



KEN PAXTON
ATTORNEY GENERAL OF TEXAS

October 15, 2018

The Honorable Dan Flynn
Chair, Committee on Pensions
Texas House of Representatives
Post Office Box 2910
Austin, Texas 78768-2910

Opinion No. KP-0220

Re: Whether the Teacher Retirement System
may invest in indexed universal life insurance
policies funded by leveraged premiums
(RQ-0221-KP)

Dear Representative Flynn:

You ask whether a particular type of life insurance policy “constitute[s] a prudent investment” for the Teacher Retirement System (the “System”) to make.¹ The Legislature established the System “to provide benefits for persons employed in the public schools, colleges, and universities” supported by the State. TEX. CONST. art. XVI, § 67(b)(1). The System holds the assets appropriated or dedicated to it “in trust for the benefit of members,” which assets “may not be diverted.” *Id.* § 67(a)(1); *see also* TEX. GOV’T CODE § 802.201. The Texas Constitution stipulates that the System’s trustees must “administer the system and . . . invest the funds of the system in such *securities* as the board may consider prudent investments.” TEX. CONST. art. XVI, § 67(a)(3) (emphasis added). As it makes investments, the System must

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 therefrom as well as the probable safety of their capital.

Id. The System’s investment decisions are additionally subject to the standard in section 117.004(b) of the Property Code, which states that any “investment . . . decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.” TEX. PROP. CODE § 117.004(b); *see also* TEX. GOV’T CODE § 825.301(a) (defining the System’s investment discretion by reference to section 117.004(b) of the Property Code). Thus, an investment in a particular asset by System trustees must (1) constitute a “security”; and (2) meet the standards for prudence and overall strategy in the Texas Constitution and statutes.

¹Letter from Honorable Dan Flynn, Chair, House Comm. on Pensions, to Honorable Ken Paxton, Tex. Att’y Gen. at 1 (Apr. 11, 2018), <https://www.texasattorneygeneral.gov/opinion/requests-for-opinion-rqs> (“Request Letter”).

You ask about the System investing in indexed universal life insurance policies funded by leveraged premiums and optimized for cash accumulation. *See* Request Letter at 1. Indexed universal life insurance is a type of permanent life insurance with a cash value or savings component.² Generally speaking, the growth in the value of the policy is linked to the performance of an external market index such as the Standard & Poor's 500.³ However, such products are complex and nuanced, and the structure of any particular policy can vary depending on the individual choices made by a policyholder and the manner in which an insurance carrier credits the gain in the index to the policy.⁴ Accordingly, we can advise you only in general terms regarding the analysis a court would undertake in examining your question.

For purposes of the System trustees' investment authority under article XVI, section 67 of the constitution, a security "includes any investment instrument within the meaning of the term as defined by" a specified section in one of three statutory sources: (1) the Texas Securities Act; (2) the federal Securities Act of 1933; or (3) the federal Securities Exchange Act of 1934. TEX. GOV'T CODE § 825.301(a).⁵ The Texas Securities Act defines "security" or "securities" to

include any limited partner interest in a limited partnership, share, stock, treasury stock, stock certificate under a voting trust agreement, collateral trust certificate, equipment trust certificate, preorganization certificate or receipt, subscription or reorganization certificate, note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title, or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not.

²See TEX. DEP'T OF INS., UNDERSTANDING LIFE INS., <http://www.tdi.texas.gov/pubs/consumer/cb018.html>.

³See U.S. DEP'T OF TREASURY, FED. INS. OFFICE, ANNUAL REPORT ON THE INS. INDUS. 54 (Sept. 2015), https://www.treasury.gov/initiatives/fio/reports-and-notice/2015%20FIO%20Annual%20Report_Final.pdf.

⁴See Stephanie Powers, *Indexed Universal Life Ins.* (Dec. 21, 2017), <https://www.investopedia.com/articles/insurance/09/indexed-universal-life-insurance.asp>.

⁵This office previously issued Opinion No. JC-0043, which concluded that in the absence of state law defining the term, "securities" in article XVI, section 67 meant the authorized investments set out in chapter 8 of the Business and Commerce Code, and not those investments deemed "securities" under the Texas Securities Act, the federal Securities Act of 1933, or the federal Securities Exchange Act of 1934. *See* Tex. Att'y Gen. Op. No. JC-0043 (1999) at 13 (overruling earlier opinions that concluded otherwise). The Legislature later amended section 825.301(a) of the Government Code to define "securities" for purposes of article XVI, section 67 with reference to those statutes. *See* Act of May 30, 1999, 76th Leg., R.S., ch. 1540, § 17, 1999 Tex. Gen. Laws 5282, 5287 (codified at TEX. GOV'T CODE § 825.301(a)). Accordingly, Opinion No. JC-0043 is superseded to the extent it is inconsistent with section 825.301(a) of the Government Code or any other provision of state law.

