each style mandate. Staff again provided the Committee with an RFP response summary sheet. The investment consultant submitted manager evaluation reports on the respondents, and reviewed the scoring system developed by Callan Associates to rank the responses. The Committee heard presentations from the managers later in the month, and decided by unanimous vote to recommend that the six small/mid cap managers listed above be appointed as investment managers of the PSF.

The SBOE generally followed what would be considered an appropriate process in the appointment of the large cap and small/mid domestic stocks managers. There was a proper review of alternative manager structures with consideration given to which assets should be managed actively and which passively, what assets should be managed internally versus externally, and diversification of assets across investment styles. There was a proper RFP process authorized by the SBOE, review and evaluation of responses by the Committee assisted by staff and the investment consultant, interviews of a short list of candidates, and finally, approval of appointments by the SBOE based on recommendations by the Committee. The SBOE appointed, on the Committee's recommendation, only one manager for each large cap style mandate instead of two managers as per the structure approved in May – which was a minor deviation from the process. However, the process could by and large be considered in accordance with the principle of prudence in decision-making by fiduciaries.

Implementation

We discussed the transition of assets required to fund the domestic stocks portfolios in implementing the SBOE's decision to appoint the new investment managers in Appendix 4(A).

7. November 2001 – Selection of High-Yield Bond Managers

The SBOE, on the recommendation of the PFS Committee, approved the appointment of Shenkman Capital and W.R. Huff as high-yield bond managers for the PSF.

The decision was based on the new asset allocation policy approved by the SBOE in May 2001, which established a 10% allocation in high-yield bonds. The Committee recommended the issuance of an RFP for high-yield bond managers in July. Staff suggested a similar process as the one used recently for the domestic stocks managers, with staff issuing the RFP, and the investment consultant, Callan Associates, summarizing the responses and developing a scoring system to evaluate and rank the managers. The SBOE directed that the RFP be issued.

The Committee met in August to review the responses. Staff provided the Committee with a compliance matrix indicating whether or not the respondents had submitted all the required information in their responses. Callan Associates reviewed the scoring system, explaining the various evaluation criteria and the weights assigned to each factor. They discussed specific issues with respect to certain firms involving changes in personnel, organization, ownership, etc. Callan Associates explained that they had divided the managers into three categories: high quality, core and aggressive, representing different approaches to managing high-yield bonds, and recommended that PSF's allocation to high-yield bonds be divided among the different management styles. The Committee interviewed four managers each in the high quality and core categories, and two managers in the aggressive category. It chose not to interview the PSF's existing high-yield bond manager, MacKay Shields, who were classified by Callan Associates in the aggressive category.

The Committee recommended in November 2001 that Shenkman Capital and W.R. Huff be appointed as high-yield bond managers of the PSF, in addition to the existing manager, MacKay Shields. In doing so, the Committee also recommended that the allocation to high-yield bonds be reduced from 10% as established in May to 5%. The SBOE approved both recommendations.

We have already commented on the reduction in the high-yield bond allocation in Appendix 4(A). With respect to the appointment of the high-yield bond managers, the SBOE generally followed what appears to be an appropriate process. There was a proper RFP process authorized by the SBOE, review and evaluation of responses by the Committee assisted by staff and the investment consultant, interviews of a short list of candidates, and finally, approval of appointments by the SBOE based on recommendations by the Committee. The decision, therefore, is consistent with the principle of prudence in decision-making by fiduciaries.

8. March 2002 – Selection of Performance Measurement Consultant

The SBOE, on the recommendation of the PSF Committee, appointed State Street as the performance measurement consultant of the PSF.

The previous performance measurement consultant, First Union Securities, resigned the account in August 2001, whereupon the SBOE, on the recommendation of the Committee, terminated their contract. The Committee also recommended that State Street – who as the custodian of the PSF were already providing a report on investment performance to staff – be asked to prepare the performance measurement report for the 3rd quarter 2001, and that the issue of a permanent performance measurement consultant be considered at the next meeting in November. The SBOE approved the Committee's recommendation.

At the November meeting, the Committee recommended unanimously not to issue a RFP and instead to consider at the next meeting in January 2002 an amendment to State Street's contract to provide performance measurement services for the PSF. The SBOE asked the investment consultant, Callan Associates, for advice. The representative from Callan Associates – after first declaring a bias since Callan Associates was also in the performance measurement business – said that as a fiduciary there were a number of questions the SBOE needed to ask in order to ensure that it had selected the most appropriate measurement service provider. The SBOE generally agreed that these were the type of questions that would be best answered through an RFP, and voted unanimously to issue an RFP for performance measurement consulting services for the PSF.
The Committee reviewed the responses to the RFP, interviewed eight candidates, and recommended to the SBOE that State Street be appointed to provide performance measurement services for the PSF. The SBOE approved the Committee's recommendation – after an alternate motion to appoint another firm was narrowly defeated by a 7-8 vote.

While we believe that the SBOE's decision was appropriate from a fiduciary perspective, we have the following concerns with the process in arriving at that decision:

a) The Committee had a fiduciary obligation to select the best possible firm as the performance measurement consultant. Since State Street was selected based on an RFP for custodial and securities lending services, the Committee did not have sufficient information to evaluate State Street's performance measurement capabilities or to compare them against other measurement service providers. It should have sought the advice of the investment consultant and staff, which it does not appear to have done. The Committee's recommendation not to issue an RFP could, therefore, be considered to be inconsistent with the principle of prudence in delegation by fiduciaries.

b) The SBOE acted appropriately in rejecting the Committee's recommendation not to issue an RFP. While we have argued in similar situations that the SBOE should have sent the matter back to the Committee, in this case the SBOE's decision to issue an RFP – the only other course of action – against the recommendation of the Committee, after seeking advice from the investment consultant (which the Committee should have done in the first place), and based on an unanimous vote was probably the appropriate thing to do. The decision, therefore, could be regarded as consistent with the principle of prudence in decision-making by fiduciaries.

c) The alternate motion by some members of the SBOE to appoint another firm as the performance measurement consultant, a firm not recommended by the Committee, would be considered contrary to good practice in fiduciary decision-making. The SBOE should not be making a decision on a matter which has been specifically delegated to a Committee that has been charged with the responsibility of doing the necessary due diligence and making a recommendation to the SBOE. The SBOE has not been provided with the same level of information the Committee has, and quite properly so. The Committee was established so that a few members of the SBOE would be able to devote the proper amount of time and attention to a matter. If the SBOE can take any decision it wants, ignoring the Committee's recommendation, then why have a Committee? The fact that the alternate motion failed to pass by the narrowest of margins does not detract from the fact that it would probably be deemed to be contrary to the principle of prudence in decision-making by fiduciaries.

APPENDIX 4(D)
THE SBOE'S MANAGEMENT PROCESS FOR INTERNAL AND EXTERNAL INVESTMENT MANAGEMENT

The SBOE hired three external investment managers for the Permanent School Fund for the first time following an asset allocation study in October 1994, which resulted in a change in the asset allocation policy from 35% stocks, 65% bonds to 65% stocks and 35% bonds. The external managers were responsible for managing about 20% of the large cap domestic stocks and bonds portfolios and 100% of international stocks. Internal staff continued to manage 80% of the large cap domestic stocks and bonds assets. Since then the SBOE has made two major changes to the allocation between internally and externally managed assets, one in 1997, another in 2000, and a failed attempt at a change in 2001.

1. July 1997

The SBOE approved a significant change in the allocation between internally and externally managed assets, based on a review of the investment management structure of the PSF by the investment consultant, IAS. IAS proposed that the assets be divided between internal and external management to take advantage of specific areas of expertise and to eliminate redundancies in investment strategy. Internal staff, operating under a limited budget, could manage asset classes characterized by broad well-established and liquid markets with a long-term performance history. More complex asset classes require specialized investment management skills and, therefore, would be more effectively managed by external investment managers. The SBOE, on the recommendation of the PSF Committee, approved a structure under which internal staff would manage all large cap core domestic stocks and investment-grade bonds, amounting to 45% of total assets, and external investment managers would invest the remaining 55% in large cap non-core stocks, small and mid cap stocks, international stocks and high-yield bonds.

The distinction between large cap core and non-core stocks was not very clear. The internally managed large cap core portfolio was benchmarked against the S&P 500 index and to focus mainly on the 100 largest capitalization companies within the index. The externally managed large cap non-core portfolio was benchmarked against the Russell 1000 index. However, since the S&P 500 is in a sense a subset of the broader Russell 1000 index, there was probably some duplication or redundancy between internally and externally managed assets. Nevertheless, we believe that most investment consultants and advisors would agree by and large with this allocation between internal and external management. The SBOE followed what appears to be an appropriate process in making this decision, which could, therefore, be considered in accordance with the principle of prudence in decision-making by fiduciaries.

The decision, however, was never fully or properly implemented. For example, as of the fiscal 1999 year-end, 65% of the assets of the PSF were still internally managed. When the domestic stocks structure of the PSF was reviewed by the new investment consultant, Callan

Associates, as of December 31, 1999, four of the ten externally managed portfolios were determined to be following a large cap core investment style, as opposed to non-core, contrary to the structure approved by the SBOE more than two years ago. The process of implementation, therefore, could be regarded as inconsistent with the principle of prudence in decision-making by fiduciaries.

2. May-July 2000

The SBOE, on a recommendation by the Committee, approved a change in the investment management structure in May 2000, based on a review by the investment consultant, Callan Associates, of the domestic stocks structure of the PSF. The review examined a number of alternative arrangements with different combinations of active and passive management, with large cap and small/mid cap core, value and growth portfolios. The Committee recommended a structure in which 51% of the domestic stocks assets would be passively managed by internal staff as a large cap stocks index fund, while the remaining 49% are actively managed by external investment managers. The SBOE approved the recommendation with the additional requirement that internal staff would continue to manage part of the large cap core domestic stocks assets. The investment consultant agreed that the internally managed core stocks portfolio should not be eliminated.

In July 2000, the SBOE, on the recommendation of the Committee, and based on an asset allocation study by the investment consultant, approved a new asset allocation policy with 35% in large cap domestic stocks, 8% small/mid cap stocks, 15% international stocks and 35% bonds assets. The externally managed high-yield bond portfolio was to be eliminated. Internal staff would continue to manage the other bonds assets. The result of these decisions by the SBOE was that internal staff would manage about 60% of the assets of the PSF, consisting of a large cap domestic stocks index fund, part of large cap core domestic stocks, and all of the bonds assets. External investment managers would manage the remaining 40% of assets consisting of large cap and small/mid cap domestic stocks in core, value and growth portfolios, with 5% to be managed by emerging managers, as well as all of international stocks.

The change to a style-based investment manager structure involved the selection and appointment of three large cap and six small/mid cap domestic stocks managers, and required a substantial transition of assets, which was finally completed in January 2001. The SBOE approved another change in the asset allocation policy of the PSF in May 2001 that established a 10% allocation to high-yield bond to be managed externally, with a reduction of 5% each in externally managed international stocks and internally managed bonds assets. The net result was a change in the allocation between internally and externally managed assets from 60% internal, 40% external to 55% internal and 45% external. As of the 2001 fiscal year-end, 55% of the assets of the PSF were, in fact, managed internally and 45% managed externally, in line with the established allocation.

The SBOE's action was based on an appropriate review of the PSF's investment management structure, with advice from the investment consultant and staff and a recommendation by the Committee. The process by which this decision was reached, and the

way it was implemented, appears generally to be in accordance with the principle of prudence in decision-making by fiduciaries.

3. May 2001

The SBOE directed staff to prepare an RFP for investment management services for investment-grade bonds, as part of a change to the asset allocation policy of the PSF. The PSF Committee had recommended that the asset allocation policy be changed to establish a 10% allocation in high-yield bonds and that an RFP be issued for investment management services for high-yield bonds, and a motion was accordingly made at a meeting of the SBOE. The SBOE's decision to also issue an RFP for investment-grade bonds, however, was based not on the recommendation of the Committee, but instead on a "friendly amendment" to the motion offered by a SBOE member, who stated that his intent was to obtain more information about investment-grade bond managers. Another member wondered whether the matter should go back to the Committee for consideration if two RFPs were to be issued. The first member responded, as indicated in the minutes, that the SBOE was "not adopting an RFP… [but] simply directing staff to prepare one." The motion as amended was passed unanimously.

When the Committee met in July to consider the authorization to issue an RFP for investment-grade bond management services, staff presented an analysis which showed that if bonds in the internally managed portfolio were sold to fund an externally managed bond portfolio, then given the decline in interest rates, this would reduce the income to the Available School Fund. Since the PSF was currently expected to meet the 2002-2003 BRE, plus the $150 million required by Rider 90, only by a very narrow margin, outsourcing the investment-grade bond portfolio would put that objective in jeopardy. Staff further explained that the cost of managing the portfolio internally was about half a basis point (0.005% of assets), and that portfolio had outperformed its benchmark over all periods ending May 31, 2001.

The investment consultant, Callan Associates, said that they had reviewed the process that internal staff uses to manage the bond portfolio. They were not aware of any other firm that managed bonds to meet an income objective, and that most manage bond portfolios with a total return objective, which would be inappropriate for the PSF. They further stated that they did not have sufficient confidence that an external bond manager could outperform internal staff to recommend outsourcing the management of the bond portfolio.

Two Committee members said, according to the minutes, that their interest was "simply to introduce competition and to better diversify the portfolio." The Committee decided to table the item and to present it the next day to the full SBOE for its consideration. The investment consultant was unable to attend the SBOE meeting, so the matter was postponed till September.

At the September meeting, the investment consultant told the Committee that there were not many bond managers who manage to an income objective, and that they did not have a high confidence level that they would find any managers who could add value to the portfolio, net

of fees. When the Chairman of the Committee asked the consultant whether they would recommend outsourcing the investment-grade bond portfolio, the consultant, according to the minutes, responded, "I don't know why you would." The Committee voted to table the item.

At the November 2001 meeting, the Committee again considered the matter. The investment consultant reiterated that they did not have more than 50% confidence that they could find an external manager that would perform better than internal staff, especially net of fees, which they estimated to be between 10 and 20 basis points. The Committee voted to table the item. In January 2002, the SBOE, on the recommendation of the Committee, decided not to issue an RFP for investment-grade bond management services.

It appears that some members of the SBOE clearly wanted to outsource the management of at least part if not all of the assets of the internally managed bond portfolio. If they had simply wanted to get more information, they could have asked the Committee to consider whether a request for information (or RFI) could be issued, or if the investment consultant could examine the issue and make a recommendation – which the consultant later did. It is surprising to us that these members would have the SBOE proceed directly to consider the issuance of an RFP, without referring the matter to the Committee, without first asking staff and, in particular, the investment consultant for their advice. We do not understand why the matter kept coming back to the Committee and the SBOE, and why it took eight months for the matter to be finally resolved, in spite of the very specific advice offered by the investment consultant time and again that they had little or no confidence that external management would add value and that it was not something they would recommend. Analysis by the staff and investment consultant showed that it would, in fact, cost 20 to 40 times as much (i.e., $8-16 million versus $400,000 a year for internal management of the $8 billion bond portfolio today). In short, we believe that the actions of some members of the SBOE in this matter would be regarded as directly contrary to the principle of loyalty in fiduciary conduct.

APPENDIX 4(E)
THE SBOE'S MANAGEMENT PROCESS FOR ACTIVE VERSUS PASSIVE INVESTMENT STRATEGIES

The Permanent School Fund began to manage part of its assets using passive investment strategies for the first time when the SBOE approved a large cap domestic stocks indexed portfolio in May 2000. The decision was based on a review of the domestic stocks structure by the investment consultant, Callan Associates, which examined a number of alternative structures with different combinations of active and passive management. The consultant's analysis indicated that indexing a portion of the domestic stocks portfolio would make it more efficient given the relative costs of active and passive strategies. The SBOE, on the recommendation of the PSF Committee, approved a structure under which 51% of domestic stocks assets (60% of large cap stocks) would be passively invested in a S&P 500 index fund to be managed by internal staff, with the remaining 49% actively managed mainly by external investment managers.

In July 2000, the SBOE, on the recommendation of the Committee, approved a new asset allocation policy with 35% in large cap domestic stocks, 8% small/mid cap stocks, 15% international stocks and 35% bonds assets. This meant that the large cap domestic stocks index portfolio should have been either 21.9% (51% of all domestic stocks) or 21% of the total assets of the PSF (60% of large cap stocks). In funding the portfolio in November 2000, the SBOE, on the recommendation of the Committee, and with the support of the investment consultant, reduced the allocation to 17.3% of the PSF.

Most large institutional funds have at least some portion of their large cap stocks passively managed. The process by which this decision was made and implemented, we believe, would be considered appropriate and in accordance with the principle of prudence in decision-making by fiduciaries.

The SBOE has not addressed the issue of active versus passive investment strategies any further until very recently. In May and June of 2002, the SBOE held two special meetings to discuss the possibility of moving significant portions of the externally managed domestic stocks assets from active to passive management. This has been prompted by the concern that the PSF may not generate sufficient income over the 2002-2003 biennium to cover the Biennial Revenue Estimate, and therefore, under the terms of a rider to the current Appropriations Act may not be able to pay investment management fees that are projected to exceed the amount appropriated under the Act. The investment consultant has conducted some analysis to determine what proportion of assets have to be moved from active to passive management to reduce management fees by the required amount. To date the SBOE has not taken any decision on this matter.

Our review of the minutes of SBOE and Committee meetings indicates that the SBOE has been aware for sometime that the external investment managers as a group for both large cap as well as small/mid cap domestic stocks have not added value, i.e., they have under performed their benchmark, even before taking management fees into account. As of August 31, 2002, the externally managed large cap domestic stocks have under-performed in aggregate by almost

0.5% a year since their inception in 1995, not including fees. The small/mid cap stocks have under-performed by nearly 1.4% a year since their inception in 1998. On the other hand, the domestic stocks portfolio actively managed by internal staff has added value since its inception in 1989, although it has under-performed its benchmark slightly on average over the last three and five years. Active management of international stocks and high-yield bonds by external managers, and bonds by internal staff, has also added considerable value.

The SBOE should review its current use of active and passive investment strategies, not just to reduce the management fees for the current biennium, but beyond that to determine whether it can realistically expect active strategies to add value, and if so, in which asset classes and market segments, and whether the expected value added will cover the significantly higher costs of active management. The failure to do so may not be regarded as consistent with the fiduciary standards of prudence and loyalty in managing the PSF.

APPENDIX 4(F)
THE SBOE'S MANAGEMENT PROCESS FOR TRANSACTION COSTS

The Permanent School Fund has had the cost of its stock transactions measured and evaluated by the Plexus Group, a recognized expert in the measurement and analysis of investment transactions, since October 1999. Plexus provides a quarterly report to the SBOE that analyzes the cost of stock transactions in terms of commissions, market impact and delays, for each investment manager and by each broker. This has now becomes standard practice for most large well-managed funds, and we commend the SBOE for its efforts in measuring the cost of investment transactions.

In many of its other actions, however, the SBOE has not placed sufficient emphasis on the importance of minimizing costs. These actions, which we have reviewed in more detail in other Appendices, are summarized below:

a) The SBOE has been aware for some time that its external domestic stocks managers have not added value. The large cap stocks managers, as a group, have under-performed their benchmark since their inception seven years ago in 1995 by nearly 0.5% or about $ 9 million a year based on the value of assets today, not counting another $6 million a year in fees. The small/mid cap stocks managers have under-performed since their inception in 1998 by 1.4% or $16 million a year, plus another $4 million in fees. A passively managed portfolio that would match the performance of an index would cost less than one-tenth in fees, and yet the SBOE did not establish an indexed portfolio for domestic stocks until fairly recently in early 2001. Today less than 17% of the total assets of the PSF are passively managed. (See Appendix 4(E) for details.)

b) There were repeated attempts by some members of the SBOE over an eight-month period from May 2001 to January 2002 to have the SBOE issue an RFP for external management of investment-grade bonds. Staff informed the PSF Committee that internal management of these bonds has generally added value and has cost only half a basis point (0.005%). The investment consultant advised the Committee on more than one occasion that it would be difficult to find an external manager who would manage bonds to an income as opposed to a total return target. An external manager would charge 10 to 20 basis points to manage a bond portfolio ($8-16 million a year versus $400,000 for internal management for an $8 billion bond portfolio), and the consultant had very little confidence that they could find a manager who would do better than internal staff or add value net of fees. (See Appendix 4(D) for details.)

c) The SBOE decided in March 1999 to separate custody from securities lending and appoint different service providers for the two functions. This was against the recommendation of staff to have one provider for both services which would have resulted in a saving to the PSF of an estimated $600,000 to $1,200,000 a year versus a one-time transition cost of $1.5 to $2 million in switching to a new securities lending agent. (See Appendix 4(G) for details.)

d) Some members of the SBOE have encouraged and even insisted that HUB brokers – most of whom provide trade execution only but no research and have limited capital and trading capability – be paid the same commission as "full service" brokers who provide investment research, first call on new information, access to industry analysts and company executives, commitment of capital, ability to handle complex trades, etc. in addition to trade execution. We find that almost all investment managers, including internal staff, are paying HUB brokers an average commission rate equal to and often more than what they are paying to non-HUB brokers. The SBOE has established a target of 20% of commissions to be directed to HUB brokers. The difference in commission rates on full service and "execution only" trades is at least 2 cents a share. The average trading volume for domestic stocks transactions (both purchases and sales) during June and July of 2002 was about 25 million shares a month. Based on these numbers we estimate that excess payments to HUB brokers could amount to $1.2 million annually. (See Appendix 4(I) for details.)

The SBOE's actions with respect to minimizing costs could be regarded as inconsistent with the standards of prudence and loyalty in fiduciary conduct.

APPENDIX 4(G)
THE SBOE'S MANAGEMENT PROCESS FOR SECURITIES LENDING

The Permanent School Fund has been engaged in securities lending since 1992 through its custodian who also served as the securities lending agent. In July 1998, the PSF Committee discussed the existing arrangement given the fact that the contract for custodial and securities lending services with the current custodian, Citibank, was expiring in August. The Committee recognized that there had been numerous changes in the custodial services industry in the past several years. Many firms had merged, been acquired, or had left the custodial and securities lending businesses. The quality of products and services was substantially different since the time the PSF last received offers for these services. The SBOE, on the recommendation of the Committee, extended the contract with Citibank for another year, and directed that an RFP be presented for approval in January of the following year.

In January 1999, the SBOE, on the recommendation of the Committee, authorized the issuance of an RFP for custodial and securities lending services. The RFP was accordingly issued in March. Responses were received from seven firms. Staff undertook a detailed evaluation of the responses and ranked the firms in the following order: Northern Trust was ranked first, State Street second, Mellon Trust third, Citibank fourth and Chase fifth. Staff recommended to the Committee that one firm be chosen as both the custodian and securities lending agent as it would be more efficient and cost-effective to combine the two services. The Committee decided, however, to consider the two issues separately, and to recommend to the SBOE that State Street be selected for custodial services. The Committee also decided to defer action on the selection of the securities lending agent until the next meeting in July, pending further analysis of the costs of separating the two services.

The SBOE approved unanimously the recommendation to appoint State Street as the custodian for the PSF. A member of the PSF Committee then proposed a motion to appoint Citibank as the securities lending agent for the PSF, contrary to the decision of the Committee the previous day to defer any action until July. The Chairman of the Committee stated that Citibank was offering a 90/10 split of the securities lending revenue versus the 80/20 split proposed by the other firms, and that this extra revenue would more than offset the additional costs of having separate custody and securities lending service providers. Staff observed that it would not, that in fact if State Street were not given the securities lending function, they would charge a hard dollar custody fee. The SBOE after some further discussion approved the motion to appoint Citibank as the securities lending agent for the PSF.

At the SBOE meeting in July, in approving the contract for custody services, another PSF Committee member observed that analysis by staff showed that separating the custodial and securities lending functions would cost $1.2 million more annually in the case of Northern Trust and $600,00 more in the case of State Street. The Chairman of the Committee responded that his analysis (which he distributed to the SBOE) showed that the added cost would be $333,000 not $600,000. He said that his discussions with PSF staff indicated that there would a transition cost in changing securities lending agents amounting to a calendar quarter's worth of securities lending revenue or $1.5 to $2 million. Therefore, even assuming that staff's number were

correct, it would not begin to cost the PSF more until the fourth year at which time the securities lending contract would be up for review. The minutes of the meeting indicate that in response to a question from a SBOE member asking who had done the analysis for him, the Chairman of the Committee responded that he had worked with another SBOE (and Committee) member and Mr. Brian Borowski.

At a meeting of the Committee in October 2000, in reviewing the securities lending income for the third quarter, a Committee member presented a copy of a letter addressed to the Executive Administrator of the PSF which was an executive summary of a report by "ASTEC Consulting Group" on the security lending results of Citibank for the 4th quarter of 1999. According to the member, the report concluded that: (1) total monthly earnings were higher, more stable and grew faster; (2) the cash collateral was invested at lower risk; (3) loan utilization rates were higher; and (4) exposure to borrower default was lower. The member said that some public recognition was needed of what an outstanding decision the SBOE had made in splitting the custodial and securities lending services. He asked why the report had not been distributed to the SBOE. The Executive Administrator responded that he had never seen the report. The Committee discussed where the document had originated. The representative of First Union Securities, the performance measurement consultant, said that he had received the report from Citibank and provided it to the Committee member.

The SBOE's decision, and the process for arriving at that decision could be regarded as contrary to generally accepted principles and standards of fiduciary conduct for the following reasons:

a) The decision of the Committee to consider the custody and securities lending issues separately was not consistent with the terms of the original RFP. If the Committee wanted to consider the two services separately, it should either have issued two RFPs, or sent the RFP out to firms other than just custodial banks – including broker/dealers and firms specializing in securities lending – and given them the option to bid separately on custody and securities lending if they wished.

   We are aware that large funds engage in securities lending in a variety of different ways, using their custodial bank for some assets and one or more specialized securities lending agents for other assets. Some funds undertake at least part of the activities associated with securities lending themselves, ranging from investing the cash collateral to bringing the entire function in-house and cutting out the middleman, at least for some of the assets. We asked one very large fund, which is considered a leader in securities lending, whether they would consider using another full-service custodial bank, besides their custodian, as a third party securities lending agent. They said it would not make much sense since the major custodial banks tend to be very similar in their securities lending capabilities. Using another custodial bank would do very little to increase the market for the fund's securities or generate more lending revenue.

   In summary, we find that the terms of the original RFP were not appropriate to the selection of the best available service provider for a specialized service such as securities lending, considered on its own separate from custody. The decision was thus not necessarily in the

best interests of the beneficiaries of the PSF and could, therefore, be considered contrary to the standard of loyalty in fiduciary conduct.

b) The additional cost of having separate service providers for custody and securities lending services, as estimated by staff, was significant on an ongoing basis. The PSF Committee Chairman's contention that the extra revenue from the higher 90/10 split proposed by Citibank would offset the cost was contradicted by staff. The 90/10 split would come with a separate charge for custody services by State Street, and thus was not directly comparable to the 80/20 (actually 75/25) split proposed by State Street with no charge for custody. Furthermore, the Chairman's statement – that the additional cost would not exceed the one-time opportunity cost of switching to a new securities lending agent (amounting to one quarter's worth of revenue) until the fourth year when the securities lending contract comes up for review – does not justify using different service providers. The same argument could also be made when the contract is reviewed, that the cost of switching would exceed the cost of having different service providers over the term of the new contract, and so on *ad infinitum*. In other words, the decision was made based on apparently faulty logic and erroneous information provided not by staff or the investment consultant but by a private third party (see below). The decision, therefore, may not have been in the best interests of the beneficiaries and would probably be considered contrary to the standard of loyalty in fiduciary conduct.

c) The decision seems to have been based in part, or at least supported, by analysis and advice provided to the Chairman of the Committee by Mr. Brian Borowski. We did not find the name of Mr. Borowski listed anywhere now or in the past as an investment consultant or advisor to the SBOE or the PSF. Mr. Borowski was not appointed by the SBOE; whatever information he provided to the PSF Committee Chairman was not provided to the other members of the SBOE. We find it highly inappropriate for the SBOE to have relied in any manner on the analysis or advice, with respect to the management of the PSF, from somebody acting in a private capacity to an individual member, somebody with no fiduciary obligations to the PSF. Since SBOE members did not question the individual providing the advice, they were in no position to evaluate whether the advice was objective and reasonable or subject to deleterious influences. The decision of the SBOE could be regarded as a violation of the standard of prudence in decision-making by fiduciaries.

d) Finally, the Committee member's use of a report provided by Citibank to evaluate the performance of Citibank in order to justify the decision of the SBOE and chastise staff was improper. The member should have questioned the objectivity of the report given its source. At the very least, he should have distributed the report to the rest of the Committee which could then have had the findings of the report be reviewed and confirmed by the investment consultant before making any judgments. We find this episode to be indicative of the extreme level of mistrust and hostility that certain members of the SBOE have towards staff. The role of the performance measurement consultant in providing the report to one specific Committee member on a matter completely outside the terms of their mandate we find only added to the atmosphere of mistrust and hostility between the SBOE and staff.

APPENDIX 4(H)
THE SBOE'S MANAGEMENT PROCESS FOR SOFT DOLLARS

The SBOE has had a policy in place since 1996 with respect to the use of so-called "soft dollars", directed brokerage and commission recapture programs. The policy recognizes that when investment managers pay commissions on securities transactions, they obtain research and other services from broker/dealers in addition to pure execution. It defines soft dollars specifically as amounts paid by broker/dealers for research services obtained by investment managers from independent third party providers. It provides for a commission recapture program in which a portion of the commissions paid on securities transactions are to be captured and returned to the PSF. The policy requires investment managers to obtain the lowest cost and best execution on soft dollar trades, with commission rates no higher than on regular trades. To that end, it provides for PSF staff to designate at least four broker/dealer firms to undertake all soft dollar/commission recapture transactions. Investment managers are to report all commissions to the SBOE, showing commissions on soft dollar trades separately from regular trades, and including the average commission per share.

The SBOE amended the policy in March 1999 to prohibit external investment managers from participating in soft dollar trading, other than commission recapture programs as directed by the PSF. The PSF has established a commission recapture program for its external large cap domestic stocks managers that requires them to allocate a minimum of 10% of all commissions towards soft dollar transactions. The investment managers are required to direct all soft dollar transactions to any one of nine designated soft dollar broker/dealers. The PSF uses the recaptured commissions to offset direct investment management expenses within the guidelines of Section 28(e) of the Securities Exchange Act of 1934. The investment managers report on their soft dollar commissions on a monthly basis and these reports are provided to the PSF Committee at every scheduled meeting.

There is a wide range of opinions within the fund management industry with respect to the use of soft dollars, directed brokerage and commission recapture programs. We do not find that there is a generally accepted view regarding the appropriate use of soft dollars. The PSF's commission recapture program generally seems to be in line with those of many other large funds. However, we have the following comments on the management of the program that could make it more consistent with the SBOE's fiduciary responsibilities:

a) Section 28(e) provides "safe harbor" guidelines regarding the types of expenses that can be paid for using soft dollars. However, it applies to investment management firms rather than the trustees or internal staff of a fund. The SBOE should establish a specific policy with respect to the types of expenses of the PSF that can properly be charged against recaptured commissions.

b) The PSF's Investment Procedures Manual does not indicate that a minimum of 10% of commissions are to be allocated towards the commission recapture program, or that the program applies only to the external large cap domestic stocks managers, not all stocks managers. That should be a decision made by the SBOE, not by PSF staff.

c) The Teacher Retirement System of Texas conducted a study four years ago which found that paying for investment products and services using soft dollars was significantly more expensive than paying directly in hard dollars. Not only is the commission rate higher but there is also a greater market impact on a soft dollar or commission recapture trade than on an execution-only trade on the same number of shares. In order to minimize this incremental cost, the PSF should ensure that: (a) its investment managers direct only those types of trades for commissions recapture that are relatively easy to execute or do not require commitment of capital; and (b) as far as possible, the nature of the trades should not be disclosed to the brokers until after they have been completed.

d) There is a limit, however, as to how much trading can be done on a soft dollar basis before the quality of execution begins to deteriorate. The PSF, as we understand from staff, used to require 20% of all commissions to be allocated to soft dollars and in 1999 reduced this to 10%. Nevertheless, this is over and above the 20% that is directed to HUB brokers (see Appendix 4(I) for details). The SBOE should review its soft dollar program periodically, including the total amount of directed brokerage, to ensure that the quality of execution remains at an acceptable level.

APPENDIX 4(I)
THE SBOE'S MANAGEMENT PROCESS FOR HUB BROKERS AND EMERGING MANAGERS

The SBOE has undertaken two major initiatives, one with respect to the use of Historically Underutilized Businesses (HUBs) as securities brokers, and the other on using emerging investment managers. To qualify as a HUB, a firm must have its "principal place of business in the State of Texas" and be at least 51% owned, operated, and actively controlled and managed by one or more women or specified minority groups. Emerging managers are generally defined to be investment management firms who do not have a long performance record, or many institutional clients or sufficient assets under management, or who are otherwise overlooked in investment manager searches by large funds.

HUB Brokers

The SBOE, on the recommendation of the PSF Committee, amended the Investment Procedures Manual in July 1999 to establish a policy, which required the internal and external managers of the PSF to target 20% of commissions on securities transactions to HUB brokers.

In March 1999, the PSF Committee had heard public testimony from representatives of a Texas-based HUB broker who advocated the use of HUB brokerage services by the PSF. They informed the Committee that they would provide trade execution only at a reduced commission, and did not wish to hire a large staff of analysts to provide research services. The Committee asked staff to establish "a good faith effort to include HUBS in allocating brokerage commissions". Staff worked with a member of the Committee to develop a policy which would require the investment managers of the PSF to target 20% of commissions on securities transactions to HUB brokers, with a similar target to be established for custodial and securities lending service providers. The Committee approved the proposal by staff but eliminated the requirement for participation by custodial and securities lending firms on the grounds that asking them to sub-contract some services to Texas-based firms went beyond what the Committee was trying to accomplish. The SBOE approved the Committee's recommendation.

In November 1999, staff informed the Committee and the SBOE that they had surveyed the marketplace and identified 21 Texas registered HUB brokers who were all sent a detailed due diligence questionnaire to which most had responded. The questionnaire asked about the company's capital position, trading capability, research, etc. In reviewing the responses, it appeared that the majority of HUB brokers would not meet the guidelines with respect to the selection of brokers as set out in the PSF's Statement of Investment Objectives, Policies and Guidelines (Texas Administrative Code, Chapter 33). Staff recommended to the Committee that it be directed to amend the guidelines with respect to the HUB brokers. In March 2000, the SBOE, on the recommendation of the Committee, approved an amendment to Chapter 33 that exempted HUB broker/dealers from three requirements of the PSF's trading and brokerage policy: (a) to have a comprehensive, proprietary, in-house research capability; (b) to be a member in good standing of the major financial exchanges; and (c) to be financially able to undertake a trade requiring a capital commitment over a standard settlement period.

At a meeting of the Committee two months later in May, a Committee member asked staff whether the policy was now in effect. Staff said that it was and that they were looking for opportunities to trade with HUB brokers. The member stated that it was his understanding that staff was not dealing with any HUB brokers, and he felt that internal staff should, in fact, set an example in the use of HUBs.

The Committee discussed the level of commissions to be paid to HUB brokers. Staff stated that their practice was to pay a full-service broker who provided research used in managing the internal stocks portfolio a commission of 5 cents a share, while brokers providing execution only services were paid 2 or 3 cents a share. Staff observed that a number of smaller HUB brokers did not provide research services. The representative of an external investment manager addressed the Committee to say that they followed a similar practice of compensating brokers differently for full-service trades and execution only trades.

The Committee member stated that the SBOE's policy did not require HUB brokers to provide research services and, therefore, they should be compensated at the higher rate, and unless they were, they would never receive enough income to build up the firm and make it competitive. Another Committee member disagreed, saying that all brokers, whether majority-owned or HUBs, should receive the same compensation for research trades and execution only trades. Staff indicated that their understanding was that the reason for waiving the requirements for proprietary in-house research and capital for HUB brokers was to allow the PSF to do business with such firms, not establish different levels of compensation for trades executed by HUB and non-HUB brokers.

The representative of the performance measurement consultant, First Union Securities, advised the Committee that the PSF (and every other major State fund) did far more business with large established brokerage firms than necessary to obtain all the research and related services these firms had to offer, and that the excess business could and should be diverted to HUB brokers. The performance measurement consultant further said that it was not unreasonable to compensate under-financed startup companies at the same rate as well-established firms while putting them on a course to developed research services.

The SBOE's HUB policy requires internal staff and external managers to provide regular reports on the use of HUB brokers. We reviewed the commissions paid by internal staff and each external managers over the first seven months of calendar year 2002, as reported to the Committee at its September 12, 2002 meeting, and found that the commissions per share paid to the HUB brokers were higher than those paid to non-HUB brokers by 8 of the 10 external stocks managers of the PSF. Only one manager paid a lower commission per share to HUB brokers, while internal staff and one external manager paid the same commission per share to HUB and non-HUB brokers.

We have found one specific instance where the SBOE's HUB brokerage policy has resulted in an increase in the expenses of the PSF. In May 2000, the SBOE terminated a small cap manager, Loomis & Sayles, and transferred the assets in their portfolio to another small cap manager, Harbor Capital, who were then allowed to transition the assets. Harbor undertook a number of transactions over the following months for which they paid a non-HUB broker 4 cents a share

instead of the instead of 2 cents per share which they would have normally paid to that broker on such trades. The difference in total commissions on these trades as estimated by PSF staff was about $216,000. Harbor Capital explained that at that time there were no HUB brokers that could undertake such large program trades. In order to comply with the SBOE's "mandate" to direct "at least" 20% of commissions to minority firms, they asked the non-HUB broker to "step-out" some of the trades to HUB brokers. In other words, the HUB brokers were paid part of the commissions but did not, in fact, execute any trades. Harbor Capital said that it was fully aware of the requirement for best execution at lowest cost under the SBOE's brokerage policy. "It is possible," the manager added, "that Harbor could have obtained a lower execution on these trades if it had requested execution only services on these trades. It did not do so because it was attempting to balance conflicting SBOE mandates."

The SBOE's implementation of its HUB brokerage policy could be considered contrary to generally accepted standards and principles of fiduciary conduct for the following reasons:

a) The SBOE has a fiduciary duty to ensure that all trades are conducted at the lowest possible cost, including commissions, subject to best execution. The PSF's trading and brokerage policy, in fact, requires that: (a) best execution and lowest cost must apply to each PSF trade; and (b) that ongoing efforts must be made to reduce trading costs, in terms of both commissions and market impact, provided that investment returns are not jeopardized. The range of services a broker provides should determine the commission they are paid. So-called "full service" brokers are typically paid a higher commission because they provide investment research, first call on new information, access to industry analysts and company executives, commitment of capital, ability to handle complex trades, etc. in addition to trade execution. Other brokers provide only execution and they are generally paid a lower "discounted" commission. We understand that most HUB brokers cannot or do not provide proprietary research, many have limited capital and institutional trading experience. This is supported by the fact that PSF's brokerage policy with respect to in-house research and capital requirements had to be relaxed to allow the PSF to do business with HUB brokers. We are even told that some HUB brokers have no actual trading capability, but merely function as "introducing" brokers, taking orders for execution by other firms and receiving a portion of the commissions under so-called "step-out" arrangements. Most of the PSF's investment managers, on the other hand, seem to be paying a slightly higher level of commissions per share to HUB brokers than to non-HUB brokers on average. The fact that some SBOE members have encouraged and even insisted that PSF should compensate HUB brokers at a higher level for less than full service is inconsistent with the principle of best execution at lowest cost as set out in the SBOE's own brokerage policy. It would clearly not be in the best interests of the beneficiaries of the PSF and could, therefore, be considered contrary to the standard of loyalty in fiduciary conduct.

b) The role of First Union Securities in this matter we find was highly inappropriate. Not only was the advice completely outside its mandate as a performance measurement consultant, but also the advice itself was questionable. The PSF does not have enough resources to maintain a large in-house research staff and must therefore rely heavily on research provided by major full-service brokerage firms. It may indeed be the case that it

could reduce the volume of business that it does with these firms without affecting the research and other services that it receives – although that would have to be properly demonstrated. But even if that were the case, it would mean that the PSF should increase the business that it does with discount brokers, whether they are HUBs or non-HUBs. To advise that the PSF should compensate HUB brokers, providing trade execution only, at the same level as full-service brokers could be regarded as irresponsible, damaging to the interests of the PSF, and contrary to the standard of loyalty in fiduciary conduct.

Emerging Managers

The SBOE approved the appointment of FIS Funds Management and Northern Trust in November 2000 as managers of emerging investment managers to manage 2.7% of the assets of the PSF.

The possibility of using emerging managers to invest part of the assets of the PSF was first discussed at the PSF Committee meeting in July 1999. Staff stated that they had discussed with a Committee member a "manager of managers" approach. The concept was further discussed at the SBOE level in January 2000. Staff explained that the SBOE could appoint a manager of managers who would in turn select a team of emerging managers who would manage an investment portfolio that would be a replica of the total domestic stocks portfolio of the PSF. The performance of the portfolio would be monitored over time and stand-alone mandates could be awarded to individual managers in the future depending on their performance and growth.

The investment consultant, Callan Associates, reviewed the domestic stocks manager structure of the PSF in May 2000. The Committee asked Callan Associates to examine the possibility of using minority or emerging managers for part of the portfolio. As part of a recommended new structure, Callan Associates proposed that 5% of the actively managed portion of the domestic stocks portfolio (or roughly 2.5% of the total domestic stocks portfolio) be managed by emerging managers. Callan Associates also suggested the SBOE use a "manager of managers" approach.

The Committee reviewed a draft RFP in August 2000 and discussed various funding levels. The representatives from Callan Associates recommended that the SBOE fund the program at a $100 million initially and then gradually work up to a higher level. One Committee member felt that $100 million was not enough; his preference would be a funding level of $200 million. The Chair of the Committee suggested an initial funding level of $150 million.

The Committee discussed the draft RFP again in September. One Committee member commented that since minorities represented 40% of the population of Texas, assigning 1% of the PSF to emerging managers was an insult, and that if the SBOE allocated a sufficient amount to emerging managers, it would not have a difficult time finding good managers. The investment consultant stated that while they had suggested that the allocation should be 2.5% of domestic stocks portfolio, there was no right or wrong answer and the Committee could increase or reduce that allocation. Another member suggested the allocation should be 5% of the domestic stocks portfolio. A third member proposed an allocation of 6% to be funded over time.

The Committee also discussed the proposed role of the manager of managers. The investment consultant and staff explained that the manager of managers would be required to provide to the SBOE the recommended definition of an "emerging manager", they would be responsible for assembling the team of emerging managers, and have discretion to hire and fire managers. The manager of managers would ensure that the portfolio complied with the SBOE's policies and to report to the SBOE on the performance of the portfolio and individual managers. The manager of managers would be paid a fee and they would, in turn, compensate the emerging managers on the team.

The Committee recommended to the SBOE that an RFP be issued for manager of emerging managers to invest 5% of the domestic stocks assets of the PSF. The SBOE approved the Committee's recommendation with an amendment to increase the allocation to emerging managers to 6% of domestic stocks assets. The Committee met in October 2000 to review the five responses and decided to interview all five respondents, following which the Committee recommended FIS Funds Management as the manager of managers for the emerging manager portfolio. At the SBOE meeting the next day the Committee Chairman made a motion on the Committee's recommendation. At the same time an alternate motion was made by two other Committee members to appoint FIS as well as Northern Trust as managers of emerging managers with the allocation split two-thirds to FIS and one-third to Northern Trust. The SBOE passed the alternate motion unanimously.

We reviewed information on the emerging managers contained in Form ADV filed with the Securities and Exchange Commission. We found that one emerging manager, Presidio Asset Management, selected by FIS, is partly owned by Mr. Carlos Resendez, who was at one time an Executive Administrator of the PSF. The other principal owner is Avatar Investors Associates, an investment management firm based in New York City, which was ranked 441st in terms of worldwide institutional assets under management by *Pension & Investments*, an investment industry publication, in its May 27, 2002 issue. The ADV indicates that Presidio has one to five employees (the exact number is not shown), and lists Mr. Resendez as the Chairman and CEO and another individual as the President and CFO, who is also a Vice Chairman of Avatar, as the only executive officers of the company. It also states that: "Presidio has contracted Avatar Investors Associates Corp. as its sub-advisor. Avatar invests all of the assets for Presidio and maintains all client investment records." In other words, it appears that Presidio does not have any investment management capabilities of its own, that all its investment operations are actually carried out by a large well-established investment management firm.

The SBOE's decision to establish an emerging managers program was undertaken in a manner that would be regarded as contrary to generally accepted standards and principles of fiduciary conduct for the following reasons:

a) The process leading up to the SBOE's decision to appoint the manager of managers was by and large well managed with appropriate advice and input from staff and consultants, a proper RFP process, interviews of the respondents and a recommendation by the Committee. The SBOE then ignored the Committee's recommendation to appoint one manager and instead appointed two managers and divided the allocation between them. The proper action, as we have said before in similar cases, would have been to send the

matter back to the Committee for further deliberation and review. What we find particularly odd is that the alternate motion was put forward by two Committee members who had supported the Committee's original recommendation the day before. We wonder why the alternate motion was not made at the Committee meeting where it could have been deliberated and discussed, instead of at the SBOE meeting where ten of the fifteen members had not participated in the due diligence process and thus did not have direct knowledge of the issues. The decision by the SBOE could, therefore, be considered inconsistent with the principle of prudence in decision-making by fiduciaries.

b) The SBOE has not established proper guidelines as to what type of firm should be considered to be an "emerging manager". Instead, it has relied on the manager of managers to provide a definition, and delegated to that manager the authority to appoint and terminate emerging managers. However, it does not appear that the SBOE has taken steps to ensure that the manager follows that definition, since some of the assets allocated to emerging managers are, in fact, being managed by a large well-established firm. The SBOE's implementation of the emerging manager program could be considered contrary to the principle of prudence in delegation by fiduciaries.

c) The manager of managers structure may be appropriate for monitoring and oversight of a number of small emerging firms. However, it does introduce an added layer of cost since the manager is responsible for due diligence in selecting the emerging managers, evaluation and review of performance and reporting to the SBOE. To the extent that some of the assets allocated to the emerging managers program are managed by large established firms, these firms could be monitored by internal staff at far less cost. The emerging managers program has not been implemented in a cost-effective manner, and could, therefore, be deemed to be inconsistent with the standard of loyalty in fiduciary conduct.

APPENDIX 5
REVIEW OF PSF ETHICS AND CONFLICT OF INTEREST POLICIES

The SBOE has had difficulty effectively addressing issues of ethics and conflict of interest, despite significant concerns which have been raised in the past regarding the use of informal advisors, and conflicts of interest among service providers.

Notwithstanding the repeated calls for reform of ethics policies and procedures of the SBOE by various investigative bodies, and despite the recent rule changes adopted by the SBOE, there are still serious gaps and weaknesses in the SBOE's *Code of Ethics, Texas Administrative Code, Title 19, §33.5* (the "Code of Ethics"). Furthermore, there are virtually no enforcement penalties prescribed in the policy, and insufficient resources have been made available to properly monitor compliance with the Code of Ethics. These findings are discussed below in more detail.

Background

In November 2000, a report issued by the House Committee on General Investigating[5] on the SBOE had found that a majority of members of the SBOE had failed to safeguard the PSF against the influence of self-interested outside parties, by failing to uncover financial relationships existing between PSF service providers and informal advisors to SBOE members. The Report also found that the SBOE failed to implement effective changes to its Code of Ethics as required by changes made by the Legislature to the Texas Education Code in 1999. Similar findings were made by the State Auditor's Office in its 2001 Report[6], especially that members of the SBOE had permitted an informal advisor to influence SBOE decisions without ensuring that the advisor was free from any conflicts of interest.

Attempts were made in 2001 and 2002 to strengthen the Code of Ethics, and to broaden its scope. A revised version of the policy was most recently approved by the SBOE on November 15, 2002.

Scope of Review

We have conducted a review of the SBOE Code of Ethics, including the revised version that was recently approved by the SBOE on November 15, 2002. We have also reviewed the Texas Education Agency ethics policies, and sections of the SBOE Operating Rules relating to the ethical conduct of SBOE members and service providers. All staff of the Texas Education Agency are subject to *TEA Operating Procedure 07-04 – Agency Standards of Conduct and Conflicts of Interest*. TEA staff that are considered staff of the Permanent School Fund, and the Commissioner of Education, are subject to a second TEA policy, the *General Ethical Standards for the Staff of the Permanent School Fund and the Commissioner of Education*. SBOE

[5] House Committee on General Investigation, Texas House of Representatives, *A Report to the House of Representatives, 77th Texas Legislature, Interim Report 2000* (the "House Committee Report"), page 2.13.
[6] Texas State Auditor's Office, *A Follow-up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities, January 2001*, (the "State Auditor's 2001 Report") page 41.

Operating Rules 4.1 (Standards of Conduct and Conflicts of Interest) and 4.3 (Disclosure of Campaign Contributions and Gifts) also relate to ethical conduct and conflict of interests issues.

We have compared these documents against the ethic policies and conflict of interest policies of other large public endowment funds, investment boards and retirement systems. The Peer Group for this section of the Report includes the following organizations:

1. Alaska Permanent Fund Corporation (Alaska)
2. New Mexico State Investment Council (New Mexico)
3. Teacher Retirement System of Texas (Texas TRS)
4. University of Texas Investment Management Company, Board of Administration (UTIMCO)
5. Los Angeles City Employees' Retirement System (LACERS)
6. Colorado Public Employees Retirement Association (COPERA)
7. Missouri State Employees' Retirement System (MOSERS)
8. Washington State Investment Board (WSIB)

We also reviewed two Canadian public retirement systems:

9. Canadian Pension Plan Investment Board (CPPIB)
10. Public Sector Pension Investment Board (PSPIB).

We also reviewed the Sample Policy on Standards of Conduct and Conflict of Interest for the National Conference of Public Employee Retirement Systems ("the Sample NCPERS policy"), and the Code of Ethics and Standards of Professional Conduct for the Association of Investment and Management and Research (AIMR), which is the international association that provides accreditation for Certified Financial Analysts.

This appendix contains our assessment of the SBOE Code of Ethics (current and proposed text) and the two policies applicable to PSF staff. We also comment on implementation issues relating to the monitoring, reporting and enforcement of the above policies. Finally, we comment on the SBOE's response to recommendations made by various State investigative bodies regarding the SBOE's Code of Ethics policy and practices.

Summary of Findings

<u>SBOE Code of Ethics</u>

Generally speaking, the SBOE Code of Ethics is comparable in scope to many of the other policies we reviewed. It covers many of the main topic areas usually found in such policies, including:

a) Fiduciary responsibility
b) Compliance with applicable laws
c) General ethical duties of loyalty and honesty
d) Conflicts of interest

e) Prohibited transactions (prohibited employment, representation and investment by SBOE members)
f) Gifts and entertainment
g) Confidential Information
h) Enforcement and Compliance

The policy also covers the behavior of service providers, which were not generally covered by many of the peer group policies.

However, there are major areas not covered by the SBOE Code of Ethics, including the following:

1. **Confidential Information –** The Code of Ethics lacks a blanket prohibition on disclosing confidential information to unauthorized parties. Such requirements are found in the Sample NCPERS ethics policy, and in the ethics policies of the Texas TRS, UTIMCO, PSPIB, CPPIB and others. The SBOE Code of Ethics actually envisions the disclosure of such information to unauthorized persons who may act as informal advisors to SBOE members. Fortunately, a recent amendment to the policy makes such advisors subject to the terms of the Code of Ethics. (See subsection (c)(2)(D) of the Code of Ethics.)

2. **Trading Rules for SBOE Members.** Such rules currently exist for PSF staff; however, other systems require trustees to disclose or pre-clear trades (see the ethics policies of the Texas TRS, CPPIB, PSPIB, COPERA, and WSIB) while some jurisdictions prohibit trustees and staff from trading securities at the same time that the fund is trading such securities (see the policies of Texas TRS, UTIMCO, New Mexico, PSPIB and CPPIB).

We also found numerous gaps and weaknesses in the existing provisions of the policy, which in some instances, appear to make some provisions ineffective. A detailed review of the policy is provided below. Some of the more serious weaknesses in the policy, however, are as follows:

1. The conflict of interest disclosure requirement for SBOE members in subsection (g)(2) do not explicitly indicate the nature of the information to be disclosed, nor is there any requirement that such disclosure should be documented in SBOE minutes. We understand that the Board adopted a rule in November 2002 requiring that any “disclosures” be documented in Board minutes. We recommend that this rule be incorporated explicitly into subsection (g)(2) of the Code.

2. There is an apparent omission in subsection (g)(3) that has the effect of allowing service providers to indefinitely postpone any disclosure of a conflict of interest. Furthermore, the prohibition under (g)(4) that prohibits service providers from giving advice at a SBOE meeting on a matter to which they have a conflict applies only **after** they have filed their disclosure statement, which they may indefinitely postpone.

3. The recently adopted amendment to the Code of Ethics that was intended to penalize service providers for failing to make timely disclosure filings is ineffective. The new

penalty under subsection (o)(5), holding back of payment to service providers, does not apply to any of the important annual filings.

A more detailed analysis of the revised provisions of the SBOE Code of Ethics is as follows:

Fiduciary Responsibility

1. **Section (a):** Section (a) identifies SBOE members as fiduciaries of the PSF. It is also important to point out that SBOE members are also trustees of a public fund, and as such, are held to the highest standard of conduct for a fiduciary (i.e. higher than for corporate directors, lawyers, etc.).[7] We believe this important distinction should be clarified in the wording of section (a), as should the fact that SBOE members, as trustees, will be held to the highest standards of ethical conduct.

Definition of PSF Service Provider

2. **Subsection (c)(2)(D):** Paragraph (D) provides two separate criteria for establishing a person who provides investment and management advice to an SBOE member (i.e. an informal advisor) as a PSF service provider for purposes of the Code of Ethics. Cortex believes that it is inappropriate for SBOE members to give confidential information to unauthorized persons, nor should they allow such persons access to PSF service providers and staff. The Code of Ethics should clearly prohibit the use of any advisors that are not subject to a process of due diligence and approval by the SBOE.

   However, should individual SBOE members continue to use informal advisors, Cortex agrees with the recent additions, as stopgap measures, of subsection (c)(2), which makes informal advisors subject to the Code of Ethics, and subsection (e)(5), which requires SBOE members to disclose the existence of such advisors.

3. **Subsection (c)(2)(D):** The definition of PSF service provider in paragraph (D)(i) includes an informal advisor, if the SBOE member gives that advisor information that is “identified as confidential”. The provision should also apply to information with which the SBOE member knows or should reasonably know is confidential, even though it may not be so identified.

Gifts, Donations and Campaign Contributions

4. Under §7.108 of the Texas Education Code, persons with an interest in selling bonds, and persons connected with the textbook industry, are prohibited from making campaign contributions to anyone seeking election or serving on the SBOE. This is to prevent any

[7] Under common law, it is recognized that the trustee/beneficiary relationship is the most intense of all fiduciary relationships because the trustee has the right and power to control property belonging to another. The legal effect of this intensity is that the trustee will be held to the highest fiduciary standards (See Scott on Trusts, §170, and *The Law of Trusts*, Eileen E. Gillese, Publications for Professionals, Canada 1997.

potential conflict or perception of conflict between such persons and elected SBOE members, who may be called on to vote on contracts involving the aforementioned.

We suggest that this prohibition is equally applicable to investment consultants, investment managers and custodians, as the SBOE votes on relatively large contracts for such services.

The SBOE may wish to revisit whether certain types of service providers should be treated differently from other service providers with respect to campaign contributions.

5. The service providers identified in §7.108 (and preferably all service providers) should also be prohibited from **indirectly** making a campaign contribution through an **intermediary**, i.e. such as a spouse, business partner, or business entity that the service provider has the ability to influence.

6. **Subsection (e)(7):** Under this subsection, PSF service providers are prohibited from making gifts or donations to a school or other charitable interest on behalf of, or at the request of, or in coordination with an SBOE member. We believe the prohibition should also cover indirect gifts or donations made through an intermediary, such as a spouse, business partner, or business entity that the service provider has the ability to influence.

7. **Section (i):** This section prohibits SBOE members from soliciting support for any political candidate from PSF service providers. We also believe that PSF service providers should be expressly prohibited from soliciting political support on behalf of an SBOE member, either directly or indirectly through an intermediary, such as a spouse, business partner, or business entity that the service provider has the ability to influence. This would more effectively prohibit a PSF service provider from getting involved in the political process of the SBOE.

8. **Paragraph (l)(2)(F):** We agree with the edits that were made to the proposed text of this section at the September 13th SBOE meeting, which is more restrictive as to the size and type of gifts that may be received by a lobbyist. Lobbyists should be under the same gift restrictions as service providers and other interested parties.

9. **Subsection (l)(G):** This subsection permits SBOE members to accept lodging and transportation in connection with speaking engagements. While such engagements may arguably be beneficial to the public relations efforts of the SBOE, they may also circumvent the Code's gifts rule. (Such engagements can also be offered by "associations" which are sponsored or supported by a PSF service provider.) In order to avoid the possibility of undue influence, such costs should be borne by the SBOE, under its budget for travel, conferences, and education, and in accordance with an SBOE travel and expense reimbursement policy. We also recommend that members be required to report to the SBOE any speaking engagements they intend to undertake by virtue of their position as an SBOE member. We should point out, however, most boards don't share this view. The majority of peer group policies we reviewed did in fact allow board

members to accept lodging and travel for speaking engagements and contracts, including both Texas TRS and UTIMCO.

Conflicts and Disclosure

10. **Subsection (e)(7):** Under this subsection, a PSF service provider or SBOE member is required to report to the Commissioner of Education any gift or donation made contrary to the subsection. We believe that such disclosure should also be made to the SBOE, as is the case with the information required to be disclosed under subsection (e)(6) (prohibited campaign contributions) and subsection (e)(8) (business or financial transactions between service providers and SBOE members).

11. **Subsection (e)(8):** Under this subsection, there is an obligation on PSF service providers to disclose any business or financial transactions with an SBOE member that are worth greater than $50, excluding certain basic financial services (i.e. checking accounts, credit cards, etc). We suggest that the onus for disclosure be on the SBOE member as well, thereby increasing the chance that such transactions will be disclosed.

12. **Section (g):** This section contains additional conflict of interest and disclosure requirements, regarding personal or private, commercial or business relationships. This section is broader than (f), in that it applies to PSF service providers as well as SBOE members. We have identified several problems with this section:

    a) The conflict disclosure requirement for SBOE members in subsection (g)(2) does not explicitly indicate the nature of the information to be disclosed. It should be clearly stated whether the SBOE member must indicate merely the existence of a conflict, or whether he or she must state the nature of the conflict.

    b) Subsection (g)(2) does not require that disclosure by a SBOE member at a meeting be documented in the minutes. We understand that the Board adopted a rule in November 2002 requiring that any "disclosures" be documented in Board minutes. We recommend that this rule be incorporated explicitly into subsection (g)(2) of the Code. The recording of a conflict in the minutes is currently required under section (f) of the Code of Ethics.

    c) PSF service providers are not required to make disclosure under subsection (g)(2). Instead, they are required to disclose any conflicts in a prescribed statement to the Commissioner of Education and to the Chair and Vice-chair of the SBOE, under subsection (g)(3). This is problematic, however, because there is no stated time limit for filing such a statement, and the service provider could potentially do so long after the SBOE makes a decision involving the conflict. We believe section (g) should require the service provider to make the disclosure within a specified period of time within which the service provider becomes aware of the conflict.

       While PSF service providers are prohibited from giving advice or making a decision about a matter affected by a possible conflict of interest under subsection (g)(4), such

prohibition **only applies** if they filed the statement under paragraph (3). Therefore, if they failed to file a disclosure statement, then, given the wording of section (g), they are free to give advice to the SBOE even if they have a conflict.

13. **Subsection (l)(2)(J):** This subsection requires a PSF service provider to file an annual report on any expenditures of $50 or more that they made on behalf of SBOE members, the Commissioner of Education, or employees of TEA. It is not clear in the subsection with whom the report is to be filed.

    Presumably, this subsection relates to the reporting requirement set out in §43.033 of the Texas Education Act, which states that such a report should be filed with the SBOE. If this is the case, either there should be a reference to §43.033 in subsection (l)(J), and/or the subsection should be amended so that it clearly indicates with whom the report should be filed. A copy of the report should also be filed with the Commissioner of Education or the TEA ethics officer.

    The wording "deemed to be filed when it is actually received" should also be included in this subsection, as is the case with the report filed under subsection (l)(K) of the Code of Ethics. Such wording puts the onus on the service provider to ensure the document is delivered promptly and is received by the SBOE or TEA.

14. **Subsection (l)(2)(M) - Annual Acknowledgement:** The SBOE Code of Ethics was recently amended to require SBOE members and PSF service providers to file an annual report affirmatively disclosing any violations of the Code of which they are aware, or affirmatively stating that they have no knowledge of any such violations. We suggest that this subparagraph be further enhanced by requiring SBOE members and PSF service providers to further declare that they agree to abide by the terms and conditions of the Code. Staff members are currently required to do this under the PSF staff ethics policy, and it is also common practice on other boards, including the Teacher Retirement System of Texas TRS, UTIMCO, the Colorado Public Employees Retirement Association, the Canadian Pension Plan Investment Board, and the Public Sector Pension Investment Board.

<u>Prohibited transactions and interests</u>

15. **Paragraph (h)(2)(B):** This paragraph prohibits an SBOE member or PSF service provider from working for an organization that the PSF has invested in, unless the organization's shares are publicly traded (i.e. a "direct placement" organization). Presumably, the intention of the paragraph is to ensure that SBOE members or staff of PSF service providers do not receive kickbacks in the form of employment contracts in return for recommending or approving a direct placement investment. The provision is as follows:

    (2) No SBOE Member or PSF Service Provider shall:

> (B) be employed for two years after the end of **his or her term on the SBOE** with an organization in which the PSF invested, unless the organization's stock or other evidence of ownership is traded on the public stock or bond exchanges. [Emphasis added]

It is common for ethics policies to prohibit board members or officers from being employed by interested parties either during their term or for a specified period of time after their term or relationship.

We believe that the paragraph may not be appropriately worded to provide adequate protection to the PSF from undue influence in the form of promises of employment. The wording used to describe the time period covered by the employment ban is not clear, and the time period does not appear to apply to a service provider, since service providers do not have a term "**on**" the SBOE. Accordingly, we would suggest some form of modification to the provision, such as the following:

(2) No SBOE Member or PSF Service Provider shall:

> (B) **accept an offer of employment, during his or her term on or with** the SBOE, with an organization in which the PSF invested, unless the organization's stock or other evidence of ownership is traded on the public stock or bond exchanges. [Emphasis added]
>
> (C) **accept an offer of employment, within the two year period following his or her term on or with** the SBOE, with an organization in which the PSF invested, unless the organization's stock or other evidence of ownership is traded on the public stock or bond exchanges. [Emphasis added]

The SBOE may also want to consider a provision prohibiting an SBOE member from accepting employment with a PSF service provider either during their term on the SBOE, or for a specified period thereafter, in order to prevent similar undue influence.

Other

SBOE operating rules §4.3 and §4.1 deal exclusively with Standards of Conduct, Conflict of Interest, and Disclosure of Campaign Contributions and Gifts, respectively. It may be more appropriate for these sections to be referenced in the SBOE Code of Ethics, to provide greater assurances that SBOE members and PSF service providers are aware of these additional provisions.

Compliance and Enforcement

We found that the enforcement tools available to the SBOE are lacking. There are no specific penalties set out for violations for SBOE members or parties not subject to a formal contract (many brokers, informal advisors). The proposed penalty under section (o)(5) is ineffective, as there is no regular filing requirement. Our specific findings are as follows:

16. **Subsection (o)(2):** It appears that the penalties for violation of the SBOE Code of Ethics, as set out in subsection (o)(2) are not well defined, are not necessarily applicable to all potential classes of violators, and are relatively weak compared to many provisions in the ethic policies of other jurisdictions (including the Teacher Retirement System of Texas, UTIMCO, and the California Model Conflict of Interest Code, adopted by many California public retirement systems). Specifically, we found the following problems with the penalties prescribed:

    a) The only specific sanction listed was termination of contract, which is only applicable to contractually bound service providers.

    b) The other penalty, "lesser sanction", is not defined.

    c) There is no specific sanction for SBOE members or informal advisors.

    Penalties for PSF staff, defined in the TEA's ethics policies, however, were well defined and commensurate with that of other jurisdictions.

    We have identified potential sanctions and penalties utilized by other jurisdictions to address violations by SBOE members and service providers. We believe the SBOE should consider incorporating some of these penalties, which include the following:

    a) For violations by PSF service providers, in addition to termination of their contract, there could be a prohibition against rehiring the service provider for a specified period of time (e.g. 6 to 10 years) depending upon the nature of the offence and number of previous contraventions of the Code of Ethics. (Adopted by Texas TRS)[8]

    b) SBOE members that have violated the Code of Ethics could receive censures or reprimands (a formal and documented expression of blame or disapproval). Although these do not carry any immediate consequences, they would become part of the public record, and could thereby result in negative publicity for the SBOE member, or may hamper their efforts for re-election. (Both UTIMCO and the Texas TRS adopted such penalties.)

    c) Serious or recurring violations by SBOE members could lead to a formal request by the SBOE that the SBOE member voluntarily hand in his or her resignation. Again, this cannot force the SBOE member to resign, but can seriously effect the member's reputation and credibility (especially where the member has previously signed a declaration agreeing to abide by the terms of the Code of Ethics, including provisions relating to penalties.) Both UTIMCO and the Texas TRS adopted this penalty. MOSERS trustees automatically forfeit their office if found guilty of conflict of interest violations set out in their enabling statute.

[8] See Texas TRS Code of Ethics for Consultants and Agents, Adopted by the Board of Trustees, September 27, 2002, Section IV, paragraph B.

17. Use of informal advisors was not covered in any of the ethics policies of the peer group. Accordingly, we could not find any precedent for appropriate penalties for such parties. Therefore, we have recommended the following penalties for informal advisors for violation of Code of Ethics provisions:

    a) All SBOE member should be prohibited from using such persons for a specified period of time (e.g. 6 to 10 years); and

    b) The SBOE should prohibit other service providers from conducting transactions involving the PSF with the informal advisor, or with an entity in which they have a substantial interest.

18. **Subsection (o)(4):** Under this subsection, the SBOE may consult with ethics officers of TEA, who in turn may consult with general counsel and the Executive Director of the PSF, who are both TEA staff. It may be appropriate to give the SBOE access to counsel outside the TEA, in instances where there is an ethics-related concern or an allegation regarding a senior member of the TEA. Such access should be guided by SBOE policy.

19. **Subsection (o)(5):** Under this subsection, the staffs of both SBOE and PSF are prohibited from making payment to a PSF service provider who has failed to timely file a competed report under as described under subsection (k) of the Code of Ethics. However the report required under (k) is not one of the regular filing requirements under the Code of Ethics, but an exception report to be made by a service provider if it becomes aware of any violation of the Code of Ethics. It is unlikely that the SBOE or PSF would ever know that the service provider failed to timely file such a report, and therefore this section is ineffective. This section should instead apply to the regular filing requirements of service providers to have any effect, such as those required under subsections (l)(J) and (l)(K).

20. **Filing Requirements:** There are inconsistencies in filing and disclosure requirements. Certain reports are required to be filed with the Commissioner of Education, others with the "PSF office", and others with the SBOE itself. In certain cases, filing dates or time limits are missing, as is the identity of the recipient of the report. A standardized procedure for filing and reporting this information is lacking. This inconsistency is clearly illustrated in Schedule 1, at the end of this section, which sets out the various filing requirements under the Education Code, the SBOE Code of Ethics and the PSF staff ethics policies.

21. **Amendments:** The SBOE Code of Ethics can be amended by the SBOE by a simply majority vote. We believe amendments to weaken the Code of Ethics should be subjected to a higher standard than amendments to other SBOE policies.

    Specifically, we suggest that the Code of Ethics contain a provision that requires a special majority of the SBOE (i.e., 2/3^{rds} of the entire SBOE) to approve the removal of any provision, or the amendment, deletion or addition of any provision that has the effect of

weakening the Code of Ethics. Such an approach can also insulate the SBOE from partisan voting by its members.

22. Ethical conduct should be an integral part of a board's culture. We feel the more it is brought to the forefront, and the more it is discussed, the more likely that board members and service providers will take the ethics provisions seriously. We recommend that the SBOE may be better able to instill an ethical culture among its members and service providers through the following activities:

    a) Establishing an ethics committee to address ethical issues on a more frequent basis, and to assist the SBOE and its committees in the monitoring and reporting of Code of Ethics violations. Such committees have been established by other public funds including Texas TRS, UTIMCO, PSPIB, and CPPIB[9]. Such a committee can assist the SBOE and PSF staff in their monitoring and reporting duties, including but not limited to the adoption of relevant policies and compliance monitoring procedures. The Committee should be required to regularly report on its activities both to the full SBOE and to the Legislature.

    b) We would recommend that the SBOE compliment the annual ethics training requirements, as set out in the Code of Ethics, by establishing further detail about the form and content of ethics training in SBOE policy or in an education plan.

    c) In their annual filing (required under section (l)(2)(M) of the Code of Ethics), SBOE members should agree to voluntarily resign their position should they be found by the SBOE to have made a serious violation of the Code of Ethics, or recurring violations. (Since SBOE members are elected officials, they cannot be forced off the SBOE. However, it may be difficult for them not to resign if they have already agreed to do so in writing.)

Implementation of the Code of Ethics

Under the SBOE Code of Ethics, the Chair and Vice Chair and the Commissioner of Education are responsible for the enforcement of the Code of Ethics (subsection (o)(1)). These parties have relied primarily on TEA staff to carry out this function.

Collection of various filings required under the Code of Ethics has been undertaken primarily by the Executive Administrator and his staff. Review of these materials consisted of an informal review by the Executive Administrator. Serious concerns or violations that were uncovered by the Executive Administrator's review would be personally brought to the SBOE's attention for their review and disposition.

The TEA has a formal Ethics Officer who assists in the implementation process by providing advice to SBOE members on the interpretation of the Code of Ethics, and giving advice to TEA

[9] Some of these organizations expanded the mandate of their Audit Committee to cover ethics and conflict of interest compliance issues.

staff regarding the various filings. The Ethics Officer also receives staff filings required under TEA Operating Procedure 07-04.

The major periodic filings previously received by TEA staff under the previous SBOE Code of Ethics include:

1. Section (l)(2)(K) - Expenditure Report, to be filed annually by each PSF service provider, reporting on any expenditures made by the service provider on behalf of SBOE members.

2. Section (l)(2)(K) - Report to be filed annually by each PSF service provider, listing the names of the directors and officers of the service provider, as well as any brokers that they employ, and such brokers' directors and officers.

3. Section (n)(2) – Report on transactions between PSF service providers to be filed quarterly by PSF service providers, only if such transactions occurred.

There are also a series of other disclosure requirements that are not required on a regular basis, but only after the occurrence of a specified event or violation.

We uncovered several weaknesses in the monitoring and compliance procedures and processes for the SBOE's Code of Ethics, including the following:

1. In the recent past there have been insufficient resources directed towards the monitoring and analyzing of the periodic filings required under the Code of Ethics. To address this problem, the TEA has recently hired a Compliance Officer to specifically deal with the compliance of PSF policies, including the Code of Ethics. Nevertheless, PSF staff still have concerns over their ability to process all the information currently received, even given the new dedicated staff person.

2. There has been a lack of formalized systems in place to analyze all the information obtained through the annual filings, and there has not been a specified or consistent format for reporting this information to the SBOE. We understand that the TEA is currently in the process of putting many of the necessary systems in place.

3. Concerns were raised by some TEA staff about the timely filing of reports by service providers. Currently, there is no formal mechanism in place to ensure timely filing, and subsection (o)(5), which establishes a penalty for late filings, is in our opinion ineffective, as indicated above. In order for the SBOE to ensure proper monitoring of potential conflicts and violations of the Code of Ethics, it should receive from the TEA regular reports indicating whether all required filings have been made by service providers, SBOE members, staff, etc., and in cases where a report is not filed, that appropriate action has been taken (e.g. service providers do not receive further compensation).

4. PSF staff have raised concerns over the usefulness of some of the information collected, specifically the information collected under section (l)(2)(K) detailing the names of directors, officers and brokers and service providers. The intention of collecting this

information was to cross-reference it against campaign contribution records collected by the State. However, staff does not believe that successful cross-referencing is feasible or even possible.

5. The SBOE has failed to enforce section (n)(2) of its Code of Ethics by not requiring PSF service providers to disclose amount of fees received from other PSF service providers. The SBOE has allowed service providers to only disclose the existence of fees and commissions, but not the amount, contrary to the Code of Ethics. Such information has been withheld by the current investment consultant regarding fees it receives from various PSF investment managers.

6. SBOE relies heavily on the TEA for implementing the monitoring and enforcement aspects of its Code of Ethics. This is a reasonable approach, given that the SBOE does not have its own staff to do such work, and is common in other jurisdictions. However, there are some situations where this relationship may cause problems.

   The Executive Administrator is required to report to the Chair and Vice Chair on any violations of the Code of Ethics, including any involving individual SBOE members. This may put the Executive Administrator in a difficult situation, since he reports to the Chair and Vice-Chair (in addition to the Commissioner of Education), especially, if the violation involves the Chair, Vice-Chair or both.

   In order to address this problem, other jurisdictions have provided for the involvement of outside agencies in the investigation and prosecution of violations. Both the Alaska Permanent Fund Corporation and the New Mexico Investment Council ethics policies have provisions that require the Attorney General to investigation into violations of such policies by SBOE members.

Recommendations from Previous Reports

We found that the SBOE has also failed to adopt recommendations from previous investigations by both the House Committee on General Investigating and the State Auditor's Office.[10]

In its November 2000 report, the House Committee made fourteen recommendations to help restore prudence and public trust in the management of the PSF, many of which required changes to the Texas Constitution and Education Code. Recommendations from the report were incorporated into Senate Bill 512, which was vetoed by the Governor. However, in his veto, the Governor pointed out that "the Chair of the SBOE and the Commissioner of Education had the constitutional and statutory authority necessary to enact many of the provisions in the Senate Bill", and he indicated that those were the proper means for such changes to be made. The veto goes on to direct the Chair of the SBOE and Commissioner of Education to adopt ethics provisions similar to those set out in the Senate Bill.[11]

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[10] House Committee on General Investigation, Texas House of Representatives, *A Report to the House of Representatives, 77th Texas Legislature, Interim Report 2000;* Texas State Auditor's Office, *A Follow-up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities, January 2001*.
[11] Proclamation by the Governor of the State of Texas, June 17, 2001.

Notwithstanding this direction, only two of the recommendations made in the House Report dealing with conflicts of interest and Code of Ethics issues were adopted, one of them only partially.[12]

In a 2001 State Auditor's Report, six specific recommendations were made to strengthen the provisions of the existing Code of Ethics.[13] Only the first of the six recommendations (disclosure of informal advisors) was adopted. (The Code also has a provision currently in place that satisfies most, but not all, of the fifth recommendation dealing with the disclosure of personal, political and financial relationships.)

Two of the more significant recommendations dealt with informal advisors, and recommended that SBOE members should refrain from sharing confidential information with such advisors unless they have ensured such advisors have sufficient technical qualifications and independence. These recommendations have not been adopted (although the Code of Ethics now requires SBOE members to disclose the existence of such advisors to the Commissioner of Education).

It should be stated that we did not necessarily agree with all the recommendations made by the House Committee and the State Auditor's Office, and that some of the recommendations appear to be more stringent than the requirements of ethics policies in other jurisdictions. Nevertheless, in light of the types of conflicts and problems faced by the State Board of Education in recent years, on the whole many of the recommendations appeared to be reasonable.

Conclusion

No policy or monitoring program can ever fully prevent or uncover determined parties seeking to take advantage of public resources and public officials, as such policies and procedures are often dependent upon the forthright disclosure and honesty of the parties involved.

Notwithstanding this, the SBOE hasn't sufficiently addressed basic gaps in its Code of Ethics, including effective enforcement methods. While it has attempted on several occasions to improve the policy document, it hasn't focused its attention to the implementation and enforcement of the Code of Ethics, by ensuring that sufficient resources and systems are in place to affect policy compliance. Finally, it appears to have dismissed advice by various State agencies for dealing with conflicts of interest and other ethical issues.

[12] See *A Report to the House of Representatives, 77th Texas Legislature, Interim Report 2000*, starting at page 2.16 until page 2.17. These recommendations are also included in Schedule 2 to this section.
[13] See *A Follow-up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities, January 2001*. State Auditor's 2001 Report, starting at page 47. These recommendations are also included in Schedule 3 to this section.

Schedule 1

Code of Ethics - Reporting and Disclosure Summary

Policy	Section	Party	Requirements	Disclosed to	Frequency/ Time limit
Education Code, Chapter 43	43.0032(a)	SBOE member Service provider	Written disclosure of conflicts of interest	Board	None
	43.0033	Consultant, advisor, broker or other service provider	Report on expenditures to members of the SBOE, commission, TEA staff	Board	Regularly
SBOE Code of Ethics	(e)(3)	SBOE members PSF service providers	General duty to disclose conflicts	See below	See below
	(f)(1)	SBOE member	Personal, private, direct or indirect financial interest in matter before the SBOE	Board Note in minutes	At meeting
	(f)(2)	SBOE members	Substantial interest in any publicly or non-publicly traded PSF investment on **Annual Financial Report** filed under **Ethics Act**	Texas Ethics Commission	Annually
	(g)(3)	SBOE member PSF service provider	Potential Conflict of Interest Disclosure Form – any conflict	Commissioner Chair Vice Chair	None
	(i)	PSF service provider	Solicitation of support from service provider by SBOE member for a political candidate	Commissioner Cc: Board	None
	(l)(2)(G)	SBOE member	Food lodging or transportation from speaking engagement in **annual personal financial statement**.	Texas Ethics Commission	Annually
	(l)(2)(I)	SBOE member	Return of gift or donation	Commissioner	None
	(l)(2)(J)	PSF service provider	Expenditure report – expenditures to SBOE members, Commissioner of Education, or TEA staff	Not indicated	Annually
	(l)(2)(K)	PSF service provider	Listing of service providers, directors, officers and brokers.	TEA's PSF office	Annually
	(n)	PSF Service providers Consultants	All investment transactions or trades and any fees or compensation paid in connection with the transactions or trades with another PSF service provider, or consultant to SBOE or PSF	Board	Quarterly

	Section	Party	Requirements	Disclosed to	Frequency/ Time limit
	(o)	Not indicated	Any violations of Code of Ethics	Chair, Vice Chair Commissioner	Quarterly
SBOE Code of Ethics – Amendments Approved Nov. 15th)	(e)(5)	SBOE members	Report name and address of informal advisors	Commissioner	30 days
	(e)(6)	SBOE members PSF service providers	Violations of §7.108 Education Code – re: campaign contributions by persons involved in books or bonds business	Commissioner	7 days
	(e)(7)	SBOE member PSF service providers	Information regarding a gift or donation by service provider on behalf of SBOE member	Commissioner	None
	(e)(8)	PSF service providers	Any business or financial transaction greater than $50 with SBOE member	Commissioner Cc: Board	30 days
	(g)(2)	SBOE member	Any meeting issue in which member has conflict.	Board	At meeting
	(k)	PSF Service Provider	Any suggestion or offer by SBOE member to deviate from ethics code	Commissioner	30 days
	(k)	PSF Service Provider	Any violation of the ethics code by another PSF service provider	Commissioner	30 days
	(l)(2)(M)	SBOE member PSF service provider	Any known violations of Code of Ethics not previously disclosed in writing	Commissioner Cc: Board	Annually
PSF Staff and Commissioner – Code of Ethics	I(A)	PSF Trustees PSF Employees Commissioner	General duty to disclose any conflicts of interest and cure in manner provided for under the policy	See below	See below
	II(B)	PSF Employees Commissioner	Disclosure of conflicts of interest in writing - disclosure **form - Form A**	General Counsel Internal Auditor Executive Director	Promptly
	IX(A)	PSF Employees	Annual financial disclosure statement, including listing of publicly traded securities transactions – **Form B, Employee Financial Disclosure Form.**	Executive Director	Annually by April 30
	IX(C)	Commissioner	File a **Personal Financial Statement** as required by Texas Ethics Commission	Texas Ethics Commission	Annually

	Section	Party	Requirements	Disclosed to	Frequency/ Time limit
	X(C)	PSF Employees	Written undertaking to comply with the provisions of the policy and report violations by employees, consultants or agents – Form **C, PSF Ethics Policy Compliance Statement**	Executive Director	Within 60 days of employment [or 30 days of adoption of policy]
	X(C)	PSF Employees	Changes in circumstances requiring reporting under policy	Executive Director	None given
	X(F)	Executive administrator	Written notification of any violations of the policy	Commissioner	Annually by June 30
TEA OP 07-04	6. a	Agency officer Agency employee	Report any financial interest in a private consultant submitting an offer to provide services to the agency (Texas Government Code, §254.032)	Chief Executive	Within 10 days of submission
	6. c, d, e	Agency employee	Report supplemental employment within State of Texas government or State regulated or related entities and request waiver– **Disclosure Reporting Form**	Ethics Advisor	None

Schedule 2

House Committee Report
Recommendations Regarding the SBOE Ethics Policies and Procedures

The following recommendations are made to restore prudence and public trust in the management of the PSF. It is equally important to ensure that conflicts of interest now affecting this major State investing entity are detected and sanctioned now, and prevented in the future.

1. The Legislature should retain a consultant to perform a comprehensive review of the PSF's management practices, with periodic follow-up reviews.
2. The Constitution should be amended to create an appointed Permanent School Fund Investment Board, separate from the State Board of Education. The jurisdiction of the State Board of Education would be limited to education policy.
3. If the Constitution is not amended, and the current State Board of Education structure is retained, then an effective Investment Advisory Committee should be established. The Investment Advisory Committee should be appointed by the Governor, Lieutenant Governor and Speaker of the House.
4. The Education Code should specify the minimum investment management qualifications for membership on the Investment Advisory Committee.
5. The Education Code should require that members of the Investment Advisory Committee be governed by the same rules regarding disclosure of conflicts of interest as are members of the State Board of Education.
6. The Education Code should require that the SBOE's rules governing conflicts of interest should be expanded to cover any person or entity that applies for, or receives, anything of value as a direct or indirect result of the PSF investments. These persons and entities should be classified as "interested parties" and brought within the scope of SBOE disclosure rules.
7. The Education Code should require that every interested party, as a condition of approval as a consultant or money manager, must sign a standard, non-negotiable contract, agreeing to be bound by all statutes and regulations, and acknowledging the SBOE's right to cancel any contract or other undertaking in the event the interested party violates SBOE rules or State law.
8. Further, the Education Code should require that every interested party, including "downstream" entities, as a condition of approval as a consultant or money manager or vendor of those entities, must acknowledge that, if one interested party has an undisclosed relationship with another interested party, both or all those interested parties may have their contracts voided and their eligibility to conduct PSF business withdrawn.

9. The SBOE should establish a frequently updated web site, on which PSF staff must post names and business addresses of all interested parties who receive, or who are eligible to receive, anything of value, directly or indirectly, as a result of PSF investment management.

10. State officers, specifically the Legislative Audit Committee, Commissioner of Education, Comptroller, Attorney General or the Texas Ethics Commission, rather than SBOE members, should make the initial findings that an interested party has violated SBOE rules and refer complaints to the appropriate agency for enforcement.

11. Any interested party who violates SBOE rules should be debarred from contracting with both the PSF and any other interested party for PSF business, for a period varying from six months to ten years, depending on whether the infraction is a first or subsequent violation.

12. The SBOE should enter into a Memorandum of Understanding under the Interagency Cooperation Act to allow another agency to investigate alleged violations and enforce SBOE rules.

13. Hearings on debarment and other sanctions should be held at the State Office of Administrative Hearings.

14. The agency performing SBOE's enforcement function should serve as liaison between the State's major investing agencies and the Securities and Exchange Commission, self-regulatory organizations like the National Association of Securities Dealers and professional organizations like the Association for Investment Management and Research to ensure close cooperation and information-sharing about disciplinary actions taken against consultants and broker-dealers doing business with, or seeking to do business with, the PSF.

Schedule 3

State Auditor's 2001 Report
Recommendations Regarding the SBOE Ethics Policies and Procedures

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: [numbers added]

1. 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.

2. 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.

3. 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.

4. 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:

5. 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.

6. Discuss with TEA 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.

APPENDIX 6
REVIEW OF THE PSF'S INCOME PROJECTION MODEL

The PSF's income projection model is used to determine whether the PSF will meet its income expectations over the biennium period. It is also used for estimating the effect of asset allocation decisions as they impact the future income of the PSF.

Our review of the PSF's income projection model found that the model is generally appropriate in that in incorporates all sources of potential income, applies fairly sophisticated modeling techniques, and is based upon reasonable assumptions. Equally important, the model has proven to be quite accurate in predicting actual income earned each biennium.

By making periodic projections of its income, the PSF is able to better evaluate whether it will achieve the budgetary expectations set out by the Legislature. The Legislature meets every two years and determines the amount of income that is expected from the PSF. All interest and dividend income generated by the PSF is paid out to the public education system of Texas. Budgetary estimates are prepared by the Comptroller of Public Accounts and, after being approved by the Legislature, are published in the Biennial Revenue Estimate.

We have reviewed the PSF's income projection model to evaluate its appropriateness and accuracy. Our findings are discussed below.

Key Assumptions of the Model

There are six modules that make up the PSF's income projection model: a bonds module, a collateralized mortgage obligation (CMO) module, a stocks module, a short-term securities module, an external manager module, and a summary module. The individual modules attempt to estimate the amount of income the various portfolios of the PSF will generate based on various assumptions with respect to changes in interest rates, stock market returns, dividend growth, asset allocation and rebalancing over the biennium period. The summary module incorporates the estimates of the other five modules as well as any sources of ancillary income (such as depository and securities lending income).

Interest Rates: The bonds portfolio generates approximately 75% of the income. Coupon income is calculated for each security based on the current holdings of the portfolio. A portion of the portfolio is sensitive to changes in interest rates. Callable bonds, and particularly CMOs, tend to prepay faster if interest rates fall. The proceeds then have to be reinvested at the lower interest rates. The PSF uses a forecast of interest rates prepared by the investment firm of J.P. Morgan. The model estimates the amount of bonds and CMOs that will be called or pre-pay based on the interest rate forecast. The proceeds from all maturities, calls and pre-pays are assumed to be reinvested at the forecast 10-year US Treasury rate plus a spread to reflect the holdings in lower-grade securities. Short-term securities mature in less than a year, with proceeds assumed to be reinvested at the forecast rates at the time of maturity.

Dividend Yield and Growth: Dividend income is estimated based on the historical payout ratio for each issue and assumptions for dividend yield and growth. The PSF uses five-year forecasts of dividend yield and growth prepared by its investment consultant, Callan Associates.

Stock Market Returns: The PSF uses the Callan Associates forecasts of total return and dividend yield for various segments of the stock market to estimate the growth in the value of the stocks portfolios. The internally managed portfolio is assumed to grow at a rate equivalent to large cap domestic stocks. The externally managed portfolios are assumed to grow at the rates based on their respective benchmarks.

Asset Allocation and Rebalancing: The model assumes that the asset allocation policy adopted by the SBOE will be maintained, with rebalancing as required by the PSF's rebalancing policy.

Appropriateness of the Model

The model by and large appears to be appropriate. It incorporates all of the potential sources of income. It is fairly sophisticated in modeling the bond portfolio, which generates most of the income. It recognizes the explicit and implicit option features embedded in callable bonds and CMOs, and how they can be affected by changes in interest rates. The model uses reasonable assumptions with respect to interest rates, dividend yields and asset allocation.

Accuracy of the Model

The model has been used since 1996. Over the three biennium since then the actual income generated by the PSF has differed from the income projected by the model by an average of 3.9%. Given the dynamic nature of capital markets and the PSF's investment program, the model would, therefore, appear to be highly accurate.

Biennium Periods	PSF Investment Income ($ million)			Percentage Difference
	Actual	Projected	Difference	
1996-1997	1,455.2	1,352.0	103.2	7.1
1998-1999	1,352.7	1,326.0	26.7	2.0
2000-2001	1,492.8	1,455.0	37.8	2.5
Average			55.9	3.9

The difference between actual and projected income can be due to a number of reasons:

Interest rates may differ from the forecast – This will affect the income on all securities that mature, are called or pre-pay during the period, the proceeds of which have to be re-invested at interest rates that are different than the forecast. It will also have a direct impact on the rate of prepayment on callable bonds and CMOs.

Stock market returns may differ from the forecast – Changes in the market value of stocks relative to bonds can affect the asset allocation of the PSF and require it to be rebalanced by

moving assets from stocks to bonds or vice versa. If stock market returns are different than forecast, the timing and extent of rebalancing required will change, which will in turn affect the relative proportion of stocks and bonds and change the amount of income generated by the PSF. (Note: the model assumes no changes in the market value of bonds.)

Asset allocation policy may change – If the SBOE adopt a new asset allocation policy during the period, the relative proportion of bonds and stocks may change which will affect the amount of income generated by the PSF.

The asset allocation may not be rebalanced as required – The model assumes that the asset allocation of the PSF will be rebalanced back to the policy mix whenever the PSF's actual allocation moves outside the range specified in the its rebalancing policy. To the extent that the PSF does not rebalance, or does not rebalance back to the policy allocation, the actual income will be different than what was projected.

Proposed Improvements to the Model

There are a number of ways in which the income projection model could be improved:

1. A sensitivity analysis, based on the volatility of interest rates and stock market returns, instead of just using a single forecast, would provide some indication of the range of incomes that could result if actual interest rates and stock market returns turn out to be different than forecast.

2. The model requires a forecast of interest rates to estimate the income on the reinvestment of bonds and CMOs that mature, are called or pre-pay. It assumes, however, that there will be no change in the market value of bonds, notwithstanding the forecast of change in interest rates. This is an inconsistency in the model. There should be an explicit assumption of changes in the market value of bonds– consistent with the forecast for interest rates. While this will not have a direct impact on the income generated by the bond portfolio (which depends on the coupon rate applied to the par value and not the market value of bonds), the change in market value will affect the asset allocation and the extent of rebalancing that may be required from stocks to bonds or vice versa. It may, therefore, have an indirect impact on the income projected by the model.

3. The model uses a five-year forecast of stock market returns as projected by Callan Associates. Stock market returns should be forecast for the biennium period, rather than over five years. Trying to predict the performance of the stock market over any period is a hazardous exercise – it is even more difficult over two years than five years. Nevertheless, two years is the relevant period to use. It allows specific consideration of the current point in a stock market cycle, as well as major events likely over the next two years – wars, elections, etc. – that could reasonably be expected to impact the stock market. The outlook for the stock market over two years could differ significantly from the average return expected over five years.

4. The forecast of dividend payout should use the most recent dividend payout ratio as a starting point rather than using the average historical payout ratio.

APPENDIX 7
THE COSTS AND BENEFITS OF INTERNAL VERSUS EXTERNAL MANAGEMENT

Costs of External Management

The major costs of external management relative to internal management include the following:

1. Higher investment management fees; and
2. Greater potential for conflicts of interest.

External management is significantly more expensive than internal management. For example, the fees for external investment management at PSF were projected to be approximately $58 million for the 2002-2003 biennium, or about 0.30% to 0.35% of externally managed assets annually.[14] Compare this to the cost of the internal management program, which in the case of the PSF totaled less than 0.02% of assets during the last fiscal year (PSF staff managed on average $10.5 billion of assets internally on a budget of under $2 million).

The other major cost area associated with external management is the greater potential for conflicts of interest. The use of external investment managers can lead to conflicts of interest that would not exist in an internally managed portfolio, because of the introduction of additional interested parties, such as external investment managers and investment consultants. Such conflicts can include undisclosed relationships between investment consultants and investment managers, or between investment managers and brokers, or attempts by such parties to unduly influence the PSF's selection process. Internal passive management further reduces the potential for conflicts due to the lower trading activity associated with passive management and therefore less interaction with brokers.

It is difficult if not impossible to determine the specific costs associated with conflicts of interests. We can, however, identify the types of costs that may arise:

Opportunity Costs: Opportunity costs are the costs that arise should, because of undue influence, the PSF engage service providers that are not the strongest candidates available or are not the most cost effective. These costs cannot be measured with any reliability but are certain to be very significant, dwarfing the enforcement costs mentioned above.

Damage to One's Reputation: Conflicts of interest, regardless of whether they result in direct or indirect costs, may significantly harm the reputation of the PSF and shatter the public's trust in the institution. Once again, it is impossible to measure such costs with any degree of accuracy.

Enforcement Costs: Enforcement costs include the cost of developing and maintaining the Code of Ethics, the costs incurred by staff and service providers in preparing the various compliance reports required by the Code, and the cost of monitoring compliance with the Code. These costs are both financial, in the case of the salaries associated with legal and compliance staff, and

[14] Source: Presentation by Paul Ballard to the PSF Committee, on May 10, 2001, titled "Income Issues Facing the PSF in the 2002-2003 Biennium". See slide no. 8.

intangible, in the case of the time that staff and service providers must spend completing reports rather than carrying out their primary job duties.

Internal management would eliminate many, though not all, conflicts of interest, including undisclosed relationships between investment consultants and investment managers, inappropriate financial payments by investment managers, undue influence, etc. Conflicts of interest that would remain include such things as the potential for insider trading by investment staff and SBOE members, or inappropriate financial payments to staff by brokers and other service providers. Given that the PSF currently has a significant internal portfolio, the PSF already faces these potential conflicts.

Benefits of External Management

The major benefits of external management relative to internal management include:

1. Less need to deal with internal human resource issues, including retention and succession.
2. Access to a broader universe of investment styles and strategies, and therefore greater diversification; and
3. Greater access to investment expertise, and therefore the potential for higher investment returns.

Human Resources

Many funds, particularly those in the public sector, find that human resource issues, particularly compensation, make it difficult to hire and retain qualified internal investment staff. The fund management industry provides a level of compensation that public funds, subject to government pay scales and hiring practices, simply cannot match. While this may potentially be addressed to some extent by setting up an State-sponsored investment management organization that is not subject to public employee salary limitations, the more talented and skilled investment professionals will generally continue to be lured away by the prospect of stocks ownership in private money management firms.

The problem of finding qualified staff is greater in the more specialized asset classes such as small cap stocks, emerging markets or high-yield bonds, and in alternative asset classes such as real estate, private stocks and hedge funds, which require even higher levels of expertise because of either the deal-oriented structure of the market, the size of individual investments, or the proprietary nature of the investment strategies. Accordingly, public investment funds generally only invest in such asset classes using specialized external investment managers.

Diversification

External management can provide a range of investment styles and strategies to choose from, which may not be available within an internal management structure, for the reasons identified above. Having all assets managed internally is arguably similar to having one investment management firm. The assets of the PSF can be better diversified across asset classes if at least some of the assets are externally managed.

Greater Expertise and Investment Performance

Finally, it may be argued that the private sector, which can generally pay significantly higher salaries than the public sector and therefore can attract the best and brightest managers, will generate higher investment returns than internal staff managing the same asset categories. The PSF's experience with external management, however, has been mixed and does not fully support such an argument. While external managers in domestic stocks, both large and small cap, have under performed their benchmarks, those in international stocks and high-yield bonds appear to have added considerable value since their inception. At the same time, internal staff managing the bond portfolio has added considerable value.

Conclusion

Internal investment management offers significant cost savings relative to external management and eliminates many common types of conflicts of interest. Accordingly, it is worthy of serious consideration by public investment funds where the avoidance of conflicts of interest, in particular, is an important consideration.

The benefits of internal management however must be weighed against the loss of diversification that arises because not all asset categories can effectively be managed internally by most public funds. If the investment goals of a public fund demand that it invest in highly specialized, non-traditional asset categories, where internal management is simply not feasible, then public funds may be forced to incur the higher fees associated with external management and expose themselves to the higher potential for conflicts of interest in these asset categories.

APPENDIX 8
FIDUCIARY STANDARDS AND PRINCIPLES

As part of the fiduciary audit, Cortex conducted a review of the State constitution, statutes, common law, and contractual provisions applicable to the management of the PSF, as well as model acts such as the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) and the Uniform Prudent Investor Act (UPIA), to determine whether they clearly establish fiduciary principles and standards applicable to the SBOE, PSF staff, service providers, and others. We report on the findings of our review in this appendix.

ISSUE #1: Do the State constitution, statutes, contractual provisions and common law applicable to the management of the PSF clearly establish fiduciary principles and standards applicable to the SBOE, PSF staff, service providers, and others?

Brief Answer

The State constitution and statutes applicable to the management of the PSF clearly establish a fiduciary standard of care for the SBOE. The contractual provisions contained in the current investment manager agreement clearly establish a fiduciary standard for investment managers.

