November 5, 2003

Members of the Legislative Audit Committee:

The State Auditor’s Office reviewed the proposed changes to the Permanent School Fund’s ethics rules that the State Board of Education (Board) approved at its September 12, 2003, meeting. The Board will vote on whether to adopt the proposed changes at its meeting that takes place on November 7, 2003. Texas Education Code, Section 43.0031(c), requires the Board to provide us with a copy of any proposed revisions for our comment. Section 43.0031(c) further requires the Board to consider our comments, which we provided to the Board on October 24, 2003.

Our review shows that the proposed Board action excludes certain requirements of Senate Bill 1059 (78th Legislature, Regular Session) and that the proposed changes need to be more specific in order to implement Senate Bill 1059. Senate Bill 1059, effective September 1, 2003, requires that the governing bodies of state investing entities adopt ethics and specified disclosure rules for outside financial advisors or service providers.

If you have any questions regarding our comments, please contact Carol Smith at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment
State Auditor’s Comments on Proposed Changes to the State Board of Education’s Permanent School Fund Ethics Rules

Senate Bill 1059 (SB 1059), 78th Legislature, Regular Session, which became effective on September 1, 2003, requires that the governing bodies of state investing entities adopt ethics and specified disclosure rules for outside financial advisors or service providers. In mid-September, the State Board of Education (Board) adopted a proposed change to the Permanent School Fund’s (PSF) ethics rules to address the requirements of SB 1059. However, the State Auditor’s Office’s (SAO) review of the proposed rule shows that the Board excluded certain requirements of SB 1059 and that the proposed changes need to be more specific in order to implement SB 1059. In addition, the Board did not take advantage of its opportunity to address previous comments regarding the PSF’s ethics rule that were suggested by the SAO, the Texas Ethics Commission, and Cortex (author of a recent fiduciary review of the PSF).

The Texas Education Code, Section 43.0031(c), requires that the State Board of Education submit any amendments or revisions of the PSF ethics rules to the Texas Ethics Commission and the State Auditor’s Office for review and comment. The Education Code also requires the Board to consider any comments from the Texas Ethics Commission or the State Auditor’s Office before adopting changes to the PSF ethics rules.

The Board’s proposed action excluded certain requirements of SB 1059. On September 12, 2003, Texas Education Agency (TEA) staff presented to the Board a proposed rule intended to implement the requirements of SB 1059. Before the Board adopted the proposed rule, it deleted proposed TEA staff language that would have addressed some statutory provisions that define the persons or entities subject to the requirements of SB 1059. Because SB 1059 does not authorize the Board to alter the law’s provisions, we conclude that the Board’s amended rule does not meet the law’s requirements. We suggest that the Board ensure that its rules are consistent with all of the requirements of SB 1059.

As a result of the Board’s deletions, its rule covers fewer people and entities than are prescribed by SB 1059. SB 1059 extends coverage to anyone who provides “important investment or funds management advice to the entity or a member of the governing body of the entity, as determined by the governing body” (such as informal advisors who may be advising individual Board members or Investment Advisory Committee members) or who receives more than $10,000 a year in compensation from the Board or from TEA. However, the Board’s adopted rule applies only to financial service providers who receive more than $10,000 a year in compensation. Specifically, the Board deleted the following bolded portions of TEA staff’s proposed rule:

Proposed Rule to Implement SB 1059

(s) Statutory Statement.

(1) A “statutory financial advisor or service provider” as defined below shall on or before April 15 file a statement as required by Texas Government Code § 2263.005, with the commissioner of education and the state auditor, for the previous calendar year. The statement will be deemed filed when it is actually received. A statutory financial advisor or service provider shall promptly file a new or amended statement with the commissioner of education and the state auditor whenever there is new information required to be reported under Texas Government Code § 2263.005(a).
A “statutory financial advisor or service provider” is an individual or business entity, including a financial advisor, financial consultant, money or investment manager, or broker, who is not an employee of TEA, but who provides financial services to the TEA or the SBOE in connection with the management and investment of the PSF, or advice to the TEA or the SBOE or an SBOE Member in connection with the management or investment of the PSF, and who:

(a) may reasonably be expected to receive, directly or indirectly, more than $10,000 in compensation from the TEA or the SBOE during a fiscal year; or

(b) may render important investment or funds management advice to the TEA or the SBOE or an SBOE Member. “Important investment or funds management advice” means advice that is provided by an individual who has been given information or has been asked to consult as specified in subsection (c)(2)(D) and the advice provided to the SBOE Member concerns the information provided or the consultation which occurred.

An annual statement required to be filed under this subsection will be made using the form developed by the state auditor.

Furthermore, the TEA staff’s proposed language and the proposed rule adopted by the Board did not address SB 1059’s requirement, set forth in Section 2263.004 “Ethics Requirements for Outside Financial Advisors or Service Providers,” that the governing body by rule shall adopt standards of conduct applicable to financial advisors or service providers. While the PSF already has a body of ethics rules, the existing rules do not apply to brokers. Because SB 1059 clearly states that the definition of “financial advisor or service provider” includes brokers, we conclude that SB 1059 requires the Board to adopt standards of conduct that specifically apply ethics requirements to all brokers who meet the definition of “financial advisors or service providers.”

The Board’s proposed rule needs to be more specific in order to implement SB 1059 effectively. The Board’s proposed rule states that “An annual statement required to be filed under this subsection will be made using the form developed by the state auditor.” SB 1059 directs the SAO to develop and recommend a uniform disclosure form. The SAO developed a recommended form that may be applicable to as many as 160 governmental entities. Because these 160 entities differ widely in their circumstances (such as sizes of funds, types of investments, and methods of management), the SAO’s recommended form is general in nature. To maximize the form’s usefulness and to avoid undue administrative and compliance burdens, each entity’s governing board may need to customize the form or provide to the expected respondents explanatory rules to reflect how that entity conducts its business. We suggest that the Board consider customizing the disclosure form or providing explanatory rules to reflect the PSF’s circumstances.

Additionally, the Board may need to clearly designate to whom the requirements of SB 1059 apply. The Board’s proposed rule follows the law’s text and does not provide clear guidance as to who is or is not covered. SB 1059’s definition of covered “financial advisors or service providers” is broad—it states that “financial advisor or service provider includes a person or business entity who acts as a financial advisor,
financial consultant, money or investment manager, or broker.” The law’s use of the word “includes” indicates that the term could apply to people and entities that are not specifically listed.¹

For example, the Board’s amended rule does not appear to apply to members of the PSF’s Investment Advisory Committee. It is also unclear as to whether “brokers” includes those hired by the PSF’s external investment managers or whether the term applies only to brokers directly hired by TEA staff. We suggest that the Board consider specifying to whom the adopted rule will apply.

The Board did not address comments by the SAO, the Texas Ethics Commission, or Cortex. At the Board’s September 11, 2003, Committee of the Whole meeting, TEA staff provided the Board with a rule change document that addressed the requirements of SB 1059 and comments previously made by the SAO, the Texas Ethics Commission, and Cortex (author of a recent fiduciary review of the PSF).

The Board voted not to consider the TEA staff document and directed TEA staff to revise the document to include only statutorily required amendments. This was defined to mean consideration of requirements set forth in SB 1059 only. We suggest that the Board address the comments made by the SAO, the Texas Ethics Commission, and Cortex.

¹ See Govt. Code 311.005(13)