

**RECEIVED** State Board of Education

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1701 North Congress Avenue  
Austin, Texas 78701-1494  
(512) 463-9007

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**OPINION COMMITTEE**

RQ-1092-GA



October 11, 2012

The Honorable Greg Abbott  
Attorney General of Texas  
Office of the Attorney General  
P.O. Box 12548  
Austin, Texas 78711-2548

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**Michael Soto, Ph.D.**  
San Antonio, District 3

Re: Application of Competitive Purchasing Requirements to Investment of  
the Permanent School Fund

Dear General Abbott:

I am writing to seek your opinion on several matters involving the investment of the Permanent School Fund ("PSF") by the State Board of Education ("Board")<sup>1</sup>. As you know, Article VII, Section 5(f) of the Texas Constitution delegates management of the investment assets<sup>2</sup> of the PSF to the Board in broad language:

Notwithstanding any other provision of this constitution, in managing the assets of the permanent school fund, the State Board of Education may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment, including investments in the Texas growth fund created by Article XVI, Section 70, of this constitution, that persons of ordinary prudence, discretion, and intelligence, exercising the judgment and care under the circumstances then prevailing, acquire or retain for their own account in the management of their affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

<sup>1</sup> Your office has previously considered PSF investments on a number of occasions, including Opinions GA-0871 (2011) and GA-0293 (2005).

<sup>2</sup> The assets of the PSF referenced in Article VII, Section 5(f) constitute the proceeds from the sale of or income derived from lands pursuant to Article VII, Section 4 and transferred to the Board under that section. The remaining lands referenced in Article VII, Section 4 are managed by the General Land Office and the School Land Board.



Your office has previously determined that the language of Article VII, Section 5(f) constitutes a direct grant of authority to the Board<sup>3</sup>.

Since 2006, the Board has expanded the scope of investments to include a number of "alternative asset classes" beyond fixed-income and equity investments in which the PSF had previously been invested. Investments in these alternative asset classes typically are made through investment vehicles or "funds." Your office provided guidance to the Board regarding investments structured like "mutual funds" in Attorney General's Opinion GA-0293 (2005), determining that investment structures that normally deduct expenses from the assets under management are not required to pay those expenses from appropriated funds. The Board has also made investments through limited partnership structures which in turn invest in alternative assets<sup>4</sup>.

As the Board has expanded the scope of investments to alternative asset classes, it has used a competitive bidding process to select investment managers who are delegated the authority to manage the investment vehicle and determine the actual alternative asset investments under such vehicle<sup>5</sup>. In each of those cases, the Board itself was contracting with the investment manager for the service of selecting appropriate investments and not determining individual investments itself. Additionally, the investment manager, and not the Board, would select and contract directly with the service providers required for the administration of the investment vehicle (such as accounting, record-keeping, account reporting, and other related services).

The Board is now considering making certain alternative asset investments directly as a means of reducing the expense of management fees. These direct investments would be made either into an investment "fund" or a "fund of funds" in which an investment manager would be utilized. To this end, the Board has adopted a process by which staff of the PSF<sup>6</sup> would ultimately select and manage

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<sup>3</sup> Attorney General's Opinion DM-175 (1992), holding that the same general investment authority (then at Article VII, Section 5(d)) authorized an investment despite the invalidity of a statute that had purported to make such an authorization. The Board is also granted authority to purchase and sell "all of the types of securities in which it is authorized by law to invest" under Section 43.007, Texas Education Code, though it is unclear as to whether that statute can grant authority beyond that conferred by the Texas Constitution.

<sup>4</sup> Attached is additional informal correspondence regarding the formation of limited partnerships as investