APPENDIX E

Key Legislative History Material

Ch. 141 SLA 1988 (HB 547)

WILLKIE FARR & GALLAGHER

New York
Washington, DC
London
Paris

M E M O R A N D U M

TO: State of Alaska Department of Revenue

FROM: Willkie Farr & Gallagher

RE: Legislative Proposals Regarding Commissioner of Revenue's Investment Powers and Duties

DATED: March 1, 1988

Introduction

This Memorandum responds to the request of the State of Alaska Department of Revenue for an examination of the legal issues relevant to, and the rationale for, proposed changes in the statutory framework currently governing investments made with the monies of certain public funds established by the State of Alaska (the "Funds"). Included among the Funds are: the State of Alaska General Investment Fund, the Public Employees' Retirement Fund, the Teachers' Retirement Fund, the Judicial Retirement Fund, the Alaska National Guard and Alaska Naval Militia Retirement Fund, the Public School Fund and the University of Alaska Fund.

Under current law, the Commissioner of Revenue of the State (the "Commissioner") has the general authority to invest all State monies under Alaska Stat. § 44.25.010 and Alaska

One Citicorp Center
153 East 53rd Street
New York, NY 10022-4669
212 935 8000

Telex: RCA 233780
RCA 238805
WU 12 7679
Fax: 212 752 2991.

Stat. § 44.25.020(2), and has either the primary or secondary authority to invest all monies deposited or held in the Funds and to safekeep the assets of the Funds under a number of other specific statutory provisions. The Commissioner's investment authority is limited by statute as to types of investments that may be held by a Fund and, in some instances, as to the maximum percentage or dollar amount of Fund assets that may be invested in particular instruments. Supplementing these limitations is a general statutory obligation imposed on the Commissioner, when investing on behalf of all of the Funds, to act prudently by exercising the judgment and care of an institutional investor managing large investments under a trust relationship.

The Commissioner has found that the current statutory framework governing the investment of the Funds' monies restricts the Commissioner's ability to invest effectively on behalf of the Funds. The various statutory limitations have, in the view of the Commissioner, served in many instances to reduce investment returns, impede the Commissioner's ability to invest in a manner appropriate to the purposes of the Funds, and limit the adaptability of the investment policies followed by the Funds to changing markets and newly developing instruments and techniques.

In an attempt to address the problems raised by current investment provisions, the Commissioner has prepared a set of legislative proposals (the "Bill") that, if adopted, would make fundamental changes to those provisions. The Bill seeks, among other things (1) to clarify the legal status of certain of the Funds, (2) to clarify the legal relationship of the Commissioner to certain of the Funds, (3) to repeal the limitations on the types and amounts of investments that may be made by the Funds, and restate and amplify the rule of prudence applicable to the Commissioner, (4) to authorize the Commissioner expressly to delegate investment, custodial and depository responsibilities with respect to certain of the Funds to officers or employees of the State or to independent firms, banks or trust companies, and (5) to establish reporting and statutory auditing requirements applicable to the Funds. The Commissioner has also presented a proposal separate from the Bill providing for the establishment of an independent trust company that would assume the responsibility for the custody of the assets and the management of the investments of certain of the Funds.

The first section of the discussion that follows sets out the legal background of each of the Bill proposals described above. Section II discusses certain issues related to the Bill proposals, but not covered by the express terms of the proposals. Finally, Section III discusses the independent trust company proposal.

Discussion

Section I: Background of the Proposals

A. Establishment and Designation of Certain Funds as Trusts

Current Alaska statutory law creates systems for the payment of retirement, disability and death benefits for the teachers (the "Teachers' Retirement System"),[1] judges (the "Judicial Retirement System"),[2] military personnel (the "Military Retirement System")[3] and other employees (the "Public Employees' Retirement System")[4] of the State of Alaska (collectively, the "Retirement Systems") and authorizes and requires the Alaska Commissioner of Administration to take certain actions for the administration of each of these Systems, including maintenance of accounts for the System and preparation of periodic reports.[5] The statutes also designate the Commissioner of Revenue as Treasurer of the Retirement Systems and assign the responsibility for investing and safekeeping the assets of the Retirement Systems to the Commissioner, thereby implicitly making him sole fiduciary for the funds of the Retirement Systems. Current statutes governing the Retirement Systems do not, however, require that the assets maintained in these Systems be segregated from other public

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1 Alaska Stat. § 14.25.010 (1987).

2 Alaska Stat. § 22.25.010 (1982).

3 Alaska Stat. § 26.05.222 (1986).

4 Alaska Stat. § 39.35.010 (1987).

5 Alaska Stat. § 14.25.030 (1987), § 22.25.025 (1982). (general delegation of responsibility for administration of the system; no delegation of specific duties). § 26.05.228 (1986), § 39.35.060 (1987).

monies.[6] Current statutory law also creates a "separate fund" in which all money derived from the sale or lease of certain public lands, and all monetary gifts made to the University of Alaska for the purpose of the fund, are to be held "in trust" (the "University of Alaska Fund")[7] and establishes "as a separate fund the public school fund" the income of which "may not be appropriated for a purpose other than for the support of public education programs" (the "Public School Fund")[8] (collectively, the "Endowment Funds").

The Bill proposes to amend the statutes governing the Retirement Systems to expressly require the establishment of a "Teachers' Retirement Trust Fund," a "Judicial Retirement Trust Fund," a "Military Retirement Trust Fund" and a "Public Employees' Retirement Trust Fund" (collectively, the "Retirement Funds") in which "the assets of the [relevant] system shall be deposited and held."[9] The Bill also proposes specifically to designate the University of Alaska Fund as an

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6 Alaska Stat. § 22.25.048(a) and § 26.05.228(a) require the Commissioner of Administration to establish "funds" for the Judicial Retirement System and the Military Retirement System and to maintain accounts and records for the Systems, but do not prohibit the commingling of other monies with the assets of the Systems within these funds.

7 Alaska Stat. § 14.40.400(a) (1987).

8 Alaska Stat. §§ 37.14.110(a), 37.14.140 (1983).

9 Sections 3, 16, 18 and 35, respectively, of the Bill.

"endowment trust" fund and to establish the Public School Fund as a "separate endowment trust" fund.[10]

(1) <u>The Retirement Funds</u>

Without the creation of separate funds for the assets of the Retirement Systems and the designation of these funds as trusts, the Commissioner has no clear mandate for the manner in which the assets of these Systems are to be held. In the event that these assets are commingled with other monies and/or appropriated for a purpose other than for the benefit of the beneficiaries of the Retirement Systems, resulting in a loss to these beneficiaries, the basis for recovery against the Commissioner, therefore, is correspondingly unclear.[11]

Designating the Retirement Funds as trusts addresses a problem that has historically characterized public plans in the United States. In a 1978 task force report on the operation of public employee retirement systems in the United States (the

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10 Sections 10 and 26, respectively, of the Bill.

11 Staff of the House Comm. on Education and Labor, 95th Cong., 2d Sess., Task Force Report on Public Employee Retirement Systems 197 (Comm. Print 1978) [hereinafter cited as the "Task Force Report"] (the absence of clear statutory fiduciary standards for public pension trustees often results in the ripening of conflicts of interest into clear examples of fiduciary abuse); Leibig & Kalman, <u>How Much Federal Regulation do Public Funds Need?</u>, Pension World, August 1978 at 25 (traditional fiduciary obligations are difficult to enforce where no specific "fund" is involved nor an explicit declaration of trust with respect to fund assets).

"Task Force Report"),[12] Congress noted that, although the nature of the responsibility vested in those who have control over and direct the investment of public plan assets dictates that these persons be held to the high standards of behavior normally reserved to those in a fiduciary relationship, such as a trustee to a trust, state and local government retirement systems rarely create a clear fiduciary relationship or impose on these persons clear standards for behavior. The report states that:

> The substance of the standard of conduct to which plan trustees and fiduciaries with plan management and investment responsibilities are subject is. . .seldom set forth with any clarity. Thus, even when it is perceived that a trustee's conduct or an investment manager's performance has been unsatisfactory, or even irresponsible and highly imprudent, the absence of a codified, substantive standard of conduct to which the fiduciary can be held frequently precludes recovery by the plan or its aggrieved participants. A review of well-known public plan 'abuses' demonstrates that the erring plan fiduciary is seldom held liable to the plan for the damages the fiduciary's irresponsible actions

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12 The Task Force Report was undertaken in accordance with a requirement contained in the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). ERISA, which regulates the conduct of private employee benefit plans in the United States, was originally intended to include public pension plans within its scope. Prior to enactment, however, ERISA's scope was narrowed to private pension plans because of the unavailability of information regarding public plans generally and questions regarding the constitutionality of federally regulating state and local pension plans. Task Force Report at 1; Note, Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions, 4 Yale L. & Pol'y Rev. 188, 207 & n.111 (1985) [hereinafter cited as "Public Pension Funds"].

have caused to the plan, its participants and the sponsoring governmental entity.[13]

The Bill proposal to require the establishment of separate funds for the Retirement Systems and the designation of those funds as trust funds clearly establishes a trust relationship between the Treasurer of the Retirement Systems and the assets of the Retirement Systems. By establishing a trust, the Treasurer is placed under a duty, as the trustee, to segregate the assets of each of the Retirement Systems from all other monies under the Commissioner's control and to earmark those assets as trust property.[14] The creation of separate trust funds to hold assets may not, by itself, be sufficient to establish the clear standards of behavior advocated by Congress for the broad spectrum of responsibility involved in the administration of public trusts such as the Retirement Funds and the investment of their assets. Trust designation is,

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13 Task Force Report at 188-89.

14 Restatement (Second) of Trusts § 179 (1959) [hereinafter cited as the "Restatement"]; A. Scott, Abridgment of the Law of Trusts §§ 2.6, 179 (1960) [hereinafter cited as "Scott on Trusts"] ("A trust involves rights and duties with respect to property. . . . In every trust there is something more than a merely personal relationship between trustee and beneficiary; there is a duty on the part of the trustee to deal with property for the benefit of another.").

We would suggest, however, the addition of the words "in trust" after the words "deposited and held" in Sections 3, 16, 18 and 35, respectively, of the Bill to conform that language to the existing statutory language governing the Endowment Funds and thereby avoid any possible ambiguity that might otherwise be created upon adoption of the Bill.

however, sufficient to establish the basic responsibility of a trustee to segregate trust property and earmark it as such.[15] Indeed Congress, in regulating private pension systems through the Employee Retirement Income Security Act of 1974, as amended ("ERISA"),[16] also uses the trust mechanism to assure segregation of pension assets.[17]

As a corollary to providing necessary guidance with respect to a fundamental aspect of conduct toward assets of the Retirement Systems, the Bill proposal may provide a basis for liability in the event of loss resulting from the commingling of assets.[18] The proposal may also benefit the Retirement

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15 Use by a legislature of terms such as "trust" and "trustee" indicate an intent to establish a traditional trustee relationship. Campbell & Josephson, Public Pension Trustees' Pursuit of Social Goals, 24 Wash. U.J. Urb. & Contemp. L. 43, 48, 51 (1983) (citing Savings Bank of New London v. New York Trust Co., 27 N.Y.S. 2d 963 (Sup. Ct. 1941); NLRB v. Amax Coal Co., 453 U.S. 322 (1981); and Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248, 1254 (S.D.N.Y. 1978), aff'd mem. 595 F.2d 1210 (2d Cir. 1979)).

16 29 U.S.C.A. §§ 1001-1461 (West 1985 & Supp. 1986) [hereinafter cited as "ERISA"].

17 ERISA § 403(a) ("All assets of an employee benefit plan shall be held in trust by one or more trustees [who shall be] named in the trust instrument."). The Department of Labor has stated that "the underlying rationale for [ERISA's] requirement that a trust be utilized [is] to prevent commingling of plan assets with assets belonging to the person managing the plan assets. . . ." 39 Fed. Reg. 44456 (Dec. 24, 1974); Department of Labor Opinion 76-35 (April 13, 1976).

18 A private trustee is chargeable with any loss or depreciation in value of the trust estate resulting from a breach of any duty which he owes as a trustee to the
(Footnote Continued)

Systems in a way that is perhaps less tangible, but no less necessary according to commentators on public pension plans generally, by encouraging in those responsible for the administration of plan assets a sense of duty toward plan participants and beneficiaries, by providing a framework and incentive for them to discharge that duty, and by encouraging them to be viewed by others as fiduciaries vis-a-vis Fund assets and beneficiaries.[19]

(2) The Endowment Funds

As noted above, current statutes already establish separate funds for the assets of the University of Alaska Fund and the Public School Fund. Although not specifically designated as a "trust fund," the Public School Fund is created under Chapter 14 of Title 37 of the Alaska Statutes, which is entitled "Trust Funds," and the statute creating the University of Alaska Fund specifies that the monies deposited in the Fund shall be held "in trust." As discussed above with respect to the Retirement Funds, legal commentators generally interpret the use of words such as "in trust" as an indication of intent

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18 (Footnote Continued) beneficiaries, any profit made by the trustee through such breach or any profit that would have accrued to the trust estate had no breach of trust occurred. Restatement § 205; Scott on Trusts § 205.

19 L. Kohlmeier, Conflicts of Interest: State and Local Pension Fund Asset Management (1976), contained as Appendix XIV to the Task Force Report at 888 ("[V]ery few public pension fund trustees are viewed or view themselves as fiduciaries responsible solely to public employees.").

to create a traditional fiduciary relationship. The Bill proposal specifying the Endowment Funds as "endowment trust" funds is, therefore, less necessary to impose trust status on these Funds than the proposal creating the Retirement Funds and designating them as trusts. The Endowment Funds proposal is more in the nature of a clarifying and conforming change that serves primarily to emphasize the special nature of these monies as trust property and the concomitant fiduciary duties that attach to those vested with responsibility for administering these assets.

The inclusion of the word "endowment" in the Bill proposal serves to distinguish the Endowment Funds from the Retirement Funds, which may expend, if necessary, the entire principal for plan benefits. In contrast, none of the principal of the Endowment Funds, which consists of gifts or the proceeds from the lease or sale of certain public lands or mineral rights, may be expended. The traditional duty of a trustee to preserve the trust corpus[20] is, therefore, heightened with respect to trusts of this nature. The particular emphasis on preservation of principal in the case of Endowment Funds is also supported by the Bill proposal's

20 Scott on Trusts §176. The various specific duties that attach to the traditional fiduciary relationship are discussed more fully in Sections I.B and I.C of this Memorandum, and the specific duties that attach to the Commissioner as the party responsible for investing the assets of the Funds under the current statutory framework and under the Bill proposal are discussed more fully in Section I.C.

requirement that net income of each Endowment Fund be accounted for separately from principal and that all realized capital gains be added to the principal and permanently maintained in the Fund for investment purposes.[21]

The Bill proposes certain changes that go beyond clarifying the nature of these Funds and reinforcing the traditional fiduciary responsibilities that attach to these Funds and their beneficiaries. By replacing the current statutory mandate to invest the assets of these Funds only in interest-bearing securities and allowing the Commissioner instead to invest these assets on the basis of "probable total return as a means of promoting the long-term generation of income,"[22] the Bill proposal would provide the Commissioner with the opportunity to increase, rather than merely preserve, the principal available for future investment and generation of income for application in accordance with the stated purposes of the Endowment Funds.

The Bill proposal also recognizes and emphasizes, however, that the factors to be considered in making investments that put the principal of the Endowment Funds at risk may be different from the investment criteria for other

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21 Sections 11, 27 and 30 of the Bill. The Bill's requirement to account separately for principal and interest comports with the common law duty of a trustee to keep and render accounts in the case of trusts established for successive beneficiaries. See Scott on Trusts § 172 ("If the trust is created for beneficiaries in succession, the accounts should show what receipts and what expenditures are allocated to principal and what are allocated to income.").

22 Sections 11 and 31 of the Bill.

types of trust property. The Commissioner is expressly required to consider the status of both principal and income on a current as well as a probable future basis and to act only in regard to the long-term financial interests of the Endowment Funds' beneficiaries.[23] In contrast, the Bill requires only that the Commissioner consider the "best financial interests" of the beneficiaries when investing the assets of the Retirement Funds.[24] The explicit language of the Bill proposal thus provides the Commissioner guidance with respect to the weight to be accorded the various factors to be considered in connection with an investment on behalf of the Endowment Funds and the appropriate level of risk to be assumed. At the same time, however, the requirement to consider only long-term financial interests may heighten a conflict that many commentators have found inherent in the statutory appointment of public officials, who are generally judged on the basis of short-term performance, as investment managers of public trusts.[25]

B. Designation of the Commissioner as a Fiduciary of the Funds and Requirement to Act Only in the Interest of Beneficiaries

As suggested in the discussion above, although certain fiduciary duties are created merely by establishing a trust, these duties may be limited in nature. The Bill effectively

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23 Sections 11 and 31 of the Bill.

24 Sections 5, 17, 19 and 36 of the Bill.

25 See, e.g., Public Pension Funds, supra note 12, at 196.

expands statutory guidance with respect to proper behavior toward trust property and beneficiaries by expressly designating the Commissioner as a "fiduciary" of certain of the Funds[26] and by requiring the Commissioner to act "only in regard to the best financial interests" of the beneficiaries of the Retirement Funds[27] and "only in regard to the long-term financial interests" of the beneficiaries of the Endowment Funds.[28] Absent specific statutory definition or administrative interpretation of the duties arising in connection with "fiduciary" status and the "only in the financial interest" standard, however, one must look to common law and analogous statutory law, particularly, ERISA,[29] to define more clearly the responsibilities that attach to these terms.

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26 Sections 5, 11, 17, 19, 31 and 36 of the Bill.

27 Sections 5, 17, 19 and 36 of the Bill. For purposes of clarity, we would suggest the addition of the words "participants and" before the word "beneficiaries" in Section 5 of the Bill (and incorporated into Sections 17, 19 and 36) to make clear that the Commissioner is a fiduciary with respect to all who have an interest in the Retirement Systems, including currently contributing plan participants as well as retirees, whose interests may not be identical. Our suggestion is supported by the language of ERISA §404(a)(1)(A), which is discussed in the text below, and which refers to "participants and beneficiaries."

28 Sections 11 and 31 of the Bill.

29 One legal commentator suggested recently that ERISA may eventually become a more extensive source of law than the common law in assessing issues relating to fiduciary obligations. See Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52, 56 n.10 (1987).

Common law has established that two primary duties flow from the fiduciary relationship: a duty to act prudently in the administration of the trust[30] and a duty of loyalty to trust beneficiaries.[31] The common law duty of prudence is discussed below as part of Section I.C of this Memorandum.

The common law duty of loyalty has been termed the most fundamental duty owed by a fiduciary.[32] The duty is present in all fiduciary relationships, but is particularly intense in the case of a trust.[33] The duty of loyalty inherent in the trust relationship is a duty to administer the trust solely in the interest of its beneficiaries.[34] The

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30 Scott on Trusts § 174.

31 Id. §§ 163A, 170.

32 Id. § 170.

33 Id.

34 Probably the most famous enunciation of the fiduciary duty of loyalty is Chief Judge (later Justice) Cardozo's statement that

> many forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. . . . Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty. . . . Only thus

(Footnote Continued)

fiduciary duty of loyalty requires a trustee to administer the trust as if he had no interest to protect other than that of the trust and its beneficiaries.[35] This duty therefore prohibits a trustee from dealing with trust property for his own account,[36] from unreasonably favoring certain beneficiaries over others in the administration of trust assets (unless authorized to do so in the trust instrument)[37] and from dealing with trust property for the benefit of a third party.[38] The Bill proposal requiring that the Commissioner act only in regard to the best financial interests of the beneficiaries of the Retirement Funds and only in regard to the long-term financial interests of the beneficiaries of the Endowment Funds incorporates the common law duty of loyalty and

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34 (Footnote Continued)

> has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. . . .

Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (N.Y. 1928).

35 Campbell & Josephson, supra note 15, at 50.

36 Withers v. Teachers Retirement Sys., 447 F. Supp. at 1256; Scott on Trusts § 170. Under certain circumstances, a trustee may be justified in dealing with trust property for his own account. Among other things, the trustee must disclose all material facts concerning the transaction to the beneficiaries, the transaction must be fair and reasonable in all respects and the beneficiaries must freely give their consent. Id.

37 Withers v. Teachers' Retirement Sys., 447 F.Supp. at 1257-58; Scott on Trusts § 183.

38 Id. § 170.

appears to expand it by requiring the Commissioner to act only in the best <u>financial</u> interests of trust beneficiaries.

Some guidance as to the parameters of permissible behavior toward Fund property and beneficiaries under the standards established by the Bill may be found in court decisions interpreting Section 404(a)(1)(A) of ERISA, which requires a fiduciary of a plan subject to ERISA "to discharge his duties with respect to [the] plan solely in the interest of the participants and beneficiaries and . . . for the exclusive purpose of . . . providing benefits to [the] participants and their beneficiaries [and] defraying reasonable expenses of administering the plan." This "exclusive purpose" rule of Section 404(a)(1)(A) has been found to have been violated, for example, by a plan fiduciary who causes the plan to invest substantially all of its assets in unsecured promissory notes of the sponsoring corporation, when the fiduciary stands to gain personally, or represents third parties who stand to benefit from the use by that corporation of the monies loaned by the trust to repurchase stock or repay stockholder loans.[39] A court similarly has found a violation of Section 404(a)(1)(A) when pension plan fiduciaries caused plan assets to be invested in the securities of corporations involved in a contest for control when the fiduciaries themselves were actively engaged

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39 <u>Freund v. Marshall and Ilsley Bank</u>, 485 F. Supp. 629, 639 (W.D. Wis. 1979).

in the battle for control of these corporations.[40] It seems clear that conduct similar to that found inconsistent with ERISA's "exclusive purpose" rule would be violative of the Bill's "only in the financial interest" standard.

C. Repeal of Legal Lists and Implementation of a New Rule of Prudence

Under Alaska law, the Commissioner has the general authority and responsibility to invest all monies deposited or held in the Funds.[41] In administering the Funds, the Commissioner has sought to achieve the general objective of increasing the amount of monies available for the benefit of each of the Funds over a time period appropriate to the specific nature of the Fund.[42] Under Alaska's current

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40 Leigh v. Engle, 727 F.2d 113, 124 (7th Cir. 1984). The investments in question in both the Freund and Leigh cases also raise questions under the fiduciary duty of prudence, discussed in Section I.C of this Memorandum.

41 The source of the Commissioner's authority for each Fund is as follows:
Alaska Stat. § 37.10.070 (1983) (Alaska General Investment Fund);
Alaska Stat. § 39.35.10 (1987) (Public Employees' Retirement Fund);
Alaska Stat. § 14.25.180 (1987) (Teachers' Retirement Fund);
Alaska Stat. § 22.25.048(c) (1982) (Judicial Retirement Fund);
Alaska Stat. § 26.05.228(c) (1986) (Alaska National Guard and Naval Militia Retirement Fund);
Alaska Stat. § 37.14.170 (1983) (Public School Fund);
Alaska Stat. § 14.40.400 (1987) (University of Alaska Fund).

42 See State of Alaska Department of Revenue Treasury Division, Memorandum Concerning General Investment Policies 8-13 (January 1988) [hereinafter referred to as "Treasury Policy Memo"].

statutory scheme, the Commissioner is responsible for implementing this general investment policy, subject to certain limitations mandated by statute. Specifically, the Commissioner's investment authority is limited with respect to certain Funds to specific types of investments and, in the case of the Retirement Funds and the Public School Fund, is limited as to the maximum percentage or dollar amount of Fund assets that may be invested in particular instruments.[43]

The permissible investments or so-called "legal lists" for all of the Funds are further limited by a statutory "prudent institutional investor" rule, which is derived from, and expands upon, the common law of trust's "prudent man" standard.[44] In implementing the rule, the statutes dictate that the Commissioner "exercise the judgment and care under the circumstances then prevailing which an institutional investor of ordinary prudence, discretion and intelligence exercises in the management of large investments entrusted to it."[45] This

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43 Currently, the Public Employees' Retirement Fund and the Teachers' Retirement Fund are restricted by identical lists of permissible investments and percentage allocations. Alaska Stat. §§ 39.35.110 (1987) and 14.25.180 (1987). The Judiciary and Military Retirement Systems incorporate those limitations by reference, Alaska Stat. §§ 22.25.048(c) (1982) and 26.05.228(c) (1986), as does the Public School Fund. Alaska Stat. § 37.14.170 (1983). The University of Alaska Fund is subject to different investment criteria. Alaska Stat. § 14.40.400 (1987).

44 Alaska Stat. §§ 39.35.110(c) (1987), 14.25.180(c) (1987), 22.25.048(c) (1982), 37.14.170 (1983).

45 Id.

rule is not applicable expressly to the University of Alaska Fund, but the 1963 Opinion No. 13 of the Attorney General concluded that the "prudent man rule" is the proper investment standard for that Fund, and the Governor of Alaska subsequently imposed the higher standard in delegating investment authority with respect to the Fund to the Commissioner. The Alaska General Investment Fund is also statutorily subject to the standard, even though it is not a trust.[46]

The Commissioner has found that the current statutory framework governing the investment of Fund monies restricts the Commissioner's ability to invest effectively on behalf of the Funds. In particular, the various statutory restrictions have been said to reduce investment returns of the Funds, impede the Commissioner's ability to invest in a manner appropriate to the purposes of each Fund, limit the adaptability of the investment policy followed by the Commissioner to changing markets, and in some cases, conflict with, or are logically inconsistent with, the dictates of the prudent institutional investor rule.

In light of the problems it has faced in managing the Funds, the Commissioner has presented as part of the Bill a proposal that would alter fundamentally the investment standards governing the Fund's investments. Specifically, the Bill proposes to repeal the "legal list" restrictions, while imposing a stringent statutory obligation requiring the

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46 Alaska Stat. § 37.10.070(b) (1983). <u>See generally</u>, Treasury Policy Memo, <u>supra</u> note 42, at 5.

Commissioner to act with "professional" prudence by exercising the judgment and care of an institutional investor managing large trust investments.[47] The Bill further clarifies the Commissioner's duties under the new prudence standard by explicitly delineating the factors to be considered when investing the monies of the Funds. These include consideration of the purpose of the particular Fund, the continuing disposition of the Fund's investments, and the probable safety of the Fund's capital as well as probable investment return.[48] In addition to setting out these general factors for investment of monies of the Funds, the Bill gives the Commissioner specific statutory guidance as to the purposes and goals that should be considered in investment of the Funds.[49]

An analysis of the Bill provisions amending the investment standards to which the Commissioner is subject requires a brief consideration of the development of investment standards applicable to public plans in the United States. Most state and federal statutes applicable to the investment of public funds derive from, and in some way incorporate, the common law of private trusts.[50] As noted above in Section

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47 Section 6 of the Bill. Sections 17, 19, 22, 30 and 36 of the Bill incorporate this standard by reference.

48 See supra note 47.

49 Sections 22, 27, 30 and 31 of the Bill.

50 See Public Pension Funds, supra note 12, at 201-205; Campbell & Josephson, supra note 15, at 48, 50, 57.

I.B of this Memorandum, under common law, trustees have two basic fiduciary duties in making investments--a duty to invest prudently by maximizing return on and safety of the trust assets, and a duty of undivided loyalty to the beneficiaries of their trusts.[51] Over the years, most states have developed and supplemented these basic fiduciary standards by placing specific restrictions on certain types of investments or by codifying the common law prudent man standard, or by using some combination of, or variation on, these concepts.[52] Although until very recently a majority of states prescribed a combination of specific legal list restrictions and statutory variations of the fiduciary duty of prudence, the modern trend is to abandon legal lists in favor of a broad, statutorily-mandated prudence standard.[53] As of the end of 1987, 26 states (including California and Washington) had adopted some form of prudence standard as the sole criterion by

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51 Scott on Trusts §§ 170 and 174; See generally, Public Pension Funds, supra note 12, at 193; Campbell & Josephson, supra note 15, at 67-109.

52 See Public Pension Funds, supra note 12, at 201-202.

53 See L. Eig & J. Luckey, An Analysis of the Fiduciary Responsibility Requirements of the Major Pension and Retirement Plans for Employees of the Fifty States (Congressional Research Service, April 19, 1984). This survey lists 19 states that utilize solely a prudence standard (though some of these place percentage limitations on certain investments). Since the time of the Eig & Luckey study, seven more states have adopted a prudence standard. See also Public Pension Funds, supra note 12, at 202 (listing a 1983 study of legal limitations on investment).

which to measure investment undertaken on behalf of their state employee pension plans.[54]

A host of reasons have been given for the shift away from a legal list approach,[55] but the trend has been given great impetus by the enactment of the rule of prudence contained in Section 404(a) of ERISA, which, as suggested above, incorporates and expands upon common law fiduciary investment standards. The Department of Labor's regulations interpreting the Section specifically reject the use of legal list restrictions in private pension fund investing.[56] In effect, the Bill adopts the rationale underlying those regulations.

The Bill not only reflects the modern trend in public fund investment standards, but also seeks to deal with several fundamental problems with Alaska's current bifurcated statutory scheme. The first problem is the statutory interpretation that should be followed in applying the mandates of these two distinctly different rules of investment. Several courts and commentators have addressed this issue in examining statutes

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54 See supra note 53.

55 See infra text accompanying notes 62-73.

56 See 29 C.F.R. § 2550.404a-1 (1987). In adopting these regulations, the Department of Labor stated that it did "not consider it appropriate to include. . .any list of investments, classes of investments, or investment techniques that might be permissible under the 'prudence' rule. No such list could be complete. . . ." 44 Fed. Reg. 37221, 37225 (June 26, 1979).

similar to the Alaska scheme.[57] The general approach that has been suggested is first to examine whether the particular investment is authorized by the legal list applicable to investing fund, and then to determine whether the fund's fiduciary exercised its duty of prudence in making that investment choice. Thus, under this approach, the presence of a particular type of security or other investment on a legal list makes it eligible for investment consideration, but does not authorize the fidiciary to invest in particular investments of that type. The fiduciary is only empowered to authorize prudent investment, and must, therefore, satisfy its duties to exercise care and skill in investing for the benefit of the fund.[58] In Delafield v. Barret,[59] an early New York case, for example, the court found that a fiduciary who invested in securities specified in the New York statutes was not thereby free from liability when he failed to exercise reasonable judgment and discretion in making the investments.[60]

Even though a legal list and a prudence standard may be interpreted as being consistent, they often conflict. As

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57 See, e.g. Withers v. Teachers Retirement Sys., 447 F. Supp. 1248 (S.D.N.Y. 1978) (in which the court decided that municipal bonds, which were permitted under the legal list, were prudent investments); Delafield v. Barret, 270 N.Y. 43, 200 N.E. 67 (1936); Campbell & Josephson, supra note 15, at 53-54.

58 See supra note 57.

59 270 N.Y. 43, 200 N.E. 67 (1936).

60 Id. at 48, 200 N.E. at 69.

discussed in detail below, under most modern formulations of the prudence rule, a fiduciary investing on behalf of a fund is under an obligation to make investments with a view toward ensuring that the investment objective of the fund will be achieved.[61] The general consensus among commentators is that specific investment limitations overly restrict fiduciaries in making those kinds of investment choices.[62] The statutory legal list formulations are, as one commentator put it, "cumbersome, inflexible and too slow to adapt to a changing environment."[63] Moreover, as the Task Force Report concluded: "[t]he investment performance of many state and local pension funds continues to be hampered because of statutory and policy restrictions on investment expenses and portfolio composition."[64] By restricting investment choices and lessening investment performance, legal lists often preclude investments that, when viewed in the context of the objectives of a fund, would clearly be deemed prudent by an institutional investor.

Several other arguments have been raised by commentators criticizing legal list approaches to investing. First, legal lists have been said to reduce the flexibility

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61 See infra text accompanying notes 86-102.

62 See, e.g. Public Pension Funds, supra note 12, at 206; Campbell & Josephson, supra note 15, at 115-116.

63 Campbell & Josephson, supra note 15, at 115.

64 Task Force Report at 196.

that may be needed if sufficient fund assets are to be invested with a view toward significant capital appreciation.[65] Higher returns through capital appreciation is, in many cases, necessary to maintain impartiality by fiduciaries to the divergent interests of participants of particular funds.[66] The need for impartiality is especially important in the context of retirement funds, where the relative interests of various fund participants in current income versus capital appreciation varies due to the range of retirement dates and life expectancies of those participants. Legal lists, however, may impede the fiduciary's ability to generate high returns on investments.

A second argument made by opponents of legal lists is that a legislature is not a proper body to determine investment strategies for public plans. Legislators, for example, may have overt political interests in promoting local investments that conflict with the interest of fund participants.[67] In addition, public plans have different investment needs determined by size, time focus, and the structure of workforce. No legislature, it has been argued, could promulgate a list of investments that would be broad enough to encompass the needs

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65 Campbell & Josephson, supra note 15, at 116.

66 Id.

67 Public Pension Funds, supra note 12, at 206.

of all funds and their participants and limited enough to ensure a prudent portfolio for each of those funds.[68]

A third argument often made against legal lists is that by limiting the field of permissive investment choices, they may cause the portfolio of a fund to be under-diversified, thereby subjecting the fund to uncompensated risks. These risks, it is asserted, could be eliminated if legal list restrictions were not so limited in scope, and conservative in approach.[69]

The Commissioner's experience with Alaska's current legal list statutes attests to the validity of the various arguments described above. Legal lists applicable to certain of the Funds, for instance, permit investment in equity securities only if the issuer of the securities has paid dividends for the three previous years.[70] Such a standard may have been an appropriate requirement in the past, but in today's market, few institutional investors would accept payment of dividends as an appropriate indicator of investment worthiness.[71]

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68 Id.

69 Id.

70 Alaska Stat. §§ 39.35.110(a)(21)(1987), 14.25.180(b)(21)(1987).

71 Fred Alger Management Inc., one of the outside investment managers utilized by certain of the Funds, has pointed out that this restriction has prevented the Funds from investing in the stock of Digital Equipment Corporation,
(Footnote Continued)

Perhaps the clearest example of the restrictive character of current legal lists to which the Commissioner is subject is a provision limiting investment for the University of Alaska Fund to interest-bearing securities.[72] The Commissioner believes that the nature and purpose of this Fund would more appropriately be served through equity investments, in order to maximize the future income of the Fund.[73] Under the current statutory restrictions, however, this end could not be achieved.

In light of the problems inherent in a legal list approach to investment, the Bill seeks to repeal these statutory restrictions and put in its place a more refined version of the prudent institutional investor rule. The new rule would require that the Commissioner "exercise the judgment and care under the circumstances then prevailing which an institutional investor of ordinary professional prudence, discretion and intelligence exercises in managing trust investments."[74] To best understand the effect that such a

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(Footnote Continued)

71 which increased in value in 1986 by 58%. Citibank N.A. and Invesco, two other managers employed on behalf of certain of the Funds, have also stated that the requirement of three years of current dividends does not signal a prudent investment.

72 Alaska Stat. § 14.40.400 (1987).

73 <u>See</u> Treasury Policy Memo, <u>supra</u> note 42, at 27-28.

74 Section 6 of the Bill (Proposed Alaska Stat. § 14.25.18(b)). Sections 17, 19, 22, 30 and 36 of the Bill incorporate this standard by reference.

standard will have on the investment conduct of the Commissioner and how the standard should be interpreted by a court of law, it is necessary to trace the development of the "prudence" rule.

The common law "prudent man" standard was first articulated by the Supreme Court of Massachusetts in the 1830 case of Harvard College v. Amory.[75] The original formulation, which has been adopted by decision or statute by a majority of states, is a model of flexibility. It dictates that in investing trust funds, the trustee is obligated 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."[76]

Although the court in Harvard College formulated a flexible guideline for trustee investment conduct, over the years it has been given a rather narrow interpretation by many courts and commentators.[77] The reasoning behind that interpretation has been that prudent decisionmaking for a trustee entails greater caution than that expected of a private

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75 26 Mass. (9 Pick.) 446 (1830).

76 Harvard College v. Amory, 26 Mass. at 461.

77 See, e.g. King v. Talbot, 40 N.Y. 76 (1869); In re Bank of New York, 35 N.Y.2d 512, 323 N.E.2d 700 364 N.Y.S. 2d 164 (1974); Scott on Trusts § 227. See generally Gordon, supra note 29, at 57-74.

investor.[78] Thus, a trustee is not only obligated to consider the yield of his investment, but is also under a duty to avoid risks that would be seen as incompatible with his obligation to safeguard the property of others.[79] In other words, under common law, the security of the trust corpus and acquisition of a reasonable income were to be a trustee's paramount objective, even if at the expense of capital appreciation.[80]

Courts applying these principles have interpreted the "prudent man" rule to require that each individual investment made by a trustee be prudent.[81] The fact that the trust's portfolio had increased substantially in value during the period under scrutiny would not insulate the fiduciary from responsibility for imprudence in selecting or retaining particular investments.[82] Prudence, it is reasoned, is a matter of conduct, not investment performance, and no inherent connection exists between a loss sustained on an investment and

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78 King v. Talbot, 40 N.Y. 76,86 (1869); Scott on Trusts § 227.

79 King v. Talbot, 40 N.Y. at 86.

80 See Campbell & Josephson, supra note 15, at 49.

81 See, e.g. In re Bank of New York, 35 N.Y. 2d at 517, 323 N.E. 2d at 703. See generally, Campbell & Josephson, supra note 15, at 49; Public Pension Funds, supra note 12, at 194 n. 33.

82 Campbell & Josephson, supra note 12, at 49-50.

imprudence in the investment selection.[83] Thus, in analyzing individual investment decisions by trustees, the common law requires that a trustee investigate the safety of each individual investment along with its probable income and exercise reasonable care in making that investigation.[84] Profit or loss to the portfolio has no bearing in this formulation.

Although the common law interpretation of the prudent man rule has persisted in some jurisdictions,[85] a general trend away from this position has been evident. Several reasons for the trend have been identified. Commentators have argued that the common law standard is formed on a narrow concept of risk and safety that severely limits the ability of a trustee to maintain an economically efficient portfolio of assets for his funds.[86] These commentators have generally expressed a "modern portfolio theory" of trust investment, which emphasizes the portfolio as a whole rather than a particular investment, as the relevant factor in determining whether prudent investment decisions have been made.[87]

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83 Id. at 50 (citing In re Morgan Guaranty Trust Co., 89 Misc. 2d 1088, 1091, 396 N.Y.S.2d 781, 784 (Sur. Ct. 1977)).

84 See Public Pension Funds, supra note 12, at 203-204.

85 See generally Gordon, supra note 29, at 70-74.

86 See Gordon, supra note 29; Public Pension Funds, supra note 12, at 204-205.

87 Id.

A second cause of the development of a new prudent man standard has been a shift in the nature of funds from an individual to an institutional setting. The conservative common law approach to prudence was developed for private trusts to resolve the basic conflict between the interests of income beneficiaries and remaindermen. That conflict does not arise in many of the new forms of institutional trusts--employee pension plans, for example--because these trusts typically do not terminate and have no remaindermen to whom principal would eventually be distributed. In addition, these types of trusts receive capital infusions throughout their existence. The common law rule was found to be ill-suited to the varying natures and objectives of institutional funds.

The trend away from the use of common law prudence has been reflected in new formulations of the prudent investor rule by Congress and state legislatures. The most prominent of these formulations is embodied in Section 404 of ERISA and the regulations and case law interpreting that Section. Under Section 404, private pension plan fiduciaries are required to discharge their investment duties "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."[88] Although this language clearly codifies certain principles from the common law, Congress instructed the courts to interpret the rule "bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by [ERISA]."[89] To date, courts and commentators have indicated that the rule establishes a standard of skill of an expert in making pension investments.[90]

In 1979, the Department of Labor issued regulations under Section 404 that explicitly set out criteria for fiduciary conduct that are consistent with the modern portfolio approach to investing.[91] Under the regulations, no investment decision on behalf of a plan is per se prudent or imprudent, but is to be judged in the context of overall portfolio design with reference to the objectives of the plan. To carry out a prudent investment policy, a trustee should take into consideration the following factors in making an investment decision: (1) the composition of the portfolio with regard to diversification; (2) the liquidity and current return of the portfolio relative to the anticipated cash flow

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88 ERISA § 404(a).

89 S. Rep. No. 127, 93rd Cong., 2d Sess. 28-29, reprinted in 1974 U.S. Code Cong. & Ad. News 4838, 4865.

90 Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378 (D. Hawaii 1980); Campbell & Josephson, supra note 15, at 103.

91 29 C.F.R. § 2550.404a-1(b)(1)(1987).

requirements of the plan; and (3) the projected return of the portfolio relative to the funding objectives of the plan.[92]

Interpretations of the ERISA prudence rule by federal courts provide additional guidance in scrutinizing trustee investment conduct. In general, the courts have examined whether trustees have employed the appropriate method to investigate the merits of an investment.[93] Court analysis has been focused, for example, on a review of the trustee's independent investigation of the merits of a particular investment transaction.[94] Courts have held that a trustee's lack of knowledge of investment is no excuse; trustees are to be judged "according to the standard of others 'acting in a like capacity and familiar with such matters.'"[95]

Cases construing ERISA's rule of prudence may be expected to be of major significance in interpreting the prudent institutional investor rule reflected in the Bill. Although ERISA is not explicitly applicable to any of the funds established by the State, the Attorney General has in recent years embraced an ERISA-type standard in interpreting the

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92 Id.

93 Donovan v. Mazzola, 716 F.2d 1226,1232 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984).

94 Donovan v. Cunningham, 716 F.2d 1455,1467 (5th Cir. 1983), cert. denied 467 U.S. 1251 (1984).

95 Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir.), cert. denied, 469 U.S. 1072 (1984)(quoting Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Hawaii 1980).

prudent investor rule.[96] In an opinion discussing the investment powers of the Department of Revenue, the Attorney General set out the general policy of that office:

> We interpret the prudent investor rule...to require that all investment decisions be consistent with an investment strategy which gives consideration to the risks and benefits to each portfolio as a whole. . . Each of the funds which you invest (teachers' retirement fund, public employees' retirement fund, general fund, and Alaska permanent fund) represents a separate portfolio for this purpose.[97]

Indeed, in a 1984 opinion dealing with the prudence of a proposed investment of the Alaska Permanent Fund Corporation (the "Permanent Fund"), the Attorney General specifically referred to the Department of Labor's ERISA regulations for guidance in rendering its decision.[98]

Even in the absence of these opinions, it seems clear that a standard that refers to an "institutional investor of ordinary professional prudence," by its very language, professes to adopt the standard of conduct that governs other institutional investors. The standard would appear to require that the Commissioner, as fiduciary, exercise the care and skill of a sophisticated professional investor whose knowledge and ability is substantially greater than that expected of an ordinarily prudent layman. A court, in analyzing the proposed

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96 See, e.g. Op. (Inf.) Att'y Gen. (Nov. 3, 1986); Op. (Inf.) Att'y Gen. (Oct. 17, 1984); Op. (Inf.) Att'y Gen. (June 17, 1982).

97 Op. (Inf.) Att'y Gen. (June 17, 1982).

98 Op. (Inf.) Att'y Gen. (Oct. 17, 1984).

formulation, therefore, would in all probability look to the body of law that governs the conduct of private, professional institutional investors in rendering a decision. The ERISA standards, and the case law interpreting these standards are, therefore, instructive.

The significance of the State's adopting an ERISA-type approach to prudence especially in conjunction with repeal of the legal list statutes, is that it permits a much larger universe of investments to be considered in investing the monies of the Funds. The Department of Labor, in interpreting ERISA's prudence rule, has stated that investment in securities issued by a small or new company, which could be riskier than those of a "blue chip" company, may be entirely proper under the rule.[99] The Department of Labor has also recognized that investments not producing current income might play a legitimate role in a portfolio. This rationale would suggest that in appropriate circumstances, these and other "nontraditional" investments, such as certain types of venture capital or futures investment, might be permissible as well under the statutory formulation contained in the Bill.[100]

This "modern-portfolio theory" approach to the prudence rule could be criticized as establishing too

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99 44 Fed. Reg. 37,221, 37,222 (June 26, 1979).

100 Id. at 37,225.

permissive a standard for evaluation of trustee behavior.[101] A claim could be made that such a broad standard would enable a fiduciary to invest in any vehicle striking its fancy, and be insulated from liability for its investment decisions.[102] Under the formulation set forth in the Bill, however, the Commissioner, as a fiduciary of the Funds, cannot ignore his obligation to evaluate a particular investment to ensure its being consistent with Fund characteristics and objectives. The Commissioner has the duty, under the prudent professional institutional investor standard of care, to investigate investments made for a Fund with the prudence of a professional to assure an appropriate risk level is maintained in light of the needs of the Fund. The extensive body of law interpreting ERISA provides general guidelines for the proper scrutiny of that investment conduct. Thus, the prudence rule reflected in the Bill, in conjunction with repeal of the existing legal lists, should provide the Commissioner with the broadest scope of investment options. At the same time, the requirement that the Commissioner meet the standard of care exercised by an institutional investor of professional prudence should provide significant protection to Fund beneficiaries and participants.

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101 Gordon, supra note 29, at 94; see also Hutchinson & Cole, Legal Standards for Governing Investment of Pension Assets for Social and Political Goals, 128 U. Pa. L. Rev. 1340, 1357 (1980).

102 Hutchinson & Cole, supra note 101, at 1357.

D. Authorization to Delegate Responsibilities

The Bill proposes to authorize the Commissioner expressly to delegate his investment, custodial and depository authority with respect to the Retirement Funds to officers or employees of the State or to independent firms, banks or trust companies.[103] This proposal is consistent with court interpretations of delegation as a necessary corollary to the fiduciary duty of prudence.

As indicated in Section I.C of this Memorandum, the rule of prudence provided for in the Bill, like ERISA's prudent person standard, requires the conduct of a prudent expert. To date, several courts have interpreted the prudent expert rule of ERISA to require delegation of authority under certain circumstances. Courts have generally held that an ERISA fiduciary cannot avoid liability with respect to investments, simply because he lacks familiarity with those investments.[104] If a fiduciary is ill-equipped to evaluate the soundness of a proposed investment, the courts have indicated, then he has the affirmative duty to seek outside assistance; only then will the fiduciary be found to have "employed the appropriate methods to investigate the merits of the investment"[105] and, thus, to

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103 Section 7 of the Bill. This section is incorporated by reference in other sections of the Bill.

104 Katsaros v. Cody, 744 F.2d 270 (2d Cir.), cert. denied, 469 U.S. 1072 (1984); Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. 378 (D. Hawaii 1980).

105 Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984).

have fulfilled his duty to act prudently. Applying these principles, the court in Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan held, for example, that plan trustees who lacked prior lending experience violated their fiduciary duty under ERISA by failing to follow the type of procedure that a prudent and skillful lender would utilize in making a real estate investment.[106]

The cases construing ERISA's prudent man rule noted above suggest that the Commissioner, in seeking to meet the prudent institutional investor rule specified in the Bill, has an affirmative duty to obtain competent professional assistance by hiring qualified employees or by entering into contracts with qualified outside professionals. The Bill's proposal regarding delegation serves to emphasize this general duty and to provide a framework for the discharge of this duty. Moreover, by, in effect, raising the standard of prudence to which the Commissioner will be subject, the Bill would seem to increase the extent of the Commissioner's duty to delegate.

E. Establishment of Reporting and Statutory Auditing Requirements

The Commissioner has presented as part of the Bill a proposal that would require the Commissioner to cause periodic reports on the condition and investment performance of certain of the Funds to be prepared and furnished to the board overseeing the operation of those Funds. Supplementing these periodic report

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106 507 F. Supp. 378 (D. Hawaii 1980).

provisions under the Bill is a provision requiring that an independent firm of certified public accountants be hired (1) to audit the accounts of the Public Employees' Retirement and Teachers' Retirement Systems annually; (2) to audit the annual report of the financial condition and financial activity of each of the Public Employees' Retirement and Teachers' Retirement Systems; and (3) to the annually audit the Retirement and Endowment Funds' financial condition and investment transactions.

In large part, the Commissioner's reporting and auditing proposals reflect current practice. At present, annual financial audits of both the Public Employees' Retirement and Teachers' Retirement Funds, including a review of internal controls and securities custody and safekeeping procedures, are conducted by independent certified public accountants. In addition, the Treasury Division of the Department of Revenue has contracted with independent organizations to receive comparative investment performance reviews of the two Funds.

The Commissioner's proposals regarding reporting and auditing are a necessary corollary to the proposals designating the Public Employees' Retirement and Teachers' Retirement Funds as trusts and designating the Commissioner as the fiduciary of the Funds. As the Task Force Report noted:

> The establishment and maintenance of professional accounting, auditing, and actuarial practices <u>is part of the general fiduciary responsibility which plan officials owe to the plan participants</u>. Obviously an accurate accounting

> of the plan's assets and liabilities, estimation of funding status and experiences, and auditing of plan procedures are essential to the honest and responsible operation of the pension system.[107]

Recognition of the importance of reporting and auditing standards to the fiduciary obligations of plan managers is reflected in ERISA, which requires private employee benefit plans subject to ERISA to file detailed annual reports with the Department of Labor and to be audited by independent public accountants.[108] Many states now require analagous reports covering their public plans.[109] The Commissioner's reporting and auditing proposal is comparable to these state and federal provisions and should facilitate the Commissioner's fulfilling his fiduciary obligations toward the Public Employees' Retirement and Teacher's Retirement Funds.

Section II: Related Issues

A. Federal Income Taxation Implications

At the present time, the federal government regulates the conduct of public pension plans through the application of

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107 Task Force Report at 185-86 (emphasis added).

108 ERISA § 103(a). The legislative history of ERISA makes clear that Congress believed that annual audit and reporting requirements provide important safeguards to plan beneficiaries by making plan fiduciaries aware that their handling of plan assets will be open to inspection. S. Rep. No. 127, 93d Cong., 1st Sess. 27 (1973), reprinted in 1974 U.S. Code Cong. & Ad. News 4838, 4863; H.R. Rep. No. 533, 93d Cong., 1st Sess. 11 (1973), reprinted in 1974 U.S. Code Cong. & Ad. News 4639, 4649.

109 See, for example, Cal. Gov't Code §§ 20206.5, 20233 (Deering Supp. 1987); Cal. Ed. Code §§ 22218, 22220 (Deering Supp. 1987).

the Internal Revenue Code of 1986 (the "Code"). Under the Code, three principal forms of tax benefits are available with respect to a public pension plan: (1) the public entity sponsoring the plan is entitled to deduct amounts contributed to the plan up to certain limits;[110] (2) the earnings of the plan are not taxed currently;[111] and (3) the contributions made by the public entity to the plan on behalf of an employee are not currently imputed to the employee, even if vested.[112] To be entitled to these benefits, a funded, government-sponsored plan must, among other things, meet certain of the requirements specified in Section 401(a) of the Code for private retirement plans seeking tax-exempt status.[113] Section 401(a) conditions tax-exempt status on,

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110 I.R.C. § 404(a)(1986).

111 Id. § 501(a).

112 Id. § 402(a). The provisions of Section 402(a) are, in effect, an exception to the general rule stated in Section 83 of the Code. Under Section 83, if an employer sets aside contributions to fund deferred compensation or retirement benefits for an employee, the contributions will be included in the employee's income, so long as the employee is not subject to a substantial risk of forfeiture of the benefits. Thus, under Section 83, an employee having a vested interest in a benefit will be currently taxed on the benefit.

113 Rev. Rul. 72-14, 1972-1 C.B. 106. The passage of ERISA in 1974 resulted in many changes in the provisions of the Code applicable to private plans seeking to qualify for tax-exempt status. Public plans are expressly exempted (Footnote Continued)

among other things, the plan's (1) being organized "for the exclusive benefit" of employees, (2) providing definitely determinable benefits, (3) satisfying anti-discrimination rules and (4) providing full vesting on discontinuance or termination of the plan.[114] Section 401(a) also implicitly requires the assets of a plan seeking to meet the Section's conditions be maintained in trust.[115]

To date, enforcement by the Internal Revenue Service (the "IRS") of the requirements of Section 401(a) against public pension plans has been, for the most part, non-existent.[116] Recognizing that enforcement of the requirements would serve only to harm innocent plan participants, the IRS announced in 1977 that, until a study of the application of Section 401(a) to public plans could be completed, disputes over compliance with the Section would be

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113 (Footnote Continued)
from ERISA and, thus, are not subject to most of the qualification requirements added by ERISA. Public plans are, however, subject to the qualification requirements applicable prior to ERISA. See, for example, Sections 410(c)(2) and 411(e)(2) of the Code.

114 I.R.C. § 401(a).

115 Section 401(a) states that "[a] trust. . .forming part of a stock bonus, pension or profit-sharing plan of an employer. . .shall constitute a qualified trust. . ." if the various requirements listed in the Section are met. <u>See also</u> 26 C.F.R. § 1.401-(a)(3) (1987); Rev. Rul. 69-231, 1969-1 C.B. 118; Internal Revenue Service Publication 778(2-72), Parts 2(b) and 2(f).

116 Task Force Report at 129; Public Pension Funds, <u>supra</u> note 12, at 191 n. 17; Campbell & Josephson, <u>supra</u> note 15, at 62.

settled in favor of the taxpayer or governmental unit.[117] The announcement continues in effect at present.

An IRS decision to change its current policy on enforcement of the requirements of Section 401(a) would not necessarily affect public plans significantly. Historically, the Section's key substantive requirement--the exclusive benefit rule--has not been a stringent constraint.[118] The IRS has interpreted the rule, which has been called a codification of the common law duty of loyalty imposed on a trustee,[119] to permit parties other than the employees covered by the plan to benefit from the plan's investments.[120] Courts considering the issue have agreed that an incidental benefit to a third party is not sufficient to disqualify the plan from tax-exempt status.[121]

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117 I.R.S. Info. Rel. IR-1869 (August 10, 1977).

118 Hutchinson & Cole, supra note 101, at 1348.

119 Campbell & Josephson, supra note 15, at 62.

120 In 1969, the IRS indicated that collateral benefits to other parties are acceptable if four requirements are met with respect to an investment: (1) the cost of the investment may not exceed fair market value at the time the investment is purchased; (2) a fair return commensurate with the prevailing rate must be provided by the investment; (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to must be present. Rev. Rul. 69-494, 1969-2 C.B. 88.

121 Hutchinson & Cole, supra note 101, at 1348; See Shelby U.S. Distribs., Inc. v. Commissioner, 71 T.C. 874, 885 (1979); Feroleto Steel Co. v. Commissioner, 69 T.C. 97, 113 (1977).

Notwithstanding the IRS' position with respect to enforcement of the Code's provisions against public plans, and the manner in which the IRS and courts have interpreted those provisions, at least two commentators have suggested that a trustee of a public plan would breach a fiduciary duty if it caused the plan to jeopardize the tax benefits available under the Code.[122] Underlying this suggestion is the assertion that the tax benefits offered by the Code--particularly the ability of an employee of a public plan to defer taxes--are quite significant.[123]

We are aware of no judicial decision supporting the view that a breach of a fiduciary obligation would be deemed to result if a public plan failed to meet the requirements of the Code. Indeed, the Task Force Report noted in 1978 that well over three-quarters of all public plans have failed to seek an IRS determination letter of tax-exempt status and that about 57 percent of the representatives of public plans surveyed by the

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122 Campbell & Josephson, _supra_ note 15, at 59.

123 _Id_. Commentators have noted that of the three benefits generally available to public plans under the Code, only the ability of employees to defer tax is of real significance. The other benefits are available to state or local governments even in the event of non-compliance with the provisions of Section 401(a), because state and local governments are generally exempt from federal taxes. See Public Pension Funds, _supra_ note 12, at 192 n.19; Task Force Report at 33.

task force's staff indicated an unfamiliarity with the application of the Code to their plans.[124]

We understand that the Commissioner currently seeks to operate the Public Employees' Retirement Fund and the Teachers' Retirement Fund in accordance with the provisions of the Code.[125] We believe that this policy with respect to compliance with the Code is appropriate. We do note, however, that versions of a proposed federal law governing the operation of public plans, entitled the "Public Employee Pension Plan Reporting and Accountability Act" ("PEPPRA"), would relieve those plans of the obligation to comply with the requirements of the Code to preserve favorable tax treatment for plan participants.

The Commissioner's proposal to designate the Public Employees' Retirement Fund and the Teachers' Retirement Funds as trusts will serve to ensure compliance with the implicit requirement of Section 401 of the Code that plan assets be held

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124 Task Force Report at 77.

125 An examination of whether these Funds are in fact in compliance with all applicable rules of the Code is beyond the scope of this Memorandum. Note, for example, that Section 503(b) of the Code effectively prohibits certain transactions between these Funds and the State. Among the transactions prohibited are (1) loans made without adequate security and a reasonable rate of interest and (2) any transaction that results in a substantial diversion of income or corpus to the State.

in trust.[126] In addition, the Commissioner's proposal that the assets of the Public Employees' Retirement Fund and the Teachers' Retirement Fund be used only in regard to the financial interests of their beneficiaries should act to ensure compliance with the exclusive benefit rule contained in Section 401(a) of the Code.

B. Liability, Indemnification and Insurance

The Commissioner's proposals discussed in Section I of this Memorandum, if adopted, would have the general effect of increasing the fiduciary obligations of the Commissioner and his staff in investing on behalf of the Funds. The increase in the extent of those obligations raises the issues of (1) the potential liability in the event of a breach of those obligations, (2) the extent to which the Commissioner's employees may be indemnified in connection with investment activity undertaken on behalf of the Funds and (3) the extent to which insurance may be obtained covering employees responsible for the Funds' investments. Each of these issues is discussed below.

(1) Liability

[A] Liability of the State, the Commissioner and State Employees

Currently, none of the provisions governing

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126 Note that versions of PEPPRA introduced to date have included a requirement that assets of public plans be held in trust.

investments that may be made on behalf of the Funds specifies the parties that may be found liable for a breach of any obligation imposed by those provisions. In light of the Commissioner's general investment authority with respect to the Funds under Alaska Stat. § 44.25.010 and Alaska Stat. § 44.25.020(2), however, an Alaska court could reasonably conclude that the Commissioner and those he employs are each potentially liable for breach of any of the investment provisions relating to the Funds. The likelihood of a court's finding potential liability on the part of the Commissioner and those he employs would increase significantly to the extent the assets of a Fund were required by statute to be held in trust and the Commissioner were deemed a fiduciary of the Fund. As noted above in Section I.A of this Memorandum, at common law, a trustee who commits a breach of trust is chargeable for any loss or depreciation in value of the trust estate resulting from the breach or any profit made by the trustee through the breach.[127] Drawing on this common law principle, Section 409(a) of ERISA states that a fiduciary of an employee benefit plan that breaches an obligation toward the plan will be:

> personally liable to make good to such plan any losses to the plan resulting from [the] breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial

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127 Restatement § 205. See note 18 supra.

> relief as the court may deem appropriate, including removal of such fiduciary.[128]

Assessing the potential liability of the Commissioner and those he employs for breaches of fiduciary obligations towards the Funds requires consideration of the doctrines of sovereign immunity and official immunity as interpreted by Alaska courts. The doctrine of sovereign immunity is incorporated in Alaska Stat. § 9.50.250, under which the State may be sued for contract and quasi-contract claims only after they have been reviewed administratively. No tort claim may be brought against the State under Alaska Stat. § 9.50.250 that is based upon the act or omission of a State employee exercising due care in the execution of a statute or regulation, and no tort claim may be brought against the State that is based upon the exercise or failure to exercise or perform a discretionary function or duty, whether or not discretion is abused.

In interpreting the term "discretionary function or duty" under Alaska Stat. § 9.50.250, the Alaska Supreme Court has applied a "planning-operational" test to distinguish between protected and unprotected levels of government decision-making.[129] Under this standard, "only decisions that rise to the level of basic planning or policy formulation will be considered discretionary; decisions that implement policy decisions and are ministerial or operational in nature

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128 ERISA § 409(a).

129 Div. of Corrections v. Neakok, 721 P.2d 1121, 1133 (Alaska 1986).

will not be immune."[130] The Alaska Supreme Court has narrowly construed this standard, refusing to immunize "even acts that involve substantial exercise of discretion, but that do not rise to the level of policy decisions."[131] The doctrine of sovereign immunity thus has been interpreted to attach only under those limited circumstances in which basic policy-making is involved.

Whether the role of State employees with respect to the Funds would be deemed to be policy-making in nature under the planning-operational test, as articulated by the Alaska Supreme Court, is questionable. The investment operations of the Funds, by their nature, clearly involve the use of some amount of discretion on the part of employees of the Department of Revenue and/or professionals hired by the State. These discretionary acts, however, could be viewed as merely involving the implementation of the policies of the State reflected in the statutes governing the investment operations of the Funds. A court's accepting this characterization of the role of those persons having investment responsibility for the Funds would result in the State's not being immune from suit under Alaska Stat. § 9.50.250 for breaches of fiduciary duty on the part of those State employees.

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130 Id.

131 Id.

Alaska Stat. § 9.50.250, by its terms, applies only to State immunity, but does not insulate employees of the State from suit.[132] Under the doctrine of official immunity formulated by Alaska courts, however, State employees may be immunized from personal liability for discretionary acts they undertake within the scope of their official authority.[133] The Alaska courts have held that the standards for determining what constitutes a discretionary act for purposes of official immunity is broader than the sovereign immunity planning-operational standard.[134] Discretionary acts, for the purposes of the doctrine of official immunity, have been defined by the courts as "those requiring personal deliberation, decision and judgment," as distinguished from ministerial acts, which are those acts amounting "only to obedience of orders, or the performance of a duty in which the officer is left with no choice of his own."[135]

Under the broader interpretation of discretionary functions used by the courts in applying the doctrine of official immunity, the decisions undertaken by those persons employed by the Commissioner in connection with the Funds' investment operations would appear to be of a discretionary

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132 Aspen Exploration Corp. v. Sheffield, 739 P.2d 150, 162 n.29 (Alaska 1987).

133 Bridges v. ASHA, 375 P.2d 696, 702 (Alaska 1962).

134 Aspen, 739 P.2d at 155.

135 Id.

nature, involving the personal deliberation, decision and judgment of the employees.[136] Thus, under current law, those employed by the Commissioner may be immune from suit for nonmalicious breach of their fiduciary obligations toward the Funds.[137]

That an employee of the Commissioner may be immune to suit for breach of a fiduciary obligation to a Fund may be viewed as inconsistent with the public policy considerations underlying many of the Commissioner's proposals; an employee

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136 The conclusion that employees of the Commissioner may be immune from suit is supported by a 1982 informal opinion of the Alaska Attorney General regarding the Alaska Permanent Fund Corporation. In that opinion, the Attorney General concluded that "[t]he immunity for discretionary acts [as defined by Alaska courts] probably covers most decisions and actions of the trustees [of the Permanent Fund]. Relationship of Alaska Permanent Fund Corporation to State, Op. (Inf.) Att'y Gen. (Dec. 1982).

137 Note that once an official act is deemed to be of a discretionary nature, the Alaska Supreme Court has utilized a balancing test to determine whether an official is entitled to "absolute immunity," applicable even if improper motives were involved in the official's acts, or "qualified immunity," which is applicable only when the acts under scrutiny were done in good faith, free of malice or corruption. The Court has stated that in making such a determination, a balance must be struck between the public's interest in vigorous, unfettered administration of policy by state officials and the interests of maliciously injured parties. The following factors should be considered in deciding whether motives are to be considered in granting employee immunity: (1) the nature and importance of the function that the officer performed to the administration of government; (2) the likelihood that the officer will be subjected to frequent accusations of wrongful motives and how easily the officer can defend against these allegations; and (3) the availability to the injured party of other forms of relief. Aspen Exploration Corp. v. Sheffield, 739 P.2d at 159-60.

who has no concern regarding potential suits may be less diligent in meeting his fiduciary obligations.[138] Thus, the Commissioner may wish to consider amending current law to provide explicitly that an employee of the Commissioner will generally not be immune from a suit asserting a breach of a fiduciary obligation, but will not be liable for a breach so long as in seeking to fulfill his obligation he acted in good faith, acted within the scope of his employment and acted prudently under the circumstances. This standard for limitation of liability of a fiduciary is generally consistent with one deemed acceptable by the staff of the Securities and Exchange Commission (the "SEC") for investment advisers registered under the Investment Advisers Act of 1940, as amended.[139]

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138 ERISA reflects the view that immunity from suit is inconsistent with fiduciary obligations. Section 410 of ERISA specifies that, subject to certain limited exceptions, "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under [ERISA] shall be void as against public policy.

139 See, e.g., Auchincloss & Lawrence, SEC No-Action Letter (February 8, 1974); Funds Advisory Co., SEC No-Action Letter (December 12, 1974); Westamerica Securities, Inc., SEC No-Action Letter (March 14, 1974). In these letters the SEC staff suggests that indemnification of an adviser guilty of negligence is inappropriate. The United States Supreme Court has stated that a registered investment adviser is a fiduciary who owes his clients an affirmative duty of utmost good faith and full and fair disclosure of all material facts. SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

[B] Liability of Service Providers

As suggested in Section I.D of this Memorandum, the Bill, if adopted, would serve not only to authorize the Commissioner to delegate certain responsibilities with respect to the Funds to independent third parties, but also to require delegation to third parties under certain circumstances. Neither the Bill nor the statutes governing the operation of the Funds currently in effect, however, address the potential liability of third parties for breaches of fiduciary obligations toward the Funds. Moreover, neither the Bill nor current law deals with the potential liability of the Commissioner for the actions or non-actions of third parties providing services to the Fund.

In the absence of an express provision dealing with the issue of third party liability to the Funds, an Alaska court might well look to the provisions of ERISA for guidance. Under ERISA, a third party service provider is liable under Section 409(a) of ERISA,[140] if the party meets the definition of "fiduciary." ERISA defines the term quite broadly to include any person who (1) has discretionary authority or control regarding management or administration of a plan, (2) gives investment advice to the plan or (3) exercises control or authority with respect to management or disposition of a plan's

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140 The terms of Section 409 are set out in full in the text in the immediately preceding sub-section of this Memorandum.

assets.[141] Most third party service providers to which the Commissioner would typically delegate responsibilities for the Funds are likely to fall within the ERISA definition of fiduciary and, thus, under an ERISA analysis, would be potentially liable for breaches of their obligations toward the Funds.[142]

ERISA provides guidance with respect to not only the potential liability of independent third parties rendering services to the Funds, but also the potential liability of the Commissioner for misconduct of those parties. ERISA expressly authorizes a fiduciary of a plan to delegate investment responsibility for the plan to any entity meeting the definition of an "investment manager."[143] If the delegation is undertaken in accordance with procedures specified in

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141 ERISA § 3(21).

142 In general, third party service providers who do not come within ERISA's definition of fiduciary are those that perform administrative functions within a framework of policies and interpretations made by other persons. See O'Toole v. Arlington Trust Co., 681 F.2d 94 (1st Cir. 1982) (non-trustee custodial bank having only physical control of plan assets and limited responsibilities for certain ministerial functions held not a fiduciary under ERISA); see also Donovan v. Williams, 4 Employee Benefits Cas. (BNA) 1237 (N.D. Ohio 1983).

143 ERISA § 405 (d)(1). Under Section 3(38) of ERISA, an investment manager is limited to an investment adviser registered under the Investment Advisers Act of 1940, as amended, a bank, as defined in that Act, or an insurance company qualified under the laws of more than one state to manage, acquire or dispose of any assets of a plan.

ERISA,[144] then the fiduciary is generally relieved of any direct liability incurred by the investment manager.[145] The Department of Labor has taken the position that the delegating fiduciary retains the duty to monitor the activities of his managers[146] and is not relieved of responsibility merely because he has followed the advice of his investment managers.[147]

Like its rules regarding delegation, ERISA's provisions dealing with co-fiduciary liability are instructive in analyzing the Commissioner's potential liabilities for breaches of fiduciary obligations towards the Funds by independent third parties. Section 405(a) of ERISA provides that a plan fiduciary is liable for a breach of fiduciary responsibility of another fiduciary to the same plan if (1) the plan fiduciary participates knowingly in, or knowingly undertakes to conceal, an act or omission of the co-fiduciary that the plan fiduciary knows constitutes a breach; (2) by his failure to comply with the prudence, diversification, exclusive

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144 See ERISA § 402(c).

145 ERISA § 405(d)(1). Section 405(d)(1) may be viewed as generally similar to the common law rule of delegation by a trustee. Under common law, a trustee may delegate its responsibilities so long as delegation is authorized by the terms of the trust. Restatement § 171 comment j; Bogert, Trusts & Trustees § 555 (2d ed. 1980).

146 Department of Labor letter to J.J. O'Donnell and Frank Borman (June 2, 1980).

147 H.R. Rep. 1280, 93d Cong., 2d Sess. 302 (1974).

purpose and plan document requirements of Section 404(a)(1) of ERISA in the administration of his own fiduciary duties, the plan fiduciary enables another fiduciary to commit a breach; or (3) the plan fiduciary has knowledge of a breach of the other fiduciary and does not make reasonable efforts under the circumstances to remedy the breach.

The Department of Labor has stated its views regarding remedial actions that should be taken to prevent co-fiduciary breaches under ERISA.[148] The Department has suggested co-fiduciaries must take all reasonable and legal steps to prevent the breach. Those steps might include obtaining a court injunction of the breach,[149] notifying the Department of the breach, notifying the plan sponsor or publicizing the action. In addition, according to the Department, all meetings with respect to management and control of plan assets should be documented and an objection on grounds of potential violations of fiduciary responsibility provisions should be made part of the record. The Department has also suggested that, if a fiduciary believes a co-fiduciary has already committed a breach, resignation as a protest against the breach will not

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148 Fiduciary Responsibility Question and Answer 10 appearing in ERISA I.B. 75-5, 29 C.F.R. § 2509.75-5 (1987).

149 <u>See</u> ERISA § 502(a)(3).

generally be considered sufficient to discharge the duty to make reasonable efforts to remedy the breach.[150]

Cases decided to date under Section 405(a) of ERISA indicate instances in which co-fiduciary liability may be present. In Freund v. Marshall & Ilsley Bank,[151] for example, the court found that certain trustees' lack of involvement in a company sale transaction did not relieve them of their fiduciary duties, because their failure to monitor the conduct of the seller trustees enabled and facilitated the seller trustees' breach. In Donovan v. Williams,[152] the court found a fiduciary to have violated Section 405 when he failed to make reasonable efforts to correct a wide range of breaches committed by a co-fiduciary and others. The court held that given his unique responsibilities for, and knowledge of, the financial books of the plans involved, and his failure to provide trustees access to those books, the fiduciary enabled the plan administrator to violate ERISA's reporting and disclosure provisions. The court also found that the fiduciary's detailed knowledge of the finances and operations of the collection account, plan book accounts and unions covered by the plans was sufficient to establish the type of knowledge required for a violation of Section 405, when the

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150 Fiduciary Responsibility Question and Answer 10 appearing in ERISA I.B. 75-5, 29 C.F.R. § 2509.75-5 (1987).

151 485 F. Supp. 629 (W.D. Wis. 1979).

152 4 Employee Benefit Cas. (BNA) 1237 (N.D. Ohio 1983).

fiduciary failed to make reasonable efforts to remedy the trustees' failure to collect amounts owed to the plan. In Free v. Briody,[153] the court concluded that a trustee's nonfeasance enabled a co-fiduciary to entrust plan assets with an embezzler. Although the majority of the losses occurred only four days after he assumed trustee status, the court found the trustee liable, noting that no grace period exists between the date one becomes a trustee and the date one is expected to assume the duties of the office.

ERISA's provisions with respect to delegation and co-fiduciary liability and court and administrative interpretations of those provisions suggest that the Commissioner may limit its potential liability for misconduct of third party service providers by diligently selecting those entities and monitoring their services. Perhaps more importantly, the various interpretations of ERISA's delegation and co-fiduciary provisions suggest that the issue of third party conduct is a significant one with which the Commissioner may wish to deal by express statute rather than by application of analogous provisions of law.

(2) Indemnification

Related to the issue of potential liability of the Commissioner for breaches of fiduciary obligations owed the Funds is the question of indemnification by the State of

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153 732 F.2d 1331 (7th Cir. 1984).

employees of the Commissioner in connection with alleged breaches.[154] A 1982 informal opinion of the Attorney General noted that "[t]o the extent that the state is exposed to liability due to the acts or omissions of an officer or employee, it is state policy to defend and indemnify the officer or employee against any personal liability, but there is no statute expressing this policy."[155] The same opinion continued by saying that Alaska "law regarding . . . indemnification of public officers is somewhat confusing, and the adoption of a statute stating the scope of indemnity would undoubtedly ease the concerns of state employees or officers who have considered the issue."[156]

The Bill in its current form contains no specific provision for indemnification of the Commissioner's employees for alleged breaches of fiduciary duty. In view of the increased amount of fiduciary duties that would be imposed on those employees under the Bill, if adopted, the Commissioner

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154 We assume that the State would not as a matter of policy wish to indemnify independent third parties in connection with alleged breaches. We understand that many state pension plans and other state authorities have adopted such a policy on the basis of notions of sovereign immunity. To our knowledge, the State has not adopted such a policy to date.

155 Relationship of Alaska Permanent Fund Corporation to State, Op. (Inf.) Att'y Gen. (Dec. 2, 1982).

156 Id. As of the date of this opinion, the Alaska Commercial Fishing and Agriculture Bank was the only Alaskan public corporation specifically providing by statute for indemnification of its officers and employees.

might consider adding a provision to the Bill concerning indemnification, even if the Bill is not amended to provide specifically that those employed by the Commissioner are not immune from suit for a breach of fiduciary responsibility toward the Funds. We suggest that, at the very least, such a provision condition indemnification on an employee's acting prudently and in good faith within the scope of his employment.

(3) Insurance

The Commissioner, in addition to providing indemnification for his employees in connection with alleged breaches of fiduciary duties, may wish to consider obtaining insurance covering those breaches. That the purchase of insurance is consistent with a policy of promoting a high level of fiduciary conduct is suggested by Section 410(b) of ERISA, which specifically authorizes the obtaining of insurance covering ERISA fiduciaries.[157] We note our general understanding, however, that a meaningful amount of insurance is currently quite difficult to obtain at acceptable prices. Due to the proliferation of fiduciary suits under ERISA, many insurance companies have significantly increased premiums for fiduciary insurance, while cutting back the coverage offered. In other cases, insurance companies have ceased completely to offer fiduciary insurance.

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157 ERISA § 410(b).

Section III: Establishment of Independent Trust Company

The Commissioner has presented, in a legislative package separate from the Bill, a proposal to create an independent trust company (the "Trust Company") that would be responsible for the management of the investments and the custody of the assets of the Public Employees' Retirement Fund, the Teachers' Retirement Fund, the Judicial Retirement Fund, the Alaska National Guard and Alaska Naval Militia Retirement Fund, the Public School Fund and the University of Alaska Fund. The Trust Company would operate under the general supervision of a board of directors (the "Board") composed of a Chairman, proposed to be either the Commissioner or Deputy Commissioner of Revenue, three outside directors, each of whom would be a professional executive trust officer from outside the State and unconnected in any way with the State, and two in-state directors, one an elected member of the administrative board of the Public Employees' Retirement System, and the other a member of the board of the Teachers' Retirement System selected by that board. Compensation of the Chairman of the Board and the in-state directors would be limited to travel expenses, a per diem and out-of-pocket expenditures, whereas outside directors would receive a flat annual fee equal to a percentage of the market value of the assets administered by the Trust Company at the start of each year.

Under the Commissioner's proposal, the Trust Company's budget would not be controlled by the Executive or Legislative branches of the State, the Trust Company's operations would not be subject to review, approval or control by the State's Department of Administration, and the Trust Company's employees and management would not be State employees. The Trust Company's management, which would include a chief executive officer, a chief investment officer, an internal auditor, a vice president of operations, a vice president of research and a senior portfolio manager, would have authority to hire and fire employees, managers, custodians, advisers, consultants, legal counsel and service vendors, procure equipment facilities and supplies, and enforce contracts and agreements. Management would also be responsible for preparing various reports, analyses and records that would be provided to the Board. Financial records of the Trust Company would be audited annually by an independent certified public accounting firm.

The investment policies to be undertaken by the Trust Company would be determined, under the Commissioner's proposal, by a committee that would be chaired by the Trust Company's chief investment officer and that would include the Trust Company's chief executive officer, vice president of research, senior portfolio manager and three out-of-state and unrelated investment management professionals recommended by the chief investment officer and appointed by the chief executive officer, who are well-regarded and have established records as managers of comparable private funds. Investment policies of the Trust Company would be executed free of any statutory restrictions other than a prudent expert rule. Thus, in the establishment of its policies and its general operations, the Trust Company would operate in a manner similar to investment management and trust operations in the private sector, except that all personnel at decision levels would be required to be professionally accredited.

The proposal to create the Trust Company reflects an attempt to deal with perhaps the most significant problem involved in the investment management of public plans; those officials responsible for that management face a conflict of interest because they "are generally appointed by, and answer to, the political process rather than plan participants."[158] As the Commissioner has himself noted, formation of the Trust Company would, among other things, "substitute a professional corporation for the state as trustee, thus reducing the chance of political or administrative factors interfering with investment policy. . ."[159]

In seeking to deal with the conflicts of interest involved in the investment management of the Funds, the Commissioner is proposing a fundamental change in the structure of the Funds' operations. Two basic structures for the control of public enterprises have been identified by commentators: the

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158 Public Pension Funds, supra note 12, at 213.

159 Memorandum from Hugh Malone, Commissioner of Revenue, to Robert A. Evans, Legislative Liaison, Office of the Governor (August 14, 1987).

government department form and the public corporation form.[160] Investment management of the Funds currently takes the government department form, which is generally characterized by

> direct responsibility on all matters devolv[ing] on the director of the department and ultimately on the chief executive of the government. Direct government control of operations is exercised by executive order and legislative review. Personnel are usually subject to civil service regulation. The enterprise is financed by annual appropriations and is subject to the budget, accounting, and audit controls applicable to other government activities. The enterprise frequently possesses the sovereign immunity of the state.[161]

The public corporation form, which form the Trust Company would take, is generally characterized by its own board of directors, financing, budget accounting and auditing procedures, as well as the ability to sue and be sued in its own name.[162]

Each of the government department and the public corporation forms suffers from operational problems. Due to pressures to conform to standard government regulations and procedures, the government department form is characterized by a lack of information, an inability to respond quickly and a high degree of operating difficulty.[163] Although the public

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160 N. Hamilton & P. Hamilton, Governance of Public Enterprise 78 (1981); United Nations Technical Assistance Administration, Some Problems in the Organization and Administration of Public Enterprises in the Industrial Field, U.N. Doc. ST/TAA/M/7 (1954).

161 N. Hamilton and P. Hamilton, supra note 160, at 72.

162 Id. at 75-84.

163 Id. at 73-75.

corporation form deals with these problems by being autonomous, it is often characterized by a lack of a consistent pattern or coherent theory addressing the issues of policy formation and efficient operation.[164] The Trust Company's proposed investment committee would appear to represent a reasonable solution to this problem of the public corporation form.

In general, public plans in the United States take the government department form.[165] Some precedent does exist, however, for the format offered by the Commissioner in proposing the Trust Company. Under the laws of the State of Minnesota, for example, public retirement systems are operated by retirement boards, but investment responsibility for the systems is delegated to the State Board of Investment, which includes five constitutional officers.[166] An executive director, who must be an experienced investment professional, is appointed by the State Board of Investments and is responsible for planning, directing, coordinating and executing administrative and investment functions in accordance with the

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164 Id. at 78.

165 See Task Force Report at 65.

166 Minn. Stat. Ann. §§ 11A.03-.04 (West 1988). The five officers include the governor, state auditor, state treasurer, secretary of state and attorney general. The Minnesota retirement system is described and analyzed at some length in Murphy, Regulating Public Employee Retirement Systems for Portfolio Efficiency, 67 Minn. L. Rev. 211 (1982).

policies and directives of the State Board.[167] Both the executive director and the State Board of Investments are in turn advised by a statutorily created Investment Advisory Council composed of seventeen members, ten of whom must be individuals experienced in general investment matters.[168] The operational framework reflected in the Minnesota statutes, like the Commissioner's Trust Company proposal, reflects an attempt at reducing the local political pressures inherent in many public employee plans.[169]

A second precedent for the proposed structure of the Trust Company is one well-known to the Commissioner, the Permanent Fund. The Permanent Fund, which has a legal existence independent of, and separate from, the State, is operated under the direction of a six-person board of trustees appointed by the Governor that includes the Commissioner, two other State commissioners and three public members.[170] The public members, who must be confirmed by the Legislature, may not hold any other State or federal office or employment and must have recognized competence and wide experience in finance, investments or other business management-related fields.[171]

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167 Minn. Stat. Ann. § 11A.07 (West 1988).

168 Minn. Stat. Ann. § 11A.08 (West 1988).

169 Murphy, _supra_ note 166, at 212 n.3.

170 Alaska Stat. §37.13.050 (1983).

171 Alaska Stat. §37.13.050 (1983).

Confirmation of the public members of the Permanent Fund's board reflects a legislative intent somewhat different from that implicit in the Trust Company proposal; as noted in the legislative history of the Permanent Fund, the aim of the Legislature was "to establish a management system for the Alaska Permanent Fund which would be protected from political influence but, at the same time, responsive to changes in state policy and accountable to the people through their elected officials. In short, the aim was insulation without isolation."[172]

Additional precedential support for the Commissioner's Trust Company proposal may be found in actions taken by the State of Connecticut in the early 1970s to reform its public pension systems.[173] In 1972, the assets of five state trust funds, which were centrally managed under the authority of the state treasurer, were organized for investment purposes into a fixed-income, a common stock and a mortgage fund. The treasurer also appointed an investment advisory council, composed principally of insurance company executives and others with investment experience, that assisted the treasurer to select an in-house staff and outside investment advisers. As a further measure, the treasurer established Connecticut Nutmeg

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172 Alaska State Legislature, Free Conference Committee Report, FCCS For SB 161 (April 2, 1980) (emphasis added).

173 The reforms are described in detail in Kohlmeier, supra note 19, at 878.

Securities, Inc., which remains operational at present, and which was the first brokerage firm owned and operated by a governmental unit to execute stock transactions. The elements of Connecticut's reforms--separation and centralization of functions and the use of experts--are generally similar to those underlying the Trust Company proposal.

The notion of separation of functions as a means of resolving conflicts of interest is one that is used not only by public pension plans, but by other financial institutions. Banks, for example, have for some time made use of a procedure, typically referred to as a "Chinese Wall," that is designed to limit, or in some instances completely block, the flow of information between trust and commercial departments. Although the use of Chinese Walls by banks was promoted in the 1960s as a means of preventing the inappropriate use of "inside information" that could potentially expose banks to liability under the federal securities laws,[174] the segregation of

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174 The concept of the Chinese Wall as a device designed to deal with potential liability under the federal securities laws was first endorsed in a late 1960s settlement of a case involving the selective "leaking" by Merrill, Lynch, Pierce, Fenner & Smith Incorporated ("Merrill") of negative news its underwriting division had learned about Douglas Aircraft Co., Inc. In settling the case with the SEC, Merrill's underwriting division agreed not to disclose material, non-public (that is, "inside") information to Merrill's other divisions. Exchange Act Release No. 8,459 [1967-1969 Dec.] Fed. Sec. L. Rep. (CCH) ¶ 77,629 (Nov. 25, 1968). The use of a Chinese Wall to ensure the compliance with federal securities laws has since been supported by the SEC, in adopting Rule 14e-3, 17 C.F.R. § 240.14e-3 (1987), and by
(Footnote Continued)

functions between a bank trust and commercial departments has proven to be useful in preventing the use of trust assets to further policies or goals of the commercial departments and their corporate clients.[175]

Among the conflicts of interest that banks have had to resolve in operating both commercial and trust departments are: (1) the exertion of pressure by the commercial side upon the trust department to service the needs of commercial customers that maintain large commercial deposits through the use of trust assets, possibly to the detriment of trust beneficiaries; (2) the allocation of brokerage commissions from trust account trades to brokers that maintain large demand deposits with, or provide research services to, the commercial side; and (3) the placement of uninvested trust cash in low-interest or non-interest bearing time deposit accounts on the commercial side of the bank, thereby limiting the productivity of trust assets.[176]

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174 (Footnote Continued) the Comptroller of Currency, in regulating the conduct of national banks, 12 C.F.R. § 9.7(d) (1987).

175 See Mendez-Penate, The Bank "Chinese Wall": Resolving and Contending with Conflicts of Duties, 93 Bank. L.J. 674, 689 (1976). See also Lybecker, Regulation of Bank Trust Department Investment Activities, 82 Yale L.J. 977 (1973).

176 See Mendez-Penate, supra note 175, at 689; Herman, Conflicts of Interest: Commercial Bank Trust Departments, 45-56, 108-114 (1975); Lybecker, supra note 175, at 981-992. Note that, although the commercial side of a bank may have the ability to influence investment decisions by the trust department, the commingling of (Footnote Continued)

Although some of the conflicts faced by banks have been addressed by specific state and federal banking regulations limiting certain practices,[177] many commentators have endorsed the use of a self-imposed separation of the commercial and trust departments to help assure that the interests of trust beneficiaries in maximizing investment performance is not subordinated to the bank's interest in maximizing profits from its commercial operations.[178] Most commentators have suggested the use of an "impermeable" or a "semi-impermeable" Chinese Wall between the trust and commercial sides of the bank to block the flow of certain types of information between the departments. Other commentators, however, have suggested the separate incorporation of the trust department outside the bank complex--that is, the complete divorce of the trust business from the commercial bank--in

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176 (Footnote Continued) trust assets with other accounts in the bank is expressly prohibited by most state and federal banking law statutes. See 12 C.F.R. § 9.13 (1987) (expressly mandating the separation of trust assets from bank assets).

177 See 12 C.F.R. §§ 9.7, 9.10, 9.12 (1987) (Comptroller of Currency National Bank regulations concerning the administration of fiduciary duties, the allocation of uninvested trust cash, and bank self-dealing).

178 See, Mendez-Penate, supra note 175, at 689-710; Lybecker, supra note 175, at 981-984.

order to alleviate completely the many conflicts of interest that exist between the two sides.[179]

The Chinese Wall approach suggested by the banking industry is instructive in analyzing the Trust Company proposal; the Commissioner, in managing the investment of the Funds, is faced with conflicts of interest somewhat analogous to those faced by banks. State officials, for example, may wish to exert pressure on Fund administrators to invest Fund assets in the securities of Alaska issuers to promote regional economic vitality, or other social policies. State officials may also desire that the Funds use local service providers in managing Fund assets, even though better, lower-cost services may be available out of state.[180] The Chinese Wall procedure established by Banks suggests that the separation of the State's political policy-making function from the Funds' investment operations might help assure that political pressure will not influence the administration and investment of Fund

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179 See Lybecker, Regulation of Bank Trust Department Investment Activities: Seven Gaps, Eight Remedies: Part II, 2 Sec. Reg. L. J. 225, 262-265 (1974); Lybecker, supra note 175, at 1001; Mendez-Penate, supra note 175, at 705-709. The proposals to divorce the trust business from commercial banking completely have been severely criticized as economically unfeasible and impractical because of the economic interdependencies of the two departments. The general consensus among commentators has been that independent trust companies would be unable to survive on their own resources; this concern would not necessarily be a problem for the proposed Trust Company. Id.

180 See, generally, L. Kohlmeier, supra note 19.

monies, and that investments on behalf of the Funds will be made in a manner consistent with the interests of Fund beneficiaries.

Of the various precedents described above supporting the establishment of the Trust Company, the one most closely resembling the Trust Company is the State of Minnesota public retirement systems. Those systems were the subject of a detailed scholarly study in 1982.[181] The shortcomings of the Minnesota systems noted in that study provide a means of evaluating the Trust Company proposal.

The most significant deficiency observed in the operation of the Minnesota retirement systems was a lack of knowledge or expertise in investment, banking and finance on the part of the members of the State Board of Investment.[182] Exacerbating this fundamental problem were the time and political demands placed on State Board members, many of whom were elected government officials whose election to office was often unrelated to State Board policies.[183] Those demands, when combined with the State Board's lack of knowledge and expertise, resulted in a number of inefficiencies in the internal operation of the Minnesota retirement systems, including: (1) difficulty in formulating investment policies;

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181 Murphy, supra note 166.

182 Id. at 230.

183 Id. at 231-32. See supra note 166 and accompanying text.

(2) difficulty in delineating powers and duties among the State Board of Investment, the executive director of the systems and the Investment Advisory Council; (3) difficulty in establishing adequate communication and reporting among the various participants in the investment process; and (4) difficulty in the establishment of appropriate investment performance measurements and staff evaluation procedures.[184] Compounding these internal inefficiencies were legal list requirements limiting investment by the Minnesota retirement systems to specified categories.[185]

The Trust Company, if operated as proposed, should be able to avoid the problems faced by the Minnesota retirement systems. The Trust Company will not be operated under the direction of unknowledgeable and inexperienced personnel; the three outside Board members, the three out-of-state members of the investment policy committee and the members of the Trust Company's staff are all proposed to be seasoned professionals with money management experience. Those individuals responsible for the operation of the Trust Company should not face the time and political pressures experienced by their Minnesota counterparts, because only a minority of the Board will be political appointees and elected office holders. The investment policy committee, and the auditing, accounting and

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184 Id. at 232-35, 237.

185 Id. at 235. Authorized investments are set out in Minn. Stat. Ann. § 11A.24 (West 1988).

reporting procedures to be applicable to the Trust Company, should serve to enable the Trust Company to avoid most, if not all, of the operational inefficiencies that has characterized the Minnesota retirement systems. Finally, in operating the Trust Company, management will be subject only to a prudent expert rule and will not face the limitations of any legal lists.

Although we believe that the Trust Company proposal represents a significant improvement over the Minnesota structure, we wish to emphasize that we are expressing no view of the merits of the proposal from a policy perspective; both the Commissioner and the Legislature are in a far better position than we to assess the problems currently presented in the investment operations of the Funds, and the benefits that would be provided to the Funds and their beneficiaries if the proposal were adopted. In addition, we express no view as to matters of Alaska law bearing on the Trust Company proposal such as the ability of the Legislature to establish an independent corporation and the legal status of such a corporation under Alaska law.

Acknowledging the improvements over the Minnesota statutory framework reflected in the Trust Company proposal, we nonetheless believe that the Commissioner may wish to consider adding two kinds of provisions to the proposal, each of which is designed to strengthen accountability of those individuals responsible for managing the assets of the Funds. The first of the provisions would specify clearly the parties who are potentially liable for breaches of their statutory obligations to the participants and beneficiaries of the Funds having assets administered by the Trust Company. Each potentially liable party could be designated as a fiduciary of the assets held by the Trust Company. The term "fiduciary" could in turn be defined functionally as it is under ERISA. Under such a definition, the Commissioner would not be potentially liable for actual investments made by Trust Company personnel on behalf of the Funds; the Trust Company proposal contemplates that responsibility for investment policies undertaken for the Funds rests with the Trust Company's investment committee and management and not with the Commissioner. The Commissioner and the other members of the Board would be potentially liable, on a co-fiduciary theory, if they did not undertake their oversight responsibility prudently.[186]

A second kind of provision that the Commissioner might consider adding to the Trust Company proposal is one specifically authorizing the participants and beneficiaries of the Funds having assets administered by the Trust Company to institute appropriate legal actions against the Company.[187]

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186 See the discussion of co-fiduciary liability included in Section II.B(1)[B] of this Memorandum.

187 An example of this sort of provision is Section 502 of ERISA, which designates the parties who may sue and the action that may be brought to enforce the provisions of ERISA.

The attorney general might also be given standing to commence an action against the Trust Company on behalf of Fund participants and beneficiaries.[188] Expressly authorizing the parties that may bring actions in connection with the investment operations of the Funds could only serve to help to ensure effective management of the Funds and compliance with fiduciary standards imposed under Alaska law.

Conclusion

The Bill, if adopted, should serve to remedy the practical problems currently faced by the Commissioner in investing on behalf of the Funds. In general, the Bill's proposals would increase the amount of the Commissioner's investment flexibility. At the same time, however, the Bill's proposals would increase the Commissioner's responsibility and accountability with respect to the Fund's investments.

The Trust Company proposal reflects a more dramatic form, than does the Bill, of changing current Alaska law regarding the Funds' investment operations. Although it contemplates a fundamental change in the structure of those operations, the Trust Company proposal is not without some precedent. Moreover, the proposal appears to reflect a significant improvement over similar structures now in place outside Alaska.

WILLKIE FARR & GALLAGHER

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188 Under Section 502 of ERISA, the Department of Labor is authorized to bring certain suits.

HOUSE BILL 547

Investment and Management of Certain State Funds

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HOUSE BILL 547

INVESTMENT AND MANAGEMENT OF CERTAIN STATE FUNDS

GOALS	MAIN PROVISIONS OF THE BILL	RESULTS
Establish Fiduciary Duties for State Trust Funds	Confirm Trust Status of Trust Funds	Assures Trust Funds Meet Beneficiaries' Needs
	Upgrade Standard of Prudence	Reduces Chances of Lawsuits or Liability
	Invoke Duty of Loyalty to Beneficiaries for Trust Funds	
	Establish Liability for Breaches of Investment Responsibilities	

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Increase Investment Earnings on All State Funds	Broaden Investment Authority	Increases Diversification of Investments
	Permit Competitive Compensation for Investment Staff	Reduces Investment Risk
	Exempt Delegations of Investment Powers from Procurement Code	Increases Investment Returns

House Bill 547
Investment and Management of Certain State Funds

EXECUTIVE SUMMARY

House Bill 547 represents a comprehensive revision of statutes governing the investment responsibilities of the Department of Revenue. The department is responsible for investment of all state funds, exclusive of the funds of independent corporations. State funds include retirement and endowment funds, which are both types of trust funds.

The legislation focuses on trust funds. Such funds carry a greater weight of responsibilities, duties, and care due to the fact that they are for the benefit of other persons. These fiduciary duties and standards have been elaborated under common law, various statutory laws such as ERISA (the Employee Retirement Income Security Act), and case law pursuant to statutory provisions.

The legislation places fiduciary duties and standards into Alaska Statutes, both clarifying and elevating the responsibilities.

The other main revision contained in the bill is the broadening of permissible investments. HB 547 places investment authority under the elevated standards of care contained in the bill, eliminating the narrow lists of investments currently in statutes. This would open up investment opportunities, permit greater diversification, reduce risk, and increase earnings on all state funds.

Legal lists evolved as a response to early judicial views of the fiduciary duty of prudence. These restrictive views often prohibited equity investments. Legal lists were a way to specifically authorize such investments.

With the development of modern portfolio theory--which assesses risk based on the total investment portfolio rather than an individual asset or security--and the adoption of this theory by the courts, legal lists have become obsolete. In fact, given the rapid evolution of securities markets, instruments, and practices in recent years, legal lists now conflict with or restrain rather than facilitate prudent investment and diversification.

Elimination of legal lists does not mean that investment will proceed without any guidelines. It only means that the guidelines will not be cast in stone and incapable of timely response to changes in the financial markets due to the limited window of opportunity, uncertainty, and delay inherent in the legislative process. The attached publication, "General Investment Policies," discusses the policies and guidelines that govern investment of funds by the Department of Revenue.

The enchancement of investment returns that can be expected by moving away from inflexible statutory guidelines can be of significant financial benefit to the State, municipalities, and trust fund beneficiaries. The attached "PERS and TRS Financial Projections" prepared by the state's actuary demonstrates how significant a small enhancement in returns can be in the case of the retirement funds.

The legislation has been reviewed by the Department of Law and Willkie, Farr & Gallagher, investment counsel to the state on contract to the Department of Law. Willkie Farr's analysis is contained in their attached March 1, 1988 memoranda. HB 547 contains Willkie Farr's recommendations on liability for fiduciary duties. The legislation has been endorsed by resolutions of the Public Employees' and Teachers' Retirement boards. The Department of Revenue strongly supports passage of HB 547.

Goals of the Legislation

There are two principal goals HB 547 would help achieve:

1. strengthening the trust status and observance of fiduciary duties for trust funds under State management; and,

2. increasing the investment returns for all funds under State management.

Need for the Legislation

The legislation is needed because:

1. there is a lack of understanding in the public's mind about the trust status of certain funds;

2. improvements in investment performance can make a significant difference in State and municipal finances;

3. the statutory lists of permissible investments for certain funds contain inherent contradictions;

4. the investment lists for certain funds conflict with fiduciary duties;

5. trust fund statutes fail to fully delineate fiduciary responsibilities;

6. compensation for investment personnel is not competitive, jeopardizing the fulfillment of the statutory requirement that State funds be invested with the judgment and care which an institutional investor would exercise;

7. statutory investment lists for certain funds contain ceilings on percentage allocations of fund assets to particular types of investments, limiting the long-run returns the funds could earn.

Financial Effects of the Legislation

HB 547 is potentially of very significant financial benefit to the State as well as trust fund beneficiaries and municipalities (participating in the Public Employees' and Teachers' Retirement Systems). The legislation holds much promise of benefit as a direct revenue-raising measure. At the June 30, 1987 level of $4,948,475,000 under investment by the State, an improvement in returns of only 10 basis points, or 0.1%, would mean increased earnings of $4.9 million per annum.

In addition, the steps the bill would take to assure the observance of fiduciary duties would limit the State's potential liability as trustee.

Main Provisions of HB 547

The legislation would take five main steps in furtherance of the goals of strengthening the observance of fiduciary responsibilities and improving investment performance in general:

1. strengthen the trust status and fiduciary responsibilities of trust funds by:

    a. designation of trust funds as trusts in statute;

    b. upgrading the standard of prudence;

    c. requiring the fiduciary to act only in the interests of a fund's beneficiaries; and,

    d. requiring that investments be acquired or sold at internationally competitive market rates or prices;

2. strengthen accountability by

    a. clarifying the Commissioner of Revenue's role as fiduciary;

b. establishing liability for the commissioner or the commissioner's designee for breaches of fiduciary or other investment responsibilities;

c. requiring annual audits by an independent firm of certified public accountants; and,

d. requiring reports on the condition and investment performance of funds;

3. repeal statutory investment lists;

Making an upgraded rule of prudence the guide for permissible investments rather than a legal list of specific instruments and percentage allocations would accomplish two main things:

a. decrease risk by permitting greater diversification, subject to the rule of prudence; and,

b. maximize earnings by permitting greater concentration in the highest yielding assets, subject to the rule of prudence.

The number of pension funds and other institutional investment funds which operate under a legal list has become a small minority.

Employee pension or welfare benefit plans of corporations and unions under ERISA; private foundations under the Internal Revenue Code; endowments of universities, hospitals, and religious or other charitable institutions in 28 states under the Uniform Management of Institutional Funds Act; and 23 state retirement funds operate free of legal list restrictions.

4. provide for competitive compensation for investment staff by placing them in the exempt service; and

5. exempt professional services contracts which are delegations of investment authority from the requirements of the State Procurement Code; most contracts for investment management services are subject to independent periodic performance evaluation; competitive selection of contractors follows from the mandates of fiduciary responsibilities and the rule of prudence.

HB 547
Bill Analysis

Teachers Retirement System

Section 1

Removes an ambiguity about the commissioner of revenue's fiduciary role for the retirement fund by recognizing the board's role as limited to administration of the system.

Section 2

Redefines responsibility for reports furnished to the board so that the commissioner of administration provides reports on the condition and administration of the system, and the commissioner of revenue provides reports on the condition and performance of the retirement fund.

Section 3

Expressly establishes the Teachers' Retirement Trust fund and adds the requirement for an annual independent audit of the system.

Section 4

Clarifies that the commissioner of revenue is the fiduciary manager of the retirement fund. Imposes duties on the commissioner relating to investment of retirement funds in general, including

(a) to establish investment policies and objectives based on the then current and probable future structure of the system's assets and liabilities; and

(b) to act only in the interests of the fund's beneficiaries.

Authorizes investment without regard to generation of income, that is, permits emphasis on capital gains, if appropriate, recognizing the long-term nature of the fund's liabilities and without regard to the distinction between principal and income, recognizing, in theory, that the principal, as well as the income, will ultimately be paid out in benefits.

References another section of statutes (AS 37.10.071) for specification of investment powers and duties generally applicable to all funds.

University of Alaska

Section 5	Reference for University of Alaska investments to general statutory provisions regarding investment powers and duties (AS 37.10.071).

University of Alaska Fund

Section 6	Adds "endowment trust" to the fund designation to better state the purpose of the fund and to distinguish it by title from other funds which do not have similar limitations.
Section 7	Clearly establishes the commissioner of revenue's role as the fiduciary for the fund and imposes the same powers and duties as for the Public School Fund (AS 37.14).
Section 8	Adds "net" as an adjective before income (clarifying that it is after expenses, costs, and amortizations of bond premiums or discounts).
Section 9	Adds the adjective "net" before income to prevent confusion with gross income.

Alaska Student Loan Corporation

Sections 10 & 11	Reference for Alaska Student Loan Corporation and its student loan fund investments to general statutory provisions regarding investment powers and duties (AS 37.10.071).

Alaska Medical Facility Authority

Section 12	Reference to general statutory provisions regarding investment powers and duties (AS 37.10.071).

Alaska Housing Finance Corporation

Section 13	Reference for the corporation's state mortgage insurance fund investments to general statutory provisions regarding investment powers and duties (AS 37.10.071).

Judicial Retirement System

Section 14	Expressly establishes the Judicial Retirement Trust Fund and what it will hold.

Section 15 — States the role of the commissioner of revenue and references general statutory provisions regarding retirement fund investment powers and duties (AS 14.25.180)

Military Retirement System

Section 16 — Expressly establishes the Military Retirement Trust Fund and what it will hold.

Section 17 — States the role of the commissioner of revenue and references general statutory provisions regarding retirement fund investment powers and duties (AS 14.25.180)

Public Contracts

Section 18 — Excludes the commissioner of revenue's delegations of investment powers from state procurement code procedures.

State Treasury

Section 19 — Repeal of the existing section of law eliminates the list of permissible Treasury investments and consequently makes investment selections subject to the more general and inclusive "prudent institutional investor rule" stated in the subsection. Eliminating the list increases the commissioner's ability to achieve investment objectives, improves the adaptability of investment policies to changing conditions, instruments, and markets, removes inconsistencies in the current list, and avoids conflicts between the limitations of the list and the requirements of the "prudent institutional investor rule." Corporate and union pension funds (ERISA) and 26 states' pension funds now are governed solely by the "prudent man" or prudent institutional investor" standard.

Reenactment states the commissioner of revenue's specific responsibilities for Treasury investments and references general statutory provisions regarding investment powers and duties (AS 37.10.071).

Investment Powers and Duties

Section 20 — This section specifies powers and duties of the commissioner of revenue generally applicable to the investment of all funds.

Subsection (a) specifies powers and duties more completely and generally than current statutes including the obligations to maintain investment accounting records and secure annual independent audits. Raises the standard to acquire or dispose of discretionary investments at competitive market prices or rates to include internationally competitive rates or prices.

Subsection (b) lists certain actions the commissioner may take. The list is not necessary from the standpoint of authorizing or limiting the investment powers of the commissioner, or of stating the types of activity presumed under the "prudence rule." It's inclusion in the statute is considered desirable in order to minimize the risk of possible litigation concerning the activities by specifying some of the activities which may not be obvious as being derived from the broad investment powers.

Section (c) restates and amplifies the "prudent institutional investor rule." The "prudent rule" standard of care is raised to a professional (sophisticated or expert) level and applied to the whole fund rather than to separate investments, and it is amplified to require consideration of the fund's purpose and objectives.

Subsection (d) establishes liability of the commissioner or a designee of the commissioner for a breach of investment duties. Includes co-fiduciary liability under standards comparable to ERISA.

Subsection (e) indemnifies the commissioner or a designee against liability for prudent actions taken in good faith.

Municipal Bonds

Section 21 — Eliminates authority of commissioner of revenue to purchase debt of Alaska municipalities except when litigation forestalls issuance.

Public School Trust Fund

Section 22	Adds "endowment" and "trust" to the fund designation to better state the purpose of the fund and to distinguish it from other funds which do not have similar limitations.
Section 23	Redefines the income as being "net," provides for its determination, and requires the accounting distinction between principal and income. Provides for the inclusion of realized capital gains or losses as part of the principal of the fund and the perpetual retention of the principal in keeping with its endowment nature.
Section 24	Modifies income to "net income" and imposes a duty to invest unexpended income.
Section 25	Restates the role and the powers and duties of the commissioner of revenue with regard to the investment of the fund as being similar to those for the retirement funds except that additional duties to separately invest and account for principal and income are imposed due to the endowment nature of the fund.
Section 26	Clearly establishes the commissioner of revenue as the fiduciary of the fund and imposes duties and authorities relating to investment policy and acting in the interests of beneficiaries.

Investment Officers

Section 27	Places Department of Revenue investment officers in exempt status with respect to the State Personnel Act.

State Group Health and Life Insurance

Section 28	Substitutes the appropriate, more comprehensive, word "income" for "interest."
Section 29	Reference to general statutory provisions for retirement fund investment powers and duties (AS 14.25.180).

Public Employees Retirement System

Section 30	Changes the investment list to a summary. This removes confusing details, makes the

report more succinctly informative, and conforms it to investment accounting principles.

Expressly establishes the Public Employees Retirement Trust Fund and adds the requirement for an annual independent audit of the system.

Section 31 — States the fiduciary role of the commissioner of revenue and references general statutory provisions for retirement fund investment powers and duties (AS 14.25.180).

<u>Power Development Fund (Alaska Power Authority)</u>

Section 32 — Reference to general statutory provisions for investment powers and duties (AS 37.10.071).

<u>Enterprise Development Fund (Alaska Industrial Development and Export Authority)</u>

Section 33 — Reference to general statutory provisions for investment powers and duties (AS 37.10.071).

<u>Repealers</u>

Section 34 — <u>Alaska State Building Authority (ASBA)</u>

Removes authority for the General Fund to purchase from ASBA mortgage loans made to cooperatives (AS 18.55.375).

<u>Medical Indemnity Corporation of Alaska (MICA)</u>

Removes requirement for General Fund to purchase MICA notes up to $6 million (AS 21.88.210(d)).

<u>Veterans Revolving Loan Fund</u>

Repeals authority of Department of Revenue to purchase commercial paper from this fund which became defunct July 1, 1981 when its authority to make new loans was terminated by Sec. 71, Ch. 106, SLA 1980 (AS 26.15.060).

<u>Sale of Bond Investments</u>

Removes requirement for governor's approval of the sale of bonds held as investments by the Department of Revenue (AS 37.10.080).

Public School Fund Advisory Board

Removes the board's responsibility for long-range investment plans to avoid conflict with the commissioner of revenue's role as fiduciary for the fund (AS 37.14.130(3)).

State Investment Officers

Removes state investment officers from partially-exempt status under the State Personnel Act (AS 39.25.120(c)(13)). Section 27 of the bill places them in exempt status.

Public Employees Retirement System

Repeals investment statutes made unnecessary by reference in section 31 of the bill to general statutory provision for investment powers and duties (AS 39.35.110).

Small Business Revolving Loan Fund

Repeals authority of Department of Revenue to purchase commercial paper, mortgages, and notes from this fund which became defunct July 1, 1981 when its authority to make new loans was terminated by Section 71, Ch. 106, SLA 1980 (AS 45.95.030 and AS 45.95.040(b)).

Historical District Loan Fund

Removes authority for the General Fund to purchase Historical District Revolving Loans (AS 45.98.050(b)).

Introduced: 3/23/88 5-2059A
Referred: Finance

IN THE HOUSE BY THE FINANCE COMMITTEE

HOUSE BILL NO. 547

IN THE LEGISLATURE OF THE STATE OF ALASKA

FIFTEENTH LEGISLATURE - SECOND SESSION

A BILL

For an Act entitled: "An Act relating to the investment and management of certain state funds; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 14.25.035(c) is repealed and reenacted to read:

(c) The board shall confer with the commissioner of administration regarding the administration of the system and may make recommendations that it considers necessary.

* Sec. 2. AS 14.25.035(d) is repealed and reenacted to read:

(d) The commissioner of administration shall report to the board concerning the condition and administration of the system. The reports shall be distributed to the members of the system. The commissioner of revenue shall provide reports to the board on the condition and investment performance of the teachers' retirement trust fund.

* Sec. 3. AS 14.25.170 is amended to read:

Sec. 14.25.170. ADMINISTRATION. The commissioner of administration is responsible for the administration of the retirement system and for making the provisions of this chapter effective. The [AND THE] powers and duties of the commissioner for this purpose include [BUT ARE NOT LIMITED TO]

(1) maintaining the accounts of the system;

(2) making payments for the various purposes specified;

(3) submitting required [SUCH] periodic reports or statements of account [AS MAY BE REQUIRED];

(4) establishing [PRESCRIBING] by regulation the rate of interest that shall be credited to the individual contribution accounts of teachers each year; the rate of interest shall be adopted on the basis of the probable effective rate of interest on a long-term basis, and the rate may be changed from time to time by subsequent regulation;

(5) establishing a teachers' retirement trust fund in which the assets of the system shall be deposited and held; and

(6) engaging an independent certified public accountant to conduct an annual audit of the system's accounts and the annual report of the system's financial condition and financial activity.

* Sec. 4. AS 14.25.180 is repealed and reenacted to read:

Sec. 14.25.180. INVESTMENT AND TREASURY. (a) The commissioner of revenue is the treasurer of the system and the fiduciary of the fund. In managing the fund, the commissioner of revenue shall

(1) consider the status of the fund's investments and the system's liabilities on both a current and a probable future basis;

(2) determine the appropriate investment objectives for the fund;

(3) establish investment policies aimed at achieving the objectives; and

(4) act only in regard to the best financial interests of the system's beneficiaries.

(b) The commissioner of revenue may invest the fund on the basis of probable total rate of return without regard to the distinction between principal and income or to the generation of income.

(c) In carrying out investment duties under this chapter, the commissioner of revenue has the same powers and duties in regard to the teachers' retirement trust fund as are provided in AS 37.10.071, except that the standard of prudence that the commissioner must obey under AS 37.10.071(c) shall be in regard to the management of large trust investments rather than large investments.

* Sec. 5. AS 14.40.255 is amended to read:

Sec. 14.40.255. INVESTMENT OF SURPLUS MONEY. If the Board of Regents determines that there is a surplus of money, received in the form of state and federal appropriations, above the amount sufficient to meet current and projected cash expenditure needs of the university, the surplus must be invested as [IN THE SAME INSTRUMENTS] set out in AS 37.10.071. Income [AS 37.10.070 APPROVED FOR INVESTMENT OF STATE TREASURY SURPLUS. INTEREST INCOME] earned on investments made under this section may be retained by the university and expended in accordance with the Executive Budget Act (AS 37.07).

* Sec. 6. AS 14.40.400(a) is amended to read:

(a) The Department of Revenue shall establish a separate endowment trust fund in which all money derived from the sale or lease of the land granted under the Act of Congress approved January 21, 1929, and in which all monetary gifts, bequests or endowments made to the University of Alaska for the purpose of the fund, shall be held in trust.

* Sec. 7. AS 14.40.400(b) is repealed and reenacted to read:

(b) The commissioner of revenue is the fiduciary of the trust fund and shall account for and invest the fund as set out in AS 37.14.110(c), 37.14.160, and 37.14.170, except that the commissioner shall report the condition and investment performance of the fund to the Board of Regents.

* Sec. 8. AS 14.40.400(c) is amended to read:

(c) The net income from the trust fund shall be used exclusively for the Agricultural College and School of Mines.

* Sec. 9. AS 14.40.400(e) is amended to read:

(e) The Department of Administration shall disburse the net income from the trust fund upon vouchers approved by the president and treasurer of the University of Alaska specifying the purpose for which the money is to be used and showing it is to be used in conformity with this section.

* Sec. 10. AS 14.42.200(8) is amended to read:

(8) invest or reinvest, subject to its contracts with noteholders and bondholders, money held by the corporation as set out in AS 37.10.071 [OBLIGATIONS OR OTHER SECURITIES AUTHORIZED FOR INVESTMENTS OF THE COMMISSIONER OF REVENUE UNDER AS 37.10.070(a)];

* Sec. 11. AS 14.42.210(b) is amended to read:

(b) Money and other assets of the student loan fund may be used to secure bonds of the corporation, invested in student loans and investments under AS 37.10.071 [DESCRIBED IN AS 37.10.070(a)] and used to purchase loans approved under AS 14.43.090 - 14.43.325, 14.43.600 - 14.43.700, or 14.43.710 - 14.43.790.

* Sec. 12. AS 18.26.170 is amended to read:

Sec. 18.26.170. INVESTMENTS BY AUTHORITY. Except as otherwise provided by this chapter, the authority may invest any funds, not needed to meet current cash expenditure needs, as set out in AS 37.10.071 [SECURITIES, OBLIGATIONS OR CERTIFICATES OF DEPOSIT APPROVED FOR INVESTMENT OF THE STATE TREASURY SURPLUS UNDER AS 37.10.070(a)(1) - (4). THESE INVESTMENTS SHALL BE PURCHASED AT NO HIGHER PRICE THAN THE OFFERING OR MARKET PRICE OF THEM AT THE TIME OF THE PURCHASE].

* Sec. 13. AS 18.56.095(b) is amended to read:

(b) In addition to any other fees and charges that the corporation may charge on mortgage loans, it may collect or cause to be collected on all mortgage loans made or purchased with the proceeds of the sale of mortgage insurance bonds, either or both a special mortgage loan insurance commitment fee or a mortgage loan insurance premium. The special mortgage loan insurance commitment fees and special mortgage loan insurance premiums when received shall be deposited in the mortgage insurance fund by the corporation, or by any mortgage loan servicer, trustee, or agent designated by the corporation to receive them, and shall be held, invested and, together with all investment income derived from them, reinvested by the commissioner of revenue as set out in AS 37.10.071 [INVESTMENTS AUTHORIZED UNDER AS 37.10.070(a)], subject to any agreement with the corporation under (a) of this section.

* Sec. 14. AS 22.25.048(a) is amended to read:

(a) The commissioner of administration shall establish a judicial retirement trust fund for the judicial retirement system in which the assets of the system are deposited and held. The commissioner [AND] shall maintain accounts and records for the [JUDICIAL RETIREMENT] system.

* Sec. 15. AS 22.25.048(c) is repealed and reenacted to read:

(c) The commissioner of revenue is the treasurer of the system and the fiduciary of the fund and has the same powers and duties under this section in regard to the judicial retirement trust fund as are provided in AS 14.25.180.

* Sec. 16. AS 26.05.228(a) is amended to read:

(a) The commissioner of administration shall establish a military retirement trust fund for the system in which the assets of the system are deposited and held. The commissioner shall [AND] maintain accounts and records for the system.

* Sec. 17. AS 26.05.228(c) is repealed and reenacted to read:

(c) The commissioner of revenue is the treasurer of the system and the fiduciary of the fund and has the same powers and duties under this section in regard to the fund as are provided under AS 14.25.180.

* Sec. 18. AS 36.30.850(b) is amended to read:

(b) This chapter applies to every expenditure of state funds, irrespective of their sources, including federal assistance except as otherwise specified in AS 36.30.890, by the state, acting through an agency, under a contract, except that this chapter does not apply to

(1) grants;

(2) contracts for professional witnesses to provide for professional services or testimony relating to existing or probable lawsuits in which the state is or may become a party;

(3) contracts of the University of Alaska where the work is to be performed substantially by students enrolled in the university;

(4) contracts for medical doctors and dentists;

(5) acquisitions or disposals of real property or interest in real property, except as provided in AS 36.30.080;

(6) disposals under AS 38.05;

(7) contracts for the preparation of ballots under AS 15.-15.030;

(8) acquisitions or disposals of property and other contracts relating to airports under AS 02.15.070, 02.15.090, and 02.15.-091;

(9) disposals of obsolete property under AS 19.05.060;

(10) disposals of obsolete material or equipment under AS 35.20.060;

(11) agreements with providers of services under AS 47.07; AS 47.08; AS 47.10; AS 47.17; AS 47.24; AS 47.25.195, and 47.25.310;

(12) contracts of the Department of Fish and Game for

flights that involve specialized flying and piloting skills and are not point-to-point;

(13) purchases of income-producing assets for the state treasury or a public corporation of the state<u>; or</u>

<u>(14) a contract that is a delegation, in whole or in part, of investment powers held by the commissioner of revenue under AS 14.-25.180, AS 14.40.400, AS 14.42.200, 14.42.210, AS 18.56.095, AS 22.-25.048, AS 26.05.228, AS 37.10.070, 37.10.071, AS 37.14, or AS 39.-35.080</u>.

* Sec. 19. AS 37.10.070 is repealed and reenacted to read:

Sec. 37.10.070. INVESTMENT OF RESIDUAL MONEY. (a) The commissioner shall invest, as set out in AS 37.10.071, the money in the state treasury above an amount sufficient to meet immediate expenditure needs. In managing the invested assets, the commissioner shall

(1) consider the status of the assets and liabilities on both a current and a probable future basis;

(2) determine the appropriate investment objectives;

(3) establish investment policies to achieve the objectives; and

(4) act only in regard to the best financial interests of the state.

(b) The commissioner may invest on the basis of probable total rate of return without regard to the distinction between principal and income and without regard to the generation of income.

(c) In this section, "commissioner" means the commissioner of revenue.

* Sec. 20. AS 37.10 is amended by adding a new section to read:

Sec. 37.10.071. INVESTMENT POWERS AND DUTIES. (a) In making investments under this section, the commissioner of revenue shall

(1) act as official custodian of cash and investments by securing adequate and safe custodial facilities for them;

(2) receive all items of cash and investments;

(3) collect and deposit the principal of and income from owned or acquired investments;

(4) invest and reinvest the assets in accordance with this section;

(5) receive and spend appropriations to cover the cost of the exercise of duties under this section;

(6) exercise the powers of an owner with respect to the assets;

(7) perform all acts, not prohibited by this section, whether or not expressly authorized, that the commissioner considers necessary or proper in administering the assets;

(8) maintain accounting records in accordance with investment accounting principles;

(9) engage an independent certified public accountant to conduct an annual audit of the financial condition and investment transactions;

(10) enter into and enforce contracts or agreements considered necessary, convenient, or desirable for the investment purposes of this section; and

(11) when choosing to acquire or dispose of investments, secure competitive national or international market rates or prices, or the equivalence of those rates or prices in the judgment of the commissioner.

(b) Under this section, the commissioner or the commissioner's designee may

(1) delegate investment, custodial, or depository authority

on a discretionary or nondiscretionary basis to officers or employees of the state or to independent firms, banks, or trust companies, by designation through appointments, contracts, or letters of authority;

(2) acquire or dispose of investments either directly, indirectly, or through investment pools or trusts, by competitive or negotiated agreements, contracts, or auctions, in public or private markets;

(3) concentrate or diversify investments as the commissioner considers appropriate to increase the probable total rate of return or to decrease the overall exposure to potentially adverse market value risks;

(4) protect the market value or the rate of return of the investments by entering into forward agreements to buy or sell assets at a future date as a hedge against existing held assets or as a precommitment of future cash flows;

(5) lend assets, under an agreement and for a fee, against deposited collateral of equivalent market value;

(6) borrow assets on a short-term basis, under an agreement and for a fee, against the deposit of collateral consisting of other assets in order to accommodate temporary cash or investment needs;

(7) hold investments in bearer or registered form in the name of the state, a fund, or nominees authorized by the commissioner;

(8) utilize consultants, advisors, custodians, investment services, and legal counsel for assistance in investment matters on either a continuing or a limited-term basis and with or without compensation;

(9) declare records to be confidential and exempt from AS 09.25.110 and 09.25.120 if the records contain information that discloses the particulars of the business or the affairs of a private

enterprise, investor, borrower, advisor, consultant, counsel, or manager.

(c) In exercising investment, custodial, or depository powers or duties under this section, the commissioner shall exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary professional prudence, discretion, and intelligence exercises in managing large investments with consideration for the purpose of the fund, the investment objectives, the continuing disposition of the fund's investments, and the probable safety of the capital as well as the probable investment returns.

(d) In exercising investment, custodial, or depository powers or duties under this section, the commissioner or a designee of the commissioner is liable for a breach of a duty that is assigned or delegated under this section, or under AS 14.25.180, AS 14.40.400(b), AS 37.10.070, AS 37.14.110(c), 37.14.160, 37.14.170, or AS 39.35.080. However, the commissioner or the commissioner's designee is not liable for a breach of a duty that has been delegated to anothr person if the delegation is prudent under the applicable standard of prudence set out in statute or if the duty is assigned by law to another person, except to the extent that the commissioner or designee

(1) knowingly participates in, or knowingly undertakes to conceal, an act or omission of another person, knowing that the act or omission is a breach of that person's duties under this chapter;

(2) by failure to comply with this section in the administration of specific responsibilities, enables another person to commit a breach of duty; or

(3) has knowledge of a breach of duty by another person, unless the commissioner or designee makes reasonable efforts under the circumstances to remedy the breach.

(e) The state shall defend and indemnify the commissioner or an officer or employee of the state against liability under (d) of this section to the extent that the alleged act or omission was performed in good faith and was prudent under the applicable standard of prudence.

(f) In this section, "commissioner" means the commissioner of revenue.

* Sec. 21. AS 37.10.079(b) is amended to read:

(b) The commissioner of revenue may purchase bonds sold by political subdivisions of the state if [:

(1) THEY HAVE BEEN SOLD IN ACCORDANCE WITH THE TERMS OF THE NOTICE OF THEIR SALE SUBJECT ONLY TO DELIVERY OF THE BONDS WITH AN APPROVING OPINION OF BOND COUNSEL TO THE EFFECT THAT THE BONDS ARE VALID AND LEGALLY BINDING GENERAL OBLIGATIONS OF THE POLITICAL SUBDIVISION AND A STATEMENT TO THE EFFECT THAT NO LITIGATION IS THREATENED OR PENDING WHICH AFFECTS THE VALIDITY OF THE BONDS; OR

(2)] the bond counsel nominated by the issuing political subdivision in connection with the original offer for sale of the bonds certifies that

(1) [(A) THAT] a lawsuit has been filed or is threatened that [WHICH] challenges the corporate existence of the issuer or its power to issue the bonds or to levy taxes to pay the bonds or otherwise prevents a [THE] statement to the effect that no litigation is threatened or pending that affects the validity of the bonds;

(2) [AS TO LITIGATION REFERRED TO IN (1) OF THIS SUBSECTION, (B) THAT] as a consequence of the filing of the suit, the bonds cannot be sold or can only be sold at interest rates substantially in excess of the interest rates the municipality would otherwise reasonably expect to pay; [,] and

(3) [(C) THAT,] in the opinion of counsel [,] the municipality is or will be pursuing all available means to establish the validity of the bonds so that the lawsuit will be ultimately determined so as to permit the delivery of the bonds with the statement as to litigation referred to in (1) of this subsection.

* Sec. 22. AS 37.14.110(a) is amended to read:

(a) There is established as a separate endowment trust fund the public school trust fund.

* Sec. 23. AS 37.14.110(c) is repealed and reenacted to read:

(c) The commissioner of revenue shall determine the net income of the fund in accordance with investment accounting principles and in a manner that preserves the distinction between principal and income and that excludes capital gains or losses realized on principal. The principal of the fund and the capital gains or losses realized on principal shall be perpetually retained in the fund for investment purposes.

* Sec. 24. AS 37.14.140 is repealed and reenacted to read:

Sec. 37.14.140. UTILIZATION OF INCOME. The net income of the fund may not be appropriated for a purpose other than the support of the state public school program. The commissioner of revenue shall invest realized net income that has not been appropriated or that has been appropriated but not expended until the income is appropriated and expended.

* Sec. 25. AS 37.14.160 is repealed and reenacted to read:

Sec. 37.14.160. DUTIES OF THE COMMISSIONER OF REVENUE. The commissioner of revenue is the treasurer of the trust fund created in AS 37.14.110 and shall

(1) exercise the powers and duties established in AS 14.25.180(c);

(2) deposit the principal and income from investments in separate principal and income accounts for the fund;

(3) invest and maintain accounting records that distinguish between the principal and income of the fund;

(4) provide reports to the board established under AS 37.14.120 on the condition and investment performance of the fund.

* Sec. 26. AS 37.14.170 is repealed and reenacted to read:

Sec. 37.14.170. INVESTMENTS. (a) The commissioner of revenue is the fiduciary of the trust fund and shall invest the fund to provide increasing net income over long-term periods to the fund's income beneficiaries. The commissioner may invest the money in the fund on the basis of probable total rate of return to promote the long-term generation of income. In managing the trust fund, the commissioner shall

(1) consider the status of the fund's capital and the income generated on both a current and a probable future basis;

(2) determine the appropriate investment objectives;

(3) establish investment policies to achieve the objectives; and

(4) act only in regard to the long-term financial interests of the fund's beneficiaries.

* Sec. 27. AS 39.25.110 is amended by adding a new paragraph to read:

(25) investment officers in the Department of Revenue.

* Sec. 28. AS 39.30.095(a) is amended to read:

(a) The commissioner of administration shall establish the group health and life benefits fund as a special account in the general fund to provide for group life and health insurance under AS 39.30.090 and 39.30.160. The commissioner shall maintain accounts and records for the fund. The fund consists of employer contributions, employee contributions, appropriations from the legislature, and <u>income</u> [INTEREST] earned on investment of the fund as provided in (d) of this section.

* Sec. 29. AS 39.30.095(d) is amended to read:

(d) If the commissioner of administration determines that there is more money in the fund than the amount needed to pay premiums or benefits for the current fiscal year, the surplus, or so much of it as the commissioner of administration considers advisable, may be invested by the commissioner of revenue in the same manner as retirement funds are invested under <u>AS 14.25.180</u> [AS 39.35.110].

* Sec. 30. AS 39.35.020 is amended to read:

Sec. 39.35.020. ADMINISTRATION. The commissioner of administration is responsible for the administration of the system and for carrying out this chapter. In addition the commissioner <u>shall</u> [HAS THE FOLLOWING POWERS AND DUTIES:]

(1) maintain the accounts of the system;

(2) make payments for the various purposes specified;

(3) submit periodic reports or statements of account that are needed;

(4) issue a statement of account to an employee requesting it showing the amount of the employee's contributions to the system;

(5) as soon as possible after the close of each fiscal year, and not later than six months after the close of each fiscal year, send to the governor, the legislature, and the board an annual statement on the operations of the system containing

(A) a balance sheet;

(B) a statement of income and expenditures for the year;

(C) a report on an actuarial valuation of its assets and liabilities;

(D) [REPEALED

(E)] a summary [LIST] of assets held in the pension fund listed by the categories of investment, as provided by the commissioner of revenue [INVESTMENTS OWNED];

(E) [(F)] other statistical financial data that are necessary for a proper understanding of the financial condition of the system, and the result of its operations;

(6) establish a public employees retirement trust fund in which the assets of the system shall be deposited and held;

(7) engage an independent certified public accountant to conduct an annual audit of the system's accounts and the annual report of the system's financial condition and activity. [REPEALED]

* Sec. 31. AS 39.35.080 is repealed and reenacted to read:

Sec. 39.35.080. DUTIES OF THE COMMISSIONER OF REVENUE. The commissioner of revenue is the treasurer of the system and the fiduciary of the fund. The commissioner has the same powers and duties established under this chapter in regard to the fund as are provided in AS 14.25.180.

* Sec. 32. AS 44.83.386 is amended to read:

Sec. 44.83.386. INVESTMENT OF FUND. The Department of Revenue shall invest the money in the fund in accordance with AS 37.10.070, 37.10.071, and 37.10.075. The Department of Revenue shall provide money in the fund to the authority only after costs have been incurred or amounts in the fund have been otherwise obligated under contracts for the acquisition and construction of a project. Amounts that have been obligated, but for which costs have not yet been incurred, may be segregated by the Department of Revenue or transferred to the authority only with the prior approval or agreement of the commissioner of revenue. <u>Income</u> [INTEREST] received on money that is segregated or transferred under this section must be deposited in the general fund.

* Sec. 33. AS 44.88.155(c) is amended to read:

(c) Money and other assets of the enterprise development account may be used to secure bonds of the authority issued to finance the purchase of loans for projects and shall be held and invested by the authority in <u>accordance with AS 37.10.071</u> [THE TYPES OF INVESTMENTS DESCRIBED IN AS 37.10.070(a) AND AS 39.35.110(a)(9) AND (14)] or shall be used to purchase loans for projects.

* Sec. 34. AS 18.55.375; AS 21.88.210(d); AS 26.15.060; AS 37.10.080; AS 37.14.130(3); AS 39.25.120(c)(13); AS 39.35.110; AS 45.95.030, 45.95.-040(b); and AS 45.98.050(b) are repealed.

* Sec. 35. This Act takes effect immediately under AS 01.10.070(c).

STATE OF ALASKA
DEPARTMENT OF REVENUE

M E M O R A N D U M

TO: The Honorable Hugh Malone
Commissioner
Department of Revenue

FROM: Milton B. Barker MB
Deputy Commissioner
Treasury Division

DATE: March 30, 1988

RE: HB 547 (An Act relating to investment and management of certain state funds)

Goals of the Legislation

There are two principal goals HB 547 would help achieve:

1. strengthening the trust status and observance of fiduciary duties for trust funds under State management; and,

2. increasing the investment returns for all funds under State management.

Need for the Legislation

Evidence of the need for such legislation is that:

1. there is a lack of understanding in the public's mind about the trust status of certain funds;

   Example: there was a suggestion during the 1987 legislative session that $41 million could be taken from the Public Employees Retirement System to fully fund State employee salaries, overlooking the fact that municipalities as well as the State are contributors to the Fund and that the purpose of the Fund is to provide retirement income for public employees, both State and municipal; see attached column "My Turn" from the May 18, 1987 edition of the Juneau Empire.

2. improvements in investment performance can make a significant difference in State and municipal finances;

Example: a 1986 revision of actuarial assumptions, including an upward revision in the assumed investment rate of return as a result of favorable investments, reduced required employer contributions to the Public Employees' and Teachers' Retirement Systems by $46,562,246 for fiscal year 1987; average employer contribution rates fell from 15.14% to 11.56% of salaries; see the attached table; continued annual savings at this level are expected in spite of the stock market crash.

3. the statutory lists of permissible investments for certain funds contain inherent contradictions;

   Example: the attached Attorney General's opinion suggests that the retirement funds' investments in foreign common stocks--which totaled $332,639,526 as of June 30, 1987 and reflected a 44.45% annual rate of return from inception on November 1, 1983--may be illegal.

4. the legal investment lists for certain funds conflict with fiduciary duties;

   Example: AS 14.40.400 permits the University of Alaska Fund to be invested only in interest-bearing securities; the attached summary of a decision by the Court of Appeals of Washington in the case of Baker Boyer National Bank v. Garver indicates that a trustee is under a duty to diversify investments and that a court should award damages for appreciation in equity securities that is foregone as a result of a trustee's failure to diversify into such investments.

5. trust fund statutes fail to fully delineate fiduciary responsibilities;

   Example: missing from trust fund statutes is any duty for the fiduciary to act only in the interests of the beneficiaries; this a requirement of section 401(a) of the Internal Revenue Code (attached) in order for a pension plan to be tax-exempt.

6. compensation for investment personnel is not competitive, jeopardizing the fulfillment of the statutory requirement that State funds be invested with the judgement and care which an institutional investor would exercise;

Example: statutory classification of investment officer positions as partially-exempt confines their salary levels to those of the State salary schedule; even with a reclass of the chief investment officer position to the highest level on the State salary schedule, the position's salary will not be competitive as demonstrated by the attached June 19, 1987 memo, especially considering the cost of living differential for Alaska.

7. statutory investment lists for certain funds contain ceilings on percentage allocations of fund assets to particular types of investments, limiting the long-run returns the funds could earn;

   Example: no more than 50 percent of the retirement and Public School funds may be invested in corporate stocks and debt securities; yet, corporate pension funds, university endowments with over $100 million in assets, and foundations all average approximately 60 percent in corporate stocks alone; the reason for such high allocations to stocks is their historically superior performance relative to alternative investments and the lack of any need for liquidity in these types of funds, which permits them to tolerate significant fluctuations in asset values over the short-run.

<u>Financial Effects of the Legislation</u>

In essence, this legislation is potentially of very significant financial benefit to the State as well as other parties. The strengthening of the trust status of trust funds is not a purely altruistic endeavor. Rather, the steps that would be taken to assure the observance of fiduciary duties would limit the State's potential liability as trustee. With over $3 billion in trust funds under management by the State, and with the funds growing rapidly, breaches of fiduciary responsibilities will be increasingly likely to generate litigation that could result in very significant adverse judgments against the State (witness the Mental Health Lands Trust litigation, Weiss v. State).

In addition to protecting against possible losses from court actions, the legislation holds much promise of benefit as a direct revenue-raising measure. Few other proposals can offer generation of revenues of the magnitude possible with this legislation. Probably none can do so in the painless manner of these proposals.

Perhaps more importantly, the augmentation of investment earnings made possible by this legislation will grow in size as the funds grow. Even at the June 30, 1987 level of $4,948,475,000 under investment by the State, an improvement in returns of only 10 basis points ,or 0.1%, would mean increased earnings of $4.9 million per annum. Enactment of the legislation should provide even greater relief in the more critical years ahead as Prudhoe production winds down.

Funds Subject to the Legislation

The funds under management by the State are:

	Market Value June 30, 1987
General Investment Fund	$1,418,392,000
Public Employees' Retirement Fund	2,005,839,000
Teachers' Retirement Fund	1,295,178,000
Judicial Retirement Fund	17,714,000
Military Retirement Fund	3,881,000
Public School Fund	86,719,000
University of Alaska Fund	11,649,000
International Airports Funds	52,741,000
State Mortgage Insurance Fund	26,789,000
Total	$4,948,475,000

All but the last two funds are directly affected by the proposed legislation. The last two funds are governed primarily by bond indentures, but would be affected by provisions of the legislation of general application, including the potential attraction or retention of superior investment personnel.

Trust Funds

The focus of this legislation is on trust funds. Because of the fiduciary responsibilities and potential liabilities attaching to trust funds, there is a need to clearly establish the roles of the parties involved.

A trust is an interest in property held by one person for the benefit of another. The person holding the property is a fiduciary or trustee. The person placing the property in trust is a trustor. The person which receives the benefits of the property is a beneficiary.

The fiduciary or trustee has certain responsibilities under common law, including the duties of prudence and loyalty to the beneficiaries, and often under statutory law as well. Any party that feels aggrieved by the failure of the trustee to perform according to fiduciary responsibilities may sue the trustee. This could include trustors, who usually have an abiding purpose for having placed the property in trust, as well as the beneficiaries, who obviously would be injured by any failure in performance.

Retirement Funds

In the case of the Public Employees' and Teachers' Retirement Funds, municipalities and school districts contribute to the funds and are trustors as well as the State. Since these, as well as the Judicial Retirement Fund, are joint contributory funds to which employees as well as employers contribute, the public employees, teachers, and judges who are the beneficiaries are also trustors. The State is the only contributor in the case of the Military Retirement Fund.

All of the retirement plans are defined benefit, as opposed to defined contribution, plans. A defined benefit plan fixes the retirement benefits in some manner, for example, a certain dollar amount or percentage of salary for each year employed. In contrast, defined contribution plans fix the contributions and vary the benefits. Retirement benefits payable to a retiree under a defined contribution plan depend on the amount of contributions made to the plan by both employee and employer and on the amount of investment earnings, these being the two sources of income for the fund.

The guarantee of benefit amounts that occurs under defined benefit plans is achieved by adjusting the required employer contribution rates. Thus, the bottom line effect of any breach of fiduciary duty or improvement in investment earnings falls on the employers for all retirement funds under State management. Employers therefore would have--in addition to their general concern as trustors of being able to offer a viable retirement plan as an incentive for their employees--a very direct financial concern with the performance of the fiduciary. Deficient fiduciary conduct by the State as trustee thus would have a high likelihood of provoking litigation from trustors of the retirement funds as well as their beneficiaries.

Endowment Funds

The Public School Fund and the University of Alaska Fund are endowment trust funds. Endowment funds are funds which limit the expenditure of principal. These two particular endowment funds are permanent funds. The property placed in trust is placed in trust in perpetuity.

The trustor for these two funds is the federal government which originally constituted the trusts with land grants. The State is the trustee. Beneficiaries are public education programs and the University of Alaska, respectively. As demonstrated by the Mental Health Lands Trust litigation, the universe of affected persons or parties which might be considered beneficiaries is probably very broad.

Main Provisions of HB 547

The legislation would take five main steps in furtherance of the goals of strengthening the observance of fiduciary responsibilities and improving investment performance in general:

1. provide statutory underpinning of the trust status and fiduciary responsibilities of trust funds;

   Discussion: four principal examples of the legislation's reinforcement of trust funds are:

   a. designation of trust funds as trusts in statute; current statutes do not identify trust funds as such;

   b. upgrading the standard of prudence required of fiduciaries to a professional level and amplifying its application (see section 20 of the bill analysis)

   c. requiring the fiduciary to act only in the interests of a fund's beneficiaries; and,

   d. requiring that investments be acquired or sold at internationally competitive market rates or prices; current statutes require only competitive national rates; yet, the retirement funds have significant holdings of foreign stocks and capital markets are becoming increasingly international at a rapid rate.

These foundation stones for a trust fund are so important that the State of California enacted an amendment placing the first three in their Constitution, applicable to all public pension systems in the state.

2. strengthen accountability;

   Discussion: four main steps the legislation would take are:

   a. clarifying the Commissioner of Revenue's role as fiduciary; in some instances the statutes could be read to assign fiduciary responsibilities to the Commissioner of Administration, the Governor, or the boards of the retirement systems and Public School Fund; a fiduciary role for a board or committee is a desirable means of increasing accountability, provided that the body contains professional expertise; the Department of Revenue is developing a proposal for a state trust company that would provide such a structure; in the absence of a body with the requisite expertise, diffusion of fiduciary responsibility among administrative officials or boards reduces accountability and jeopardizes adherence to fiduciary obligations;

   b. establishing liability for the commissioner or the commissioner's designee for breaches of fiduciary or other investment responsibilities; liability would incude co-fiduciary liability (liability for acts or omissions of other persons) according to standards that parallel the federal ERISA (Employee Retirement Income Security Act of 1974) provisions (ERISA governs employee pension or welfare benefit plans of corporations and unions); the liability and indemnification provisions of HB 547 reflect the recommendations of Willkie, Farr & Gallagher (investment counsel to the state on contract to the Department of Law) contained in their March 1, 1988 memorandum;

   c. requiring, as a matter of statute, annual audits by an independent firm of certified public accountants of funds managed by the State; and,

   d. requiring, as a matter of statute, that reports on the condition and investment performance of funds managed by the State be made to the retirement boards, Public School Fund Advisory Board, and University of Alaska Board Regents; this at least would assure public exposure of investment activities, even though true accountability would require critical review by professional peers as contained in the trust company proposal.

