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State Board of Education

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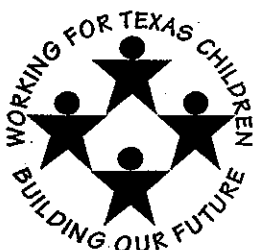
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November 4, 2008

Honorable Greg Abbott
Texas Attorney General
Post Office Box 12548
Austin, Texas 78711-2548

FILE # ML-45897-08
I.D. # 45897

RQ-0758-GA

RE: Attorney General Opinion Request

Dear General Abbott:

I am writing to seek your guidance as to the implementation of Article VII, Subsection 5(a)(2) of the Texas Constitution ("Subsection 5(a)(2)"). That provision may limit current or future transfers from the Permanent School Fund ("PSF") to the Available School Fund ("ASF"). Because of the immediate need for the State Board of Education ("SBOE") to exercise its constitutional role to effect that transfer, and the proximity of the 2009 legislative session that would appropriate the ASF to support public education, I would ask that you expedite this request.

As you know, the PSF is a constitutionally-dedicated endowment for the support of public education¹. Subsection (a) provides for a process by which a portion of the investment assets of the PSF are biennially transferred to the ASF:

Sec. 5. PERMANENT SCHOOL FUND; AVAILABLE SCHOOL FUND; USE OF FUNDS; DISTRIBUTION OF AVAILABLE SCHOOL FUND. (a) The permanent school fund consists of all land appropriated for public schools by this constitution or the other laws of this state, other properties belonging to the permanent school fund, and all revenue derived from the land or other properties. The available school fund consists of the distributions made to it from the total return on all investment assets of the permanent school fund, the taxes authorized by this constitution or general law to be part of the available school fund, and appropriations made to the available school fund by the legislature. The total amount distributed from the permanent school fund to the available school fund:

(1) in each year of a state fiscal biennium must be an amount that is not more than six percent of the average of the market value of the permanent school fund, excluding real property belonging to the fund that is managed, sold, or acquired under Section 4 of this article, on the last day of each of the 16 state fiscal quarters preceding the regular session of the legislature that begins before that state fiscal biennium, in accordance with the rate adopted by:

¹ Your office has previously addressed others aspects of Article VII, Section 5 following its 2003 amendment in Attorney General Opinions GA-0617 (2008), GA-0516 (2007) and GA-0293 (2005).

- (A) a vote of two-thirds of the total membership of the State Board of Education, taken before the regular session of the legislature convenes; or
 - (B) the legislature by general law or appropriation, if the State Board of Education does not adopt a rate as provided by Paragraph (A) of this subdivision; and
- (2) over the 10-year period consisting of the current state fiscal year and the nine preceding state fiscal years may not exceed the total return on all investment assets of the permanent school fund over the same 10-year period.

My questions involve the application of Subsection 5(a)(2) in light of the recent dramatic declines in the financial markets. Because of that decline², it is possible that a distribution from the PSF to the ASF could exceed the total return on all investments of the PSF over the relevant 10-year period.

My first question deals with the calculation of "total return on all investment assets of the permanent school fund" as that term is used in Subsection 5(a)(2)³. We have understood the term "investment assets" to mean all of the PSF assets under the management of the SBOE, exclusive of assets managed by the General Land Office pursuant to Article VII, Section 4 ("GLO land")⁴. We have calculated "total return" of the investment assets as the net appreciation or decline in value, plus income (including interest, dividends and income from securities lending and litigation awards). Performance measurement is calculated by a third party vendor, the Fund's custodian bank, and is compliant with the Global Investment Performance Standards (GIPS)⁵. Please note that for purposes of this calculation, transfers from the General Land Office of funds representing the "proceeds" from the sale of GLO land or income generated by GLO land are not treated as income for purposes of the calculation of total return because they do not at that point represent a return on "investment assets". Any subsequent returns on funds after being transferred in that manner would of course be considered part of the total return of the investment assets. Subject to your answer to my second question, please confirm that this methodology is appropriate for purposes of Section 5(a)(2).

My second question is whether the total return should be reduced either by 1) investment management fees or 2) total administration expenses such that the total return is presented on a net of cost basis. Article VII, Section 5(b) provides for "the expenses of managing [PSF] land and investments" to be paid from the PSF. Neither of

² The PSF additionally experienced declines during the period from 2000 through 2003 that are within the 10-year period and thus currently part of the relevant calculation.