TEX. REV. CIV. STAT. art. 581-4(A). This provision, however, expressly excludes insurance policies. *See id.* (“[T]his definition shall not apply to *any insurance policy* . . . issued by an insurance company subject to the supervision or control of the Texas Department of Insurance” and duly filed with that agency as required by law. (emphasis added)). Next, under the federal Securities Act of 1933, a “security”

means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1). Finally, the federal Securities and Exchange Act of 1934 defines “security” to mean

any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Id. § 78c(a)(10). Thus, while the Texas Securities Act excludes insurance policies on its face, if the investment in question meets the definition of “security” found in either the federal Securities

Act of 1933 or the federal Securities Exchange Act of 1944, the investment is a “security” for purposes of the System’s constitutional investment authority.

In addition to referencing these statutory provisions, the Legislature also defined the meaning of “security” for purposes of the System’s investment authority to include a “derivative instrument” and “any other instrument commonly used by institutional investors to manage institutional investment portfolios.” TEX. GOV’T CODE § 825.301(a). A derivative instrument is “a contract whose value is based on the performance of an underlying financial asset, index, or other investment.” BARRON’S DICTIONARY OF FINANCIAL & INVESTMENT TERMS 182 (8th ed. 2010); *see also* BLACK’S LAW DICTIONARY 538 (10th ed. 2014) (defining a derivative instrument as a “financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity”); TEX. INS. CODE §§ 424.201(7), 425.125(7) (defining “derivative instrument” in the context of authorized risk control transactions for insurers). The Legislature’s broad reference to “any other instrument commonly used” for institutional investments could encompass a wide variety of financial instruments, depending on the current investment practices of institutional investors.

Whether an indexed universal life insurance policy is a “security,” either for purposes of the federal Securities Act of 1933 or Securities Exchange Act of 1934, or as a derivative instrument or an instrument commonly used to manage institutional investment portfolios, will depend on the structure of the product and other fact-based inquiries that this office cannot undertake in the opinion process. *See* Tex. Att’y Gen. Op. No. KP-0178 (2018) at 3 (“this office does not resolve questions of fact in the opinion process”). Briefing received from the System likewise notes that when an investment involves something other than registered or exchange traded instruments, which are clearly securities, the “analysis depends on the facts and circumstances of each instrument.”⁶

Assuming a particular investment is a “security,” the constitution’s requirement that investments be considered prudent vests discretion squarely with the trustees of the System. TEX. CONST. art. XVI, § 67(a)(3) (“Each statewide benefit system must have a board of trustees . . . to invest the funds of the system in such securities as *the board* may consider prudent investments.” (emphasis added)). Only the trustees can make a prudence determination, as they are in the best position to know and consider the factors the Legislature specified, such as the probable income from the investment, the probable safety of the investment capital, the context of the trust portfolio as a whole, the overall investment strategy, and whether the risk and return objectives are reasonably suited to the trust. *See id.*; *see also* TEX. GOV’T CODE § 825.301(a); TEX. PROP. CODE § 117.004(b).

In summary, whether the System may invest in an indexed universal life insurance product depends on whether the product (1) constitutes a “security”; and (2) meets the standards for prudence and overall strategy set forth in article XVI, section 67(a)(3) of the Texas Constitution and section 825.301(a) of the Government Code, which determinations cannot be made in the opinion process.

⁶Brief from Brian K. Guthrie, Exec. Dir., Tex. Teacher Ret. Sys. at 2 (May 16, 2018) (on file with Op. Comm.).

S U M M A R Y

Whether the Teacher Retirement System may invest its assets in an indexed universal life insurance product depends on whether the product (1) constitutes a "security"; and (2) meets the standards for prudence and overall strategy set forth in article XVI, section 67(a)(3) of the Texas Constitution and section 825.301(a) of the Government Code. Each of these factors require factual determinations beyond the scope of an attorney general opinion.

Very truly yours,

A handwritten signature in black ink that reads "Ken Paxton". The signature is written in a cursive, flowing style.

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