3. repeal statutory investment lists;

Discussion: making an upgraded rule of prudence the guide for permissible investments rather than a legal list of specific instruments and percentage allocations would accomplish two main things:

--decrease risk by permitting greater diversification, subject to the rule of prudence; and,

--maximize earnings by permitting greater concentration in the highest yielding assets, subject to the rule of prudence.

Some of the problems with a legal list are:

1. internally inconsistent provisions, as noted under <u>Need for the Legislation</u>, item 3, in this memo;

2. conflicts with the rule of prudence, as noted under <u>Need for the Legislation</u>, item 4, in this memo;

3. legal lists become outdated; this is truer today than ever before; new markets, instruments, and investment techniques are being developed or evolving more rapidly than ever; some new developments such as options--which are not specifically permitted by Alaska statutes--offer an improved means to hedge or control investment risk; other developments--such as the emergence of a taxable municipal bond market, a result of Tax Reform Act of 1986's restrictions on tax-exempt debt--provide opportunities to diversify portfolios further and also earn a higher return than permitted under current law; a third example is the wave of privatization of government corporations that is sweeping many European countries; the public stock offerings for these companies--often

large, very profitable, and frequently de facto or legislated monopolies--is usually off-limits under Alaska statutes because of a requirement that the company have paid dividends for the last three years; as government corporations, such companies usually never paid dividends;

4. legal lists have a limited window of opportunity for revision--essentially 120 days of each year, in the spring, when the legislature is in session; yet, capital market developments can occur at any time;

5. legal list revisions, even if promptly initiated, often incur significant delays before enactment; yet, the best returns often occur early in the life of new developments before other investors become familiar with the investment or themselves receive authority to make such investments; delay also often means that authorization is out of phase with market cycles; an example is gold which required the lustre of a bull market to secure enactment of investment authority; such enactment at the peak of market cycles is not an auspicious way to initiate investments in new areas;

6. legal lists may result in the deferral or avoidance of legislative proposals containing needed revisions because of potential sponsors' concerns or fears about social or political issues being injected into the statutory framework; and,

7. legal lists may be an impediment to the attraction and retention of highly qualified investment personnel; in addition to compensation, the presence or absence of a legal list is one of the more important factors in securing competent professional staffing for investment programs; this factor is becoming more critical as states around the country drop such lists.

Legal lists do not assure prudence. Instances of imprudent investment activity are seldom illegal. The staggering investment losses of the City of San Jose and the losses of many municipalities and school districts around the country, including Alaska, in the repo market in recent years resulted from willfully imprudent action or negligence due to a lack of professional competence, all within the bounds of applicable legal strictures.

This points up the fact that the greatest assurance of prudence lies with having professional career investment staff. It also requires clear accountability, outside professional review, and public reporting, disclosure, and exposure--measures that would be implemented under the proposed legislation.

The number of pension funds and other institutional investment funds which operate under a legal list has become a small minority:

1. the Employee Retirement Income Security Act of 1974 ("ERISA"), which governs employee pension or welfare benefit plans of corporations and unions, rejected the imposition of a legal list; the preamble to ERISA regulations states

    "the Department (of Labor) does not consider it appropriate to include in the regulation any list of investments, classes of investments, or investment techniques that might be permissible under the 'prudence' rule. No such list could be complete."

2. the Tax Reform Act of 1969 likewise avoided a legal list in establishing rules governing investments for private foundations; section 53.4944-1(a)(2) of IRS regulations states

    "No category of investments shall be treated as a per se violation of section 4944."

3. the Uniform Management of Institutional Funds Act ("UMIFA")--promulgated in 1972, adopted by 28 states, and applicable to endowments of universities, hospitals, and religious or other charitable institutions--in section 6 establishes a rule of prudence as the sole investment guideline;

4. a May, 1986 survey by the National Conference of State Legislatures indicates 23 states do not have legal lists for their retirement funds;

5. within Alaska state government, there are three State corporations that do not have legal lists restricting their investment powers--the Alaska Railroad Corporation, Alaska Power Authority, and Alaska Industrial Development Authority.

The case for jettisoning legal lists has been stated by Girard Miller, author of Investing Public Funds, published by the Government Finance Officers Association ("GFOA"),

> "Investment research has demonstrated that fully diversified and balanced portfolios out-perform one-dimensional portfolios over long time periods, and that risk is best controlled by including assets that behave independently in different market environments. State laws that confine local pension plans to narrowly defined lists of permitted investments are therefore archaic, and usually work only to the benefit of the industries and vendors whose products hold a monopoly position. Accordingly, 35 reform-minded states have adopted 'prudent person' language for their state pension plans. A few states, including California, Iowa and Missouri, have adopted similar language for their local government retirement systems. Public officials in other states should take notice and campaign for similar legislation. Modern experience has shown that new investment instruments and strategies emerge faster than the legislatures can act, so the time has come for the authority to make prudent decisions to be delegated to those who will be responsible: the local government officials and representatives of the beneficiaries."

and by Assemblyman Louis Papan, author of the California Constitutional amendment which makes the prudent person rule the sole restriction on investments of state or local government retirement plans,

> "This measure adopts the proven, conservative federal approach which cuts risks by allowing greater variety <u>if the dictates of prudent judgment are met</u>" (emphasis in original).

Attached are written communications from Citibank, J. P. Morgan Investment, Fred Alger Management, and Invesco Capital Management--firms which manage common stock investments for certain State funds--which provide their analyses or perceptions of the effects on investment performance of some of the State's statutory restrictions.

Also attached are minutes from the March 24, 1987 meeting of the retirement boards of the Public Employees' and Teachers' Retirement Systems at which the proposed legislation, including the trust company concept, was discussed.

4. provide for competitive compensation for investment staff;

Discussion: as indicated by the discussion under <u>Need for the Legislation</u>, item 6, in this memo and in the attached memo of June 19, 1987, current State salaries are not competitive for top flight investment professionals; not only is the pay better elsewhere, but, in what may be an emerging trend, four states, including California, South Dakota, and Virginia have instituted performance-based compensation or bonuses for investment personnel.

Recruitment and retention of State investment staff is difficult enough given Alaska's climate, remoteness from financial centers and metropolitan areas, lack of peers with which to associate, lack of opportunities for career advancement, and higher cost of living as well as the bureaucratic and political burdens associated with working for state government; it would be quite reasonable for the average investment professional to expect better than average compensation to locate in Juneau, just to offset some of the perceived drawbacks.

Recruitment of truly outstanding individuals requires compensation of a wholly different magnitude; yet, given the size of funds under management, the potential increases in earnings, and the State's fiduciary obligations where trust funds are involved, it is a valid question whether the State can afford not to seek the most qualified investment talent it can find; the fact that the cost of such personnel would be paid mostly from retirement and other trust fund monies lends support to this idea.

The legislation would address these problems by transferring State investment officers from the partially-exempt to the exempt service; this would free the establishment of compensation from the State salary schedule.

5. exempt professional services contracts which are delegations of investment authority from the requirements of the State Procurement Code;

Discussion: delays in the review and approval process by the Department of Administration or their requirement to initiate and complete a new selection of contractors within a particular time frame can wreak havoc with the implementation of investment strategies, the reaction to sudden market moves or developments, or the execution of other critical tasks that are in process; the substantial documentation and formality of the contracting process as implemented under the Department of Administration's procedures is not a productive use of investment officers' time; their conversion from investment officers to contracting officers can be very detrimental to the earnings the State receives from its investments.

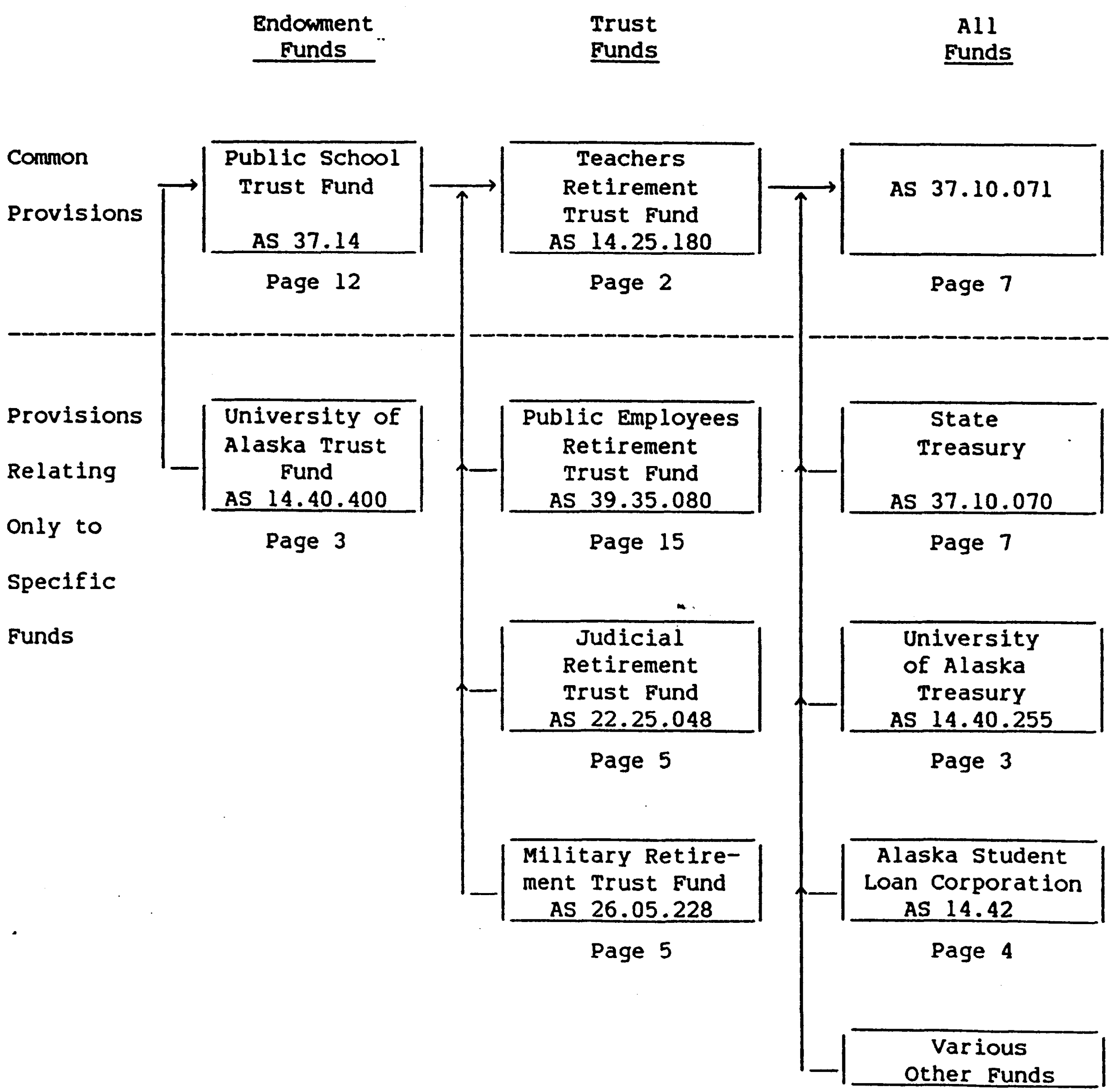
In place of the Procurement Code, regulations would be adopted to provide that contractor selection be on a competitive basis; most contracts for investment management services are subject to independent periodic performance evaluation, which would normally be the basis for their continuation or termination; assurance of not only proper but also the most conscientious possible selection of contractors follows from the mandates of fiduciary responsibilities and the rule of prudence in any event.

MBB/gb

Attachment

Schematic
of
HB 547

The various funds invested by the Department of Revenue or independent corporations have different elements in common. Trust funds have more specialized requirements and duties than other funds. Endowment funds have even more specialized requirements and duties than other types of trust funds such as retirement funds. The following schematic shows the statutory references used in the bill to invoke common provisions rather than repeat such provisions throughout Alaska Statutes.



of misconduct or unauthorized editing have been raised.[2]

Thus, we conclude the testimony of the officers was properly admitted in District Court; it is unnecessary to remand to the trial court for another hearing.

The judgment of the Superior Court is reversed; the verdict of the jury is reinstated.

THOMPSON and REED, JJ., concur.

BAKER BOYER NATIONAL BANK, Appellant,

v.

Richard GARVER, Russell R. Garver, and Gregory L. Garver, Respondents and Cross Appellants.

No. 6404-2-III.

Court of Appeals of Washington, Division 3, Panel Two.

May 15, 1986.

Trustee petitioned for approval of final accounting and remaindermen objected, alleging mismanagement of trusts. The Superior Court, Walla Walla County, Yancey Reser, J., surcharged the trustee for failing to properly diversify trust assets and for unauthorized transfer of trust property. Trustee appealed, and life estate holder and remaindermen cross-appealed. The Court of Appeals, Munson, J., held that: (1) trustee was under a duty to diversify trust investments pursuant to statutorily codified prudent investor rule; (2) granting remaindermen attorney fees and expenses and denying trustee its trustee and attorney fees was proper, given resolution of surcharge issue; (3) trustee which had purportedly conveyed one-half interest in land that was not held in trust would be required to compensate for damages resulting from bringing quiet title action against party to whom land was purportedly conveyed; and (4) court should have considered in damage award lost appreciation in equity securities that would have been realized but for the trustee's improper failure to diversify.

Affirmed in part; remanded in part; and reversed in part.

Green, C.J., filed dissenting opinion.

1. Trusts ⇐217.3(6)

Trustee is under a duty to diversify trust investments, subject to at least two exceptions of express provision by settlor relieving trustee of duty to diversify or circumstances dictating that it is not prudent to diversify, under prudent investor rule codified by statute. West's RCWA 30.24.020 (now RCWA 11.100.020).

2. Trusts ⇐217.3(6)

Any new standards of care created by Trust Act statute setting out "total asset" approach to investment of assets by fiduciaries in considering whether there has been sufficient diversification applied only from effective date of January 1, 1985, even though the statutory provisions applied to instruments created before that time. West's RCWA 11.100.020, 11.100.050.

3. Appeal and Error ⇐758.1

Finding of fact that appellant did not assign error to in its opening brief was a verity on appeal, even though appellant claimed in its reply brief that finding of fact was not supported by substantial evidence.

4. Trusts ⇐262

Evidence supported finding that trustee did not consciously balance risk and advantages, weighing the amount invested

2. Because we find admissibility of the testimony proper under *Rupe*, it is not necessary to address the State's argument under the RCW 9.73.-030(2) exception, recording of threats of extortion, blackmail, or bodily harm.

Amendments

P.L. 99-514, § 1805(c)(1):

Act Sec. 1805(c)(1) amended Code Sec. 386 by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) new subsection (d) to read as above.

The above amendment is effective as if included in the provision of P.L. 98-369 to which such amendment relates.

P.L. 98-369, § 75(a):

Act Sec. 75(a) added Code Sec. 386 to read as above.

The above amendment applies to distributions, sales and exchanges made after March 31, 1984, in tax years ending after such date.

Subchapter D—Deferred Compensation, Etc.

PART I—PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

Subpart A—General Rule

[Sec. 401]

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

[Sec. 401(a)]

(a) REQUIREMENTS FOR QUALIFICATION.—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404 (a) (3) (B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries (but this paragraph shall not be construed, in the case of a multiemployer plan, to prohibit the return of a contribution within 6 months after the plan administrator determines that the contribution was made by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) or the trust which is part of such plan is exempt from taxation under section 501(a), or the return of any withdrawal liability payment determined to be an overpayment within 6 months of such determination));

(3) if the plan of which such trust is a part satisfies the requirements of section 410 (relating to minimum participation standards); and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are—

Public Employees' Retirement Board

Resolution Regarding Legislation Relating to the Commissioner of Revenue's Investment Powers and Duties

WHEREAS, the Public Employees' Retirement ("PERS") Board is authorized by AS 39.35.040(3) to consider and adopt resolutions regarding revisions of Chapter 39.35 of the Alaska Statutes;

WHEREAS, the PERS Board has reviewed and considered draft legislation for an Act entitled "An Act relating to the Commissioner of Revenue's investment powers and duties, and providing for an effective date." (the "Legislation");

WHEREAS, the Legislation significantly reinforces the trust status of the PERS retirement fund by:

a) designating the fund as a trust fund;

b) upgrading the standard of prudence required of the fund's fiduciary; and

c) requiring the fund's fiduciary to act only in the interests of the fund's beneficiaries;

WHEREAS, the Legislation strengthens accountability for investment of the fund by:

a) clarifying the Commissioner of Revenue's role as the fiduciary for the fund;

b) requiring annual audits of the fund; and

c) requiring reports on the condition and investment performance of the fund;

WHEREAS, the Legislation removes impediments to the ability of the fiduciary, subject to the standards of professional prudence, to:

a) diversify fund assets among the full range of investment opportunities; and

b) maximize investment income of the fund over the long run

by repealing statutory specification of permissible investment classes and percentage allocations to particular classes;

WHEREAS, the Legislation assists the recruitment and retention of highly qualified professional investment staff by placing them in the exempt service, permitting the establishment of competitive compensation; and

WHEREAS, the Legislation provides for timely execution of investment strategies by exempting professional services contracts which are delegations of investment authority from the requirements of the State Procurement Code, AS 36.30; and

WHEREAS, the improvement in investment returns that can be expected as a result of the Legislation will be of critical importance to PERS beneficiaries and employers as State petroleum revenues decline.

BE IT HEREBY RESOLVED by the PERS Board that the Board supports introduction, passage, and enactment into law of legislation containing substantially the same provisions as the draft Legislation.

DATED this 13th day of November, 1987.

PUBLIC EMPLOYEES' RETIREMENT BOARD

By James "Pat" Wellington

James "Pat" Wellington
Vice-Chairman

Teachers' Retirement Board

Resolution Regarding Legislation Relating to the Commissioner of Revenue's Investment Powers and Duties

WHEREAS, the Teachers' Retirement ("TRS") Board is authorized by AS 14.25.035(e) to consider and adopt resolutions regarding revisions of Chapter 14.25 of the Alaska Statutes;

WHEREAS, the TRS Board has reviewed and considered draft legislation for an Act entitled "An Act relating to the Commissioner of Revenue's investment powers and duties, and providing for an effective date." (the "Legislation");

WHEREAS, the Legislation significantly reinforces the trust status of the TRS retirement fund by:

a) designating the fund as a trust fund;

b) upgrading the standard of prudence required of the fund's fiduciary; and

c) requiring the fund's fiduciary to act only in the interests of the fund's beneficiaries;

WHEREAS, the Legislation strengthens accountability for investment of the fund by:

a) clarifying the Commissioner of Revenue's role as the fiduciary for the fund;

b) requiring annual audits of the fund; and

c) requiring reports on the condition and investment performance of the fund;

WHEREAS, the Legislation removes impediments to the ability of the fiduciary, subject to the standards of professional prudence, to

a) diversify fund assets among the full range of investment opportunities; and

b) maximize investment income of the fund over the long run

by repealing statutory specification of permissible investment classes and percentage allocations to particular classes;

WHEREAS, the Legislation assists the recruitment and retention of highly qualified professional investment staff by placing them in the exempt service, permitting the establishment of competitive compensation; and

WHEREAS, the Legislation provides for timely execution of investment strategies by exempting professional services contracts which are delegations of investment authority from the requirements of the State Procurement Code, AS 36.30; and

WHEREAS, the improvement in investment returns that can be expected as a result of the Legislation will be of critical importance to TRS beneficiaries and employers as State petroleum revenues decline,

BE IT HEREBY RESOLVED by the TRS Board that the Board supports introduction, passage, and enactment into law of legislation containing substantially the same provisions as the draft Legislation.

DATED this 12th day of November, 1987.

TEACHERS' RETIREMENT BOARD

By Dorothy Wells

Dorothy Wells, Chairman