³ Total return as used in the investment industry includes all aspects of an investment's gain or loss. Bloomberg Financial defines total return as "an investment's current cash flow combined with its ultimate gains or losses." Forbes' Investopedia states that total return is "the actual rate of return of an investment or a pool of investments over a given evaluation period. Total return includes interest, capital gains, dividends and distributions realized over a given period of time."

⁴ See, Attorney General Opinion GA-0516 (2007): "Investment assets' with respect to which the ASF distribution is calculated and generally addressed by article VII, section 5 are thus assets subject to the investment control and management of the Board".

⁵ The GIPS standards are created and administered by the CFA Institute, a not-for-profit association of investment professionals.

those expenses are currently included in the calculation of "total return". Please also clarify whether expenses associated with GLO lands and not the investment assets are properly included in that calculation.

My third question is when the limit expressed in Subsection 5(a)(2) should be applied to a transfer from the PSF to the ASF. The SBOE met in November, 2006 and determined to transfer 3.5% of the preceding 16 quarter market value of the PSF investment assets for the 2008-2009 state fiscal biennium, pursuant to Subsection 5(a)(1) of the Texas Constitution. At that time, the total return on the investment assets (based on fiscal years-ending August 31, 1997 through August 31, 2006) greatly exceeded the amount that had been distributed in the preceding nine state fiscal years and would be distributed during the 2008 state fiscal year based on that percentage of market value. Transfers from the PSF to the ASF are made monthly through the biennium⁶.

Please assume that for purposes of this question a distribution in accordance with the SBOE percentage determined in November of 2006 would exceed the total return on investment assets. Section 5(a)(2) limits transfers based on a total return calculated for the "*current* state fiscal year and the nine preceding state fiscal years" (emphasis added) and appears to require consideration of payments during a fiscal year. That provision could be read to require each monthly transfer from the PSF to the ASF to be tested against the Subsection 5(a)(2) limit on an ongoing basis through the fiscal year. An alternative reading would be to test transfers at the end of each fiscal year, or only at the point at which the SBOE sets the percentage to be transferred to the ASF before each state fiscal biennium. At what point (or points) in time should the limit in Section 5(a)(2) be applied?

My fourth question is what actions would be necessary should it be determined that a transfer of funds from the PSF to the ASF exceeded the limit set in Subsection 5(a)(2) during any fiscal year, or that less than the required amount of funds had been transferred. Article VII, Section 5(c) of the Texas Constitution prohibits appropriation of the PSF for any purpose not authorized by that section⁷. Conversely, Section 43.002 of the Education Code requires a transfer of one-twelfth of the annual distribution from the PSF to the ASF on the first day of each month. A determination of the total return of the PSF can not be made on a monthly basis sooner than roughly the end of the following month and annual audited figures are not available until several months following the end of the state fiscal year. If it were determined after the relevant month or fiscal year-end that either an amount in excess of that allowed under Subsection 5(a)(2) had been transferred, or that too little had been transferred due to preliminary calculations under that section, would the Texas Constitution require repayment from or additional transfers to the ASF? Could such an additional repayment or transfer be made in a subsequent fiscal year?

My last question is whether Subsection 5(a)(2) limits the ability of the SBOE to determine a percentage of the PSF to transfer on a biennial basis. We have understood the percentage determination under Subsection 5(a)(1) to be a separate process from the limit expressed in Subsection 5(a)(2). That appears consistent with the different

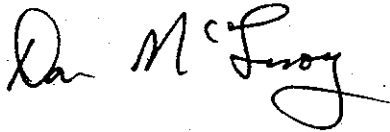
⁶ See, Section 43.002, Texas Education Code.

⁷ I.e., the ASF transfer, expenses of managing the PSF and any payments required by virtue of the bond guarantee program authorized by Section 5(d).

periods on which the two subsections are based⁸, as well as the limited ability of the SBOE to determine whether Subsection 5(a)(2) would be triggered during the following two fiscal years when they are required to set a percentage distribution. Please confirm that the SBOE may adopt a percentage distribution even if Subsection 5(a)(2) would preclude all or part of that distribution based on information available at the time the SBOE acts.

Thank you for your consideration of this request. Should you need any additional information, please feel free to contact me or David Anderson, TEA General Counsel, at (512) 463-9720.

Sincerely,

A handwritten signature in black ink that reads "Don McLeroy". The signature is written in a cursive style with a large, stylized "D" and "M".

Don McLeroy, Chair
State Board of Education

cc: SBOE Members

⁸ The SBOE is directed to base the percentage determination on "the 16 state fiscal quarters preceding the regular session of the legislature" while Subsection 5(a)(2) is based on the "current state fiscal year and the nine preceding state fiscal years".