The *PSF Investment Objectives, Policies and Guidelines*[15] may extend the standard of care and fiduciary principles to those "acting on behalf of the SBOE", including PSF staff, and money managers, although this is not definitive.

The *PSF Investment Objectives, Policies and Guidelines* incorporates the fiduciary principles of loyalty and honesty, and makes them applicable to the SBOE, the PSF staff, certain service providers, members of the Investment Advisory Committee, and certain informal advisors.

Discussion

For purposes of this report, we have made a distinction between fiduciary standard and fiduciary principles. The fiduciary standard is the general standard of care, or measure of conduct, for fiduciary activities. This element deals with the broad obligation that a fiduciary undertakes and how the actions of that person to discharge that obligation will be judged in the event that a legal action arises. Fiduciary principles refer to a number of specific fiduciary duties that have been imposed in some jurisdictions.[16]

[15] Texas Administrative Code, Title 19, Chapter 33.
[16] *Legal Obligations of Public Pension Plan Governing Board and Administrators*, Lawrence A. Martin, Government Finance Officers Association, 1990.

Fiduciary Standard of Care

The fiduciary standard of care applicable to the SBOE with respect to its management of the PSF can be found in the Texas State Constitution, Article VII, section 5(d):

> "in managing the assets of the permanent school fund, the State Board of Education may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment … *that persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, acquire or retain for their own account in the management of their affairs*, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital" [Emphasis added]

The PSF's standard is derived from the "prudent man rule" established in early American case law, *Harvard College v. Armory*[17]*,* in 1830.

This standard is also incorporated into the sections of the Texas Education Code dealing with the PSF, specifically subsections §43.003(7)(A) and §43.007(6), albeit with slightly different wording.[18]

> "In making purchases, sales, exchanges, and reissues, the State Board of Education 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 not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital."[19]

Some of the PSF's investment managers are held to a higher fiduciary standard than the SBOE, by virtue of section 15 of the PSF's standard investment manager agreement. In their case, the standard of care is that of a prudent expert:

> "and without limitation as to any other legal standards applicable to its performance as a fiduciary, it will act with the same care, skills, prudence, and diligence under the prevailing circumstances that a *prudent expert, who was familiar with such matters*, would exercise when acting in a like capacity and in a similar enterprise having similar purpose." [Emphasis added]

The standard applicable to investment managers that contracted with the PSF under the older investment advisor agreements (prior to 2000) is unclear. The older standard agreement does not explicitly prescribe a fiduciary standard for the manager, but instead acknowledges that the investment advisor is a fiduciary, and will exercise its investment authority in accordance with applicable fiduciary standards.

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[17] 26 Mass. (9 Pick.) 446 (1830).
[18] The §43.003(7)(A) standard is limited in application to the SBOE's selection of "stocks" only. However, the latter standard in §43.007(6) has a much broader application, that being the Board's decisions "regarding the purchase, sale, exchange, and reissue of securities."
[19] Texas Education Code, §43.007(6).

There is nothing in the State constitution or statute that establishes a fiduciary standard of care for the PSF staff, or for service providers, other than the investment managers discussed above.

The SBOE's Code of Ethics[20], subsection 33.5(a), however, states that anyone "acting on behalf of the SBOE" shall comply with the provisions of the Code of Ethics, Texas Constitution, Texas Statutes and "all other applicable provisions governing the responsibilities of a fiduciary".

Common law fiduciary standards of care and principles may apply to some of the PSF service providers, where those service providers have discretion or control over PSF assets. Under the common law, a fiduciary relationship **may** arise whenever the property of one person is placed in charge of another,[21] or when a confidential relationship has been acquired.[22]

We understand that the standard of conduct to which the fiduciary will be held will vary with the degree of discretion that the fiduciary has, and the nature of the relationship.[23]

Fiduciary Principles

As indicated above, "fiduciary principles" refer to a number of specific fiduciary duties, in addition to the general fiduciary standard of care governing the investment process, that have historically been imposed on fiduciaries in some jurisdictions.

Recognized fiduciary principles have been articulated in the US *Restatement of Trusts Third: Prudent Investor Rule*, a leading authority on trust law[24], and endorsed in some of the model acts (*The Uniform Management of Public Employee Retirement Systems Act*[25] (UMPERSA), and *The Uniform Prudent Investor Act*[26] (UPIA)). Such principles, or duties, include the following: loyalty and honesty, diversification, recognition of the risk/return relationship, reasonableness of fees and transaction costs, impartiality between beneficiaries, and the requirement to delegate prudently.

[20] Texas Administrative Code, Title 19, §33.5(a).
[21] Hamby v. St. Paul Mercury Idem. Co., CA.Va., 217 F.2d 78, 80; Commissioner of Internal Revenue v. Owens, C.C.A., 78 F.2d 768, 773.
[22] Pfaff v. Petrie, 71 N.E.2d 345, 348, 396, Ill. 44.
[23] Scott on Trust, §170.
[24] American Law Institute's *Restatement of Trusts (3d): Prudent Investor Rule (1992).*
[25] National Conference of Commissioners on Uniform State Laws, 1997. UMPERS was developed for use by public retirement systems.
[26] National Conference of Commissioners on Uniform State Laws, 1994. UPIA was developed for use by private gratuitous trusts.

In reviewing PSF legislation, we found that two fiduciary principles have been incorporated into the *PSF Investment Objectives, Policies and Guidelines*:[27]

1. Duty of honesty –Code of Ethics, §33.5(e)(2): "SBOE Members and PSF Service Providers must be honest in the exercise of their duties and must not take actions that will discredit the PSF."

2. Duty of loyalty – Code of Ethics, §33.5(e)(3): "SBOE Members and PSF Service Providers shall be loyal to the interests of the PSF to the extent that such loyalty is not in conflict with other duties, which legally have priority."

Given the wording of the Code of Ethics, these fiduciary principles are applicable to the SBOE and to PSF service providers that provide investment and management services. They are also applicable to members of the Investment Advisory Committee and certain informal advisors[28].

Application of Common Law

The extent of the duties and powers of a trustee depends primarily on the terms of the trust. Where there is no provision, express or implied, in the terms of the trust, the duties and powers of the trustee will be determined by the principles and rules set out in the common law.[29] The settlor may, however, by provisions in the trust instrument, limit or extend these duties.[30]

Accordingly, there are numerous common law principles that will apply, even if they are not expressly provided for in the trust. We have identified some of the more relevant of these principles below.

1. Duty to exercise reasonable care and skill (see also Fiduciary Standard of Care above)
2. Duty of loyalty
3. Duty to preserve the fund
4. Duty to keep accounts
5. Duty to consider the entire portfolio in making investment decisions
6. Duty to act impartially among all beneficiaries
7. Duty to diversify
8. Duty to delegate prudently

The authority for each of the above principles is provided in Schedule 1 to this appendix.

[27] Texas Administrative Code, Title 19, Chapter 33.
[28] See definition of "service provider" in §33.5(c)(2) of the PSF Code of Ethics, *PSF Investment Objectives, Policies and Guidelines,* Texas Administrative Code, Title 19.
[29] Scott on Trusts, §164.
[30] Ibid.

ISSUE #2: How do the fiduciary principles and standards that apply to the PSF compare to those governing other large public funds?

Brief Answer

The prudent man rule, which is reflected in the PSF fiduciary standard, is followed by most public funds[31], and in most States and federal legislation dealing with trustees, either in its original form or in various restatements. (The standard has been updated over time, especially with the introduction of the *Restatement of Trusts Third: Prudent Investor Rule*).

Most jurisdictions we reviewed did not explicitly extend the fiduciary standards or principles to parties other than the governing body, although there were some exceptions.

The enabling statutes of most large public sector funds incorporate several fiduciary principles, though they vary among the funds. The PSF legislation establishes the fiduciary principles of loyalty and honesty in its Code of Ethics.

Discussion

Fiduciary Standard of Care

The "prudent man rule" used in the PSF legislation has been adopted by decision or legislation in most American jurisdictions, often displacing the more restrictive, so-called "legal list" statutes.[32]

Some jurisdictions have adopted a different version of the "prudent man rule" which incorporates elements of the "prudent investor rule", which is articulated in the *Restatement of Trusts Third: Prudent Investor Rule*. This newer standard was incorporated into UMPERS and UPIA, and has also been adopted by most of the public employee retirement systems in the peer group of funds, and by the New Mexico State Council of Investment Funds. (See Table 1 below).

In some cases, the wording has been modified and the standard raised slightly. For example, the standard found in ERISA incorporates the following wording:

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and *familiar with such matters* would use in the conduct of an enterprise of a like character and with like aims"[Emphasis added]

Given the wording "familiar with such matters", the ERISA standard is considered generally stricter than the common law prudent person standard. The standard under ERISA for an average prudent person "is not that of a prudent lay person, but rather of a prudent fiduciary with

[31] Survey Results on Structure and Governance, Prepared for the Governor's Task Force on the Iowa Public Employees' Retirement System, 2001, Independent Fiduciary Services, Inc.
[32] American Law Institute's *Restatement of Trusts (3d): Prudent Investor Rule (1992)*, chapter 7, page 3.

experience dealing with a similar enterprises." [Whitfield v. Cohen, 682 F Supp 188, 194 (SDNY 1988)] This wording is also used in the UMPERSA model act, and in all the public employee retirement statutes that we reviewed.

Of the peer group, one fund has incorporated a lower standard, that of "ordinary business care and prudence". This standard was developed under *The Uniform Management of Institutional Funds Act*[33] (UMIFA), which was developed for use by endowment funds of colleges, universities, hospitals, religious organizations and other institutions of eleemosynary nature.[34] This "ordinary business care and prudence" standard is more comparable to a director of a corporation, rather than a trustee, and according to the UMIFA commentary was considered more appropriate for the board of a not-for-profit corporation. This standard can be found in section 163 of the Texas Property Code, which governs the management and administration of endowment funds in Texas.[35]

Table 1: Fiduciary Standards by Jurisdiction (Fund or Statute)

Standard	Fund / Legislation
Prudent person rule - *Harvard College v. Armory* (1830)	Texas Permanent School Fund Texas Growth Fund
"Prudent person" rule – UMPERSA model (1997)	Teacher Retirement System of Texas Colorado Public Employees Retirement System Missouri State Employees' Retirement System Virginia Retirement System New Jersey State Investment Council Washington State Investment Board Employees Retirement Income Security Act
"Ordinary business care and prudence" - UMIFA (1972)	Texas Property Code (Chapter 163)
"Prudent investor" rule (1992) - also found in UPIA model (1994)	New Mexico State Investment Council Texas Permanent University Fund[36]
"Institutional investor of ordinary prudence…" modification of *Harvard* standard	Alaska Permanent Fund

[33] National Conference of Commissioners on Uniform State Laws, 1972. UMIFA was developed for use by endowment funds of colleges, universities, hospitals, religious organizations and other institutions of eleemosynary nature.
[34] UMIFA, 1972, ibid, Commentary, p. 7.
[35] Texas Property Code, Title 10, Chapter 163: Management, Investment and Expenditure of Institutional Funds.
[36] The Texas PUF amended the constitution to incorporate the UPIA fiduciary standard; see section 11b of Article 7 of the Texas Constitution. The previous standard for the Texas PUF was the same as the one currently applicable to the SBOE.

Fiduciary Principles

As identified above, the Code of Ethics incorporates the fiduciary principles of loyalty and honesty. The enabling statutes of a number of the peer group incorporated several additional fiduciary principles, including the following:

1. The duty to act impartially, taking into account any differing interests of beneficiaries;
2. The duty to incur only costs that are appropriate and reasonable;
3. The duty to delegate with reasonable care, skill, and caution; and
4. The duty to diversify, unless prudent to do otherwise.

(See Table 2 for a survey of the fiduciary principles incorporated in various investment fund legislation.)

Many of the jurisdictions we reviewed did not clearly extend the fiduciary standards or principles to parties other than the governing body. Some notable exceptions include the following:

1. Texas Permanent University Fund – legislation explicitly subjects the board and investment managers to the fiduciary standards and principles found in that legislation.
2. Missouri State Employees' Retirement System – legislation provides a broad definition of "investment fiduciary", and sets out the fiduciary standards and principles by which investment fiduciaries must abide.[37]
3. New Mexico State Investment Council – legislation indicates that an agent, in performing a delegated function, owes a duty to the trust "to exercise reasonable care to comply with the terms of the delegation".

In the cases of New Mexico and New Jersey, both of which employ a State Investment Council to oversee the management of various State funds, the funds are managed by State officers and their staff. In each case, the State officer is considered a fiduciary of the fund or funds, and is subject to the fiduciary standards and principles of the applicable legislation. In both cases, the activities of the State Investment Officer are supervised by the State Investment Council.

[37] Pursuant to Missouri Revised Statute section 105.687(3), an "Investment fiduciary" is defined as a person who either exercises any discretionary authority or control in the investment of a public employee retirement system's assets or who renders for a fee advice for a public employment retirement system.

Table 2: Fiduciary Principles by Jurisdiction (Fund or Statute)

Board / State Office	Principle
Teacher Retirement System of Texas	Loyalty / best interests of beneficiaries Reasonable costs Prudent Delegation Diversification
Texas Permanent University Fund	Prudent delegation
Employees Retirement Income Security Act	Loyalty / best interests of beneficiaries Reasonable costs Diversification
Alaska Permanent Fund	Diversification Risk / return relationship
Colorado Public Employees Retirement System	Loyalty / best interests of beneficiaries Reasonable costs Diversification
Missouri State Employees' Retirement System	Reasonable costs Diversification Risk / return relationship
New Jersey State Investment Council	Loyalty / best interests of beneficiaries Risk / return relationship
New Mexico State Investment Council	Loyalty / best interests of beneficiaries Reasonable costs Prudent Delegation Diversification Impartiality
Virginia Retirement System	Loyalty / best interests of beneficiaries Diversification
Washington State Investment Board	Diversification Risk / return relationship

ISSUE #3: Would the application of the fiduciary principles and standards embedded in model acts such as the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) and the Uniform Prudent Investor Act (UPIA) enhance the management of the PSF?

Currently the SBOE is held to the standard of persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, and as if acting on their own account. Furthermore, the SBOE is held to the fiduciary principles of honesty and loyalty.

Although more modern adaptations of the prudent person rule are in use in other jurisdictions, we do not believe it is necessary to modify the SBOE prudence standard for the following two reasons:

1. The SBOE is a lay board that is also responsible for non-investment issues pertaining to education. The current standard would seem reasonable.
2. The fiduciary standard applicable to endowment funds generally in Texas, under chapter 163 of the Texas Property Code, is in fact a lower standard than the existing SBOE standard.
3. Changing the SBOE fiduciary standard would require a constitutional amendment, and we are not convinced that the benefits from a slightly higher standard would warrant such an amendment.

However, we do believe there would be benefit to incorporating additional applicable fiduciary principles directly into either the statute or the SBOE Rules. Such principles that could be applied to the SBOE include:

1. The duty to act impartially, taking into account any differing interests of beneficiaries;

2. The duty to incur only costs that are appropriate and reasonable; and

3. The duty to delegate with reasonable care, skill, and caution.

These principles are recognized in the model acts, in the *Restatement of Trusts Third: Prudent Investor Rule*, and for the most part in many of the statutes of the peer group. We believe that these principles are fundamental to the proper management of a public fund, would enhance the management of the PSF, and are particularly relevant to the PSF.

The principle of impartiality means that the fiduciaries must act impartially between different classes of beneficiaries in investing and managing the fund assets, taking into account any differing interests of the beneficiaries. In the context of an endowment fund, the fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of future purchasing power. It is an important concept in the case of an endowment fund, a fundamental goal of which is to achieve intergenerational equity.

The principle of incurring only costs that are appropriate and reasonable is also particularly important for a fund as large as the PSF with assets of approximately $17 billion. For a fund of this size, a cost savings of as little as 0.05% translates into a savings of $8.5 million. This would suggest prudent management of costs should be a primary consideration of the SBOE when dealing with issues such as active and passive management, HUB brokerage policy, and the selection of service providers.

The principle of prudent delegation requires the SBOE to exercise reasonable care, skill, and caution in delegating responsibility. It is an important principle for a board such as the SBOE, which is not required to have members possessing investment expertise. Accordingly, the SBOE must rely heavily on external experts or agents. Prudent selection and oversight of such experts is therefore an important criterion for success. Currently, delegation is allowed under §43.006 of the Education Code. We suggest that the above principles be incorporated in order to help guide the SBOE in the manner in delegating its authority.

We would recommend that the above fiduciary principles be incorporated either into the Texas Education Code (Chapter 43) or alternatively, the *PSF Investment Objectives, Policies and Guidelines*. However, it is not sufficient to simply incorporate the above principles into the PSF legislation. Unless the SBOE is provided continual and effective education designed to inform them of the standards and principles, and provided with the knowledge and background required to meet the additional principles and standards, the management of the PSF will be unaffected.

Service Providers

Subsection 33.5(a) of the *PSF Investment Objectives, Policies and Guidelines* indicates that anyone acting on behalf of the SBOE are subject to the provisions of the Code of Ethics, the Texas Constitution, the Texas statutes, and other applicable provisions governing the responsibilities of a fiduciary. The wording "The SBOE members or anyone acting on their behalf" would appear to include TEA staff, the custodian and money managers, but may not include investment consultants or investment advisors. We recommend that this section be expanded to include "anyone providing investment and management advice to the SBOE", so that it is clear that investment consultants and advisors are subject to the above mentioned legislation, policies and standards. Alternatively, this subsection could be written to apply to "PSF service providers" as defined in the subsection (c)(2) of the Code of Ethics.

Schedule 4

Fiduciary Principles in the Common Law

The following is a summary of the common law fiduciary principles that we found in case law, and in the leading authority texts on trust law:[38]

Duty of care and skill

The common law fiduciary standard of care for a trustee was established in an early American case, *Harvard College v. Armory*[39], in 1830, which established the following standard, known as the "prudent man rule":

> "[Trustees are] to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

A more modern restatement of this standard is found in *Scott on Trusts*, which describes the common law fiduciary standard on a trustee as follows:

> A trustee is under a duty in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property.[40]

Scott on Trusts describes another fiduciary principle whereby the trustee should use the caution exercised by a prudent man in conserving trust property. It goes on to say that the appropriate standard isn't that of a trustee managing his own property, but that of a trustee managing the property of others "in view of the preservation of the estate entrusted to him".[41] Scott on Trusts identifies this higher standard a "prudent trustee standard".

The other leading authority on trust law in the US is the American Law Institute's Restatement of Trusts (3d). It introduces a similar standard, that of the "prudent investor", wherein:

> "The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust."

[38] Including *Scott on Trusts* [full citation to be included] and *Restatement of Trusts (3d): Prudent Investor Rule (Restatement of Trusts (3d))*. *Scott on Trusts* and the *Restatement of Trusts (3d)* are leading authorities on trust law, and are often cited in trust case law.

[39] 26 Mass. (9 Pick.) 446 (1830).

[40] Scott on Trusts §174. Also see Morse v. Stanley, 732, F.2d 1139 (2d Cir. 1984), and Neuhaus v. Richards, 846 S.W.2d 70, 74 (Tex. App. Corpus Christi 1992), judgment set aside without reference to merits to effect settlement agreement, 871 S.W.2d 182 (Tex. 1994); Interfirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882, 888 (Tex. App.--Texarkana 1987, no writ).

[41] Estate of Weingart, 130 Cal. App. 3d 627, 182 Cal. Rptr. 369 (1982).

"(a) This standard requires the exercise of reasonable care, skill and caution…"[42]

There is also a principle in common law that if a trustee has greater skill or more facilities than those of the ordinary prudent person, he is under a duty to exercise the skill that he has and to employ the facilities that are available to him.[43] Case law also strongly supports the concept of the higher standard of care for the trustee representing itself to be an expert or professional.[44]

Duty of Loyalty

The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty. This duty is imposed on the trustee not because of any provision in the terms of the trust but because of the relationship that arises from the creation of the trust.[45]

It is also and established common law principles that anyone acting in a fiduciary relation shall not be permitted to make use of the relationship to benefit his own personal interest[46].

Duty to Preserve the Fund

The trustee has a duty to preserve and protect the property of the trust for the benefit of the beneficiary.[47]

Duty to Keep Accounts

A trustee is under a duty to the beneficiaries of the trust to keep clear and accurate accounts. His accounts should show what he has received and what he has expended. They should show what gains have accrued and what losses have been incurred on changes of investments.[48]

Duty to Consider the Entire Portfolio

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[42] Restatement of Trusts (3d): Prudent Investor Rule, § 227

[43] Citizens & S. Natl. Bank v. Haskins, 254 Ga. 131, 327 S.E.2d 192 (1995), citing the text; Dickerson v. Camden Trust Co., 140 N.J. Eq. 34, 53 A.2d 225 (147) (citing Restatement of Trusts §174), aff'd, 1 N.J. 459, 64 A.2d 214 (1949); Matter of Green Charitable Trust, 172 Mich. App. 298, 431 N.W.2d 492 (1988).

[44] UPIA, comment at p. 9; Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. At 48-49; Liberty Title & Trust Co. v. Plews, 142 N.J. Eq. 493, 60 A.2d 63 (1948), aff'd, 6 N.J. Super, 196, 70 A.2d 784, aff'd, 6 N.J. 28, 77 A.2d 219 (1950), noted in 16 U. Chi. L. Rev. 579.

[45] Scott on Trust, §170; Restatement of Trusts (3d), §170; Committee on Children's Television, Inc. v. General Foods Corp., 35 Cal. 3d 197, 673 P.2d 660, 197 Cal. Rptr. 783 (1983), citing Restatement (Second) of Trusts §170; Stern v. Lucy Webb Hayes Natl. Training School, 381 F. Supp. 1003 (D.D.C. 1974) (liability for self-dealing in the case of the trustees or directors of charitable institutions); InterFirst Bank Dallas, N.A. v Risser (1987, App Texarkana) 739 SW2d 882.

[46] Johnson v. Mansfield Hardwood Lumber Company, D.C. La. 159 F. Supp. 104, 118; Committee on Children's Television, Inc. v. General Foods Corp., 35 Cal. 3d 197, 673 P.2d 660, 197 Cal. Rptr. 783 (1983), citing Restatement (Second) of Trusts §170; Ahuna v. Department of Hawaiian Home Lands, 64 Hawaii Adv. Sh. 6420, 640 P. 2d 1161 (1982) (citing Restatement of Trusts 2d §170), Slay v Burnett Trust (1945) 143 Tex 621, 187 SW2d 377; InterFirst Bank Dallas, N.A. v Risser (1987, App Texarkana) 739 SW2d 882.

[47] First Nat. Bank v Sassine (1977, Tex Civ App Beaumont) 556 SW2d 116.

[48] Scott on Trusts, §172, Estate of McCabe, 98 Cal. App. 2d 503, 220, P.2d 64 (1950); Chopelas v. Chopelas, 294 Mass. 327, 1 N.E. 2d 374 (1936) (citing Restatement of Trusts §172).

In determining the propriety of the securities held by the trustee, it is important to consider the portfolio as a whole, and not merely each individual security.[49] However, we saw conflicting case law that stated that the risk of each investment in a portfolio must be measured in isolation. The trustee must exercise prudence in making each investment and is chargeable with any loss for failing to do so.[50]

Impartiality

It is the duty of the trustee to act impartially for all beneficiaries.[51]

The divergent economic interests of trust beneficiaries give rise to conflicts of types that cannot simply be prohibited or avoided in the investment decisions of typical trusts. These problems regularly present the trustee with problems of conflicting obligations. These conflicting fiduciary obligations result in a necessarily flexible and somewhat indefinite duty of impartiality. The duty requires the trustee to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner.[52]

In the context of an endowment fund, the fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of future purchasing power.

Diversification

The trustee should exercise prudence in diversifying investments so as to minimize the risk of large losses.[53] The requirement of diversification has not been recognized in all States[54], however it has been recognized in the Restatement of Trusts (3d) (§227).

In Texas case law, a trustee is under a duty to the beneficiary, unless provided otherwise by the terms of the trust, to distribute the risk of loss by reasonable diversification of investments unless, under the circumstances, it was prudent not to do so.[55]

A trustee is relieved of the duty to diversify if it is expressly so provides in the trust instrument.[56] Accordingly, it should be noted that under the Texas Trust Code, section 113.003 states that there is no duty to diversify: "a trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from the retention, any property that constitutes the initial trust corpus or that is added to the trust."

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[49] Scott on Trusts, §227.12
[50] Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc. 137 F.3d 313 (5th Cir., 1999)
[51] Scott on Trusts, §183; Restatement of Trusts (3d), §183; Brown v Scherck (1965, Tex Civ App Corpus Christi) 393 SW2d 172; Mississippi Valley Trust Co. V. Buder, 47 F.2d 507 (8th Cir., cert denied, 283 U.S. 854 (1931))
[52] Restatement of Trusts (3d), §227.
[53] Dickinson, Appellant, 152 Mass. 184, 25 N.E. 99, 9 L.R.A. 279 (1890).
[54] Scott on Trusts § 228
[55] Jewett v Capital Nat. Bank (1981, Tex Civ App Waco) 618 SW2d 109, writ ref n r e
[56] Scott on Trust, §230.3

Delegation

A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.[57]

The trustee is liable for the acts of an agent employed by him in the administration of the trust, if he did not use reasonable care in the selection or retention of the agent.[58]

[57] Restatement of Trusts (3d), §171
[58] Scott on Trust, §225.1, p. 417, Fry v. Tapson, 28 Ch. D. 268 (1884); Robinson v. Harkin, [1896] 2 Ch. 415; California Probate Code, §16401 (b)(3), enacted by Laws 1986, c. 820.

APPENDIX 9
THE ALASKA PERMANENT FUND

Individuals interested in the governance practices and structures of public endowment funds may wish to consider the Alaska Permanent Fund (APF). Below is a brief overview of the APF:

> The largest state sponsored endowment fund in the U.S. is the Alaska Permanent Fund, which held investments of $24.8 billion as of June 30, 2002. The Alaska Legislature created the Alaska Permanent Fund Corporation (APFC) in 1980 to manage the Alaska Permanent Fund's assets. The APFC operates as a quasi-independent state entity, intended to be insulated from political decisions yet accountable to the people as a whole.
>
> This establishment as a quasi-independent entity protects the Alaska Permanent Fund's focus on long-term performance by keeping it as removed as possible from short-term political considerations. While the legislature wanted the APFC to be independent, it also recognized the need for the APFC to be responsive to changes in state policy and be accountable to the people of Alaska through their elected representatives.
>
> This critical balance of independence and accountability is attained through the Board of Trustees (Board) and by close legislative oversight. The Board is comprised of six trustees. Four Trustees are public members who possess recognized competence and expertise in finance, investments and other business management-related fields. The four public members are appointed by the governor to staggered, four-year terms, and each year one of them is elected by the Board to serve as chair. The other two trustees include an ex-officio trustee, the Commissioner of Revenue, and another cabinet member chosen by the governor.
>
> To inject another level of checks and balances, the Legislature retains oversight authority over the Alaska Permanent Fund through its Legislative Budget and Audit Committee. The legislature also maintains budget control over APFC expenditures and has final decision over the eligible investment list.[59]

Cortex briefly considered the APF. We support some, though not all, of the practices and structures in place at the APF.

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[59] *An Alaskan's Guide to the Permanent Fund* dated November 2, 2001 and other APFC publications

Consistent with our analysis of the PSF, we support the following practices of the APF:

a) The APF has a traditional organizational structure in which the governing board has the authority to appoint an Executive Director.
b) The APF is required to have on its governing board individuals who possess relevant investment or related qualifications.

Consistent with our analysis of the PSF, we do not support the following practices of the APF:

a) The APF follows an income-based spending policy.
b) The APF does not fully subscribe to the prudent man rule. Instead the Legislature has final authority over the eligible investment list.

APPENDIX 10
DETAILED PLAN OF WORK

Section 3.4 of the Consultant Proposal Request Issued by the State Auditor's Office at the Inception of the Project

The proposal must include a plan of work that describes in detail the methodology to be employed by the Offeror to perform a Fiduciary Review of Key Governance and Investment Issues for the Permanent School Fund (PSF). The detailed plan of work must be consistent with the following Statement of Purpose and should follow the outline below, separately addressing each Task Area.

Statement of Purpose

The purpose of this Review is to determine (1) whether the PSF's investment practices follow sound fiduciary principles; and (2) whether the PSF's organizational structure and governance are designed in a manner that provides for the prudent, efficient, and ethical management of the PSF. The Review should convey a clear understanding of (1) those areas where the PSF's investment practices, organizational structure, and governance exceed, meet, or fall short of those of similar funds; and (2) areas where the PSF's investment practices, organizational structure, and governance can be improved. In assessing the PSF, the consultant should consider the actions taken, decisions made, or recommendations and input provided by any party associated with the PSF. However, this Review is not intended to be a conclusive investigation of any individual allegations or occurrences.

Task Area 1

Evaluate whether the state constitution, statutes, common law, and contractual provisions applicable to the management of the PSF clearly establish fiduciary principles and standards applicable to the SBOE, PSF staff, service providers, and others. Discuss how these fiduciary principles and standards compare to those governing other large public funds. Determine if the application of the fiduciary principles and standards embedded in model acts such as the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) and the Uniform Prudent Investor Act (UPIA) would enhance the management of the PSF.

Task Area 2

Compare the authority granted to the SBOE to manage the PSF with (1) the authority granted to the governing bodies of other large endowment funds; and (2) identified best practices. This includes but is not limited to: allowable investments, asset allocation, employment of external investment managers, budgeting, and setting spending policy. If the SBOE's existing authority does not allow the SBOE to optimize the management of the PSF, make recommendations to address any identified deficiencies.

Task Area 3

Review the governance and organizational structure of the PSF as established by the Texas Constitution, statutes, bylaws, regulations, and current practices. Assess whether and to what extent the duties of the SBOE and its committees are defined clearly, understood by all parties, and facilitate or impede the decision-making process. Among the items to consider are the following: (1) the degree of PSF staff accountability to the SBOE; (2) the SBOE's status as a lay board (e.g., no investment knowledge or experience required for membership); (3) the SBOE's access to the requisite level of investment expertise and information; (4) the extent of the SBOE's delegation to PSF staff or service providers; (5) the independence of the SBOE, PSF staff, and service providers from conflicts of interest, undue outside influences, and other possible impairments of judgment; and (6) the sufficiency of the SBOE's time to oversee complex investment and policy issues and to carry out its fiduciary duties. Compare and contrast the PSF's governance and organizational structure with identified best practices and those of other large public funds. If necessary make recommendations to address any identified deficiencies.

Task Area 4

Assess the adequacy of PSF's ethics and conflict of interest policies as regards all parties managing, advising, investing, or doing business with the PSF. Evaluate the parties' implementation of these policies. Compare and contrast to identified best practices and to similar policies at other large public funds. Analyze the costs and benefits of internal versus external asset management. This analysis should specifically include protecting the PSF and its governance structure from conflicts of interests arising from individuals and entities seeking to do business with the PSF.

Task Area 5

Based on identified sources of best practices and academic, federal, Texas, and other legal precepts, present a detailed exposition as to what, in the Offeror's professional opinion, constitutes generally accepted principles and standards of fiduciary conduct as regards managing investment matters in a public setting. Compare and contrast the SBOE's management process of the below listed investment matters against the principles and standards presented. Management process should be construed to include, but not be limited to, (1) making informed decisions based on objective information; (2) making decisions consistent with the interests of the PSF; (3) taking appropriate and timely actions to make and implement decisions; (4) monitoring adherence to, and the results of, previous decisions; and (5) ensuring that decisions are not subject to potentially deleterious influences.

A. Asset allocation

B. Portfolio rebalancing

C. Evaluation, selection, monitoring, and retention of investment managers, advisors, and consultants

D. Allocation between internal and external investment management

E. Use of active versus passive investment styles

F. Transaction cost minimization

G. Securities lending

H. Soft dollars

I. Policies for investment initiatives such as historically underutilized business (HUB) and emerging manager

Task Area 6

Analyze the PSF's ability to maintain inflation-adjusted and per-capita-adjusted spending over the past ten years. Address any necessary steps designed to maximize the likelihood of maintaining or increasing inflation and per-capita- adjusted spending over the next ten years.

Task Area 7

Evaluate the appropriateness and accuracy of the PSF's income projection model.

Exclusion from Scope

The actions and conduct of the School Land Board's management of the real property and mineral rights belonging to the PSF is excluded from the Review's scope. However, the School Land Board's role within the PSF's governance and organizational structure should be addressed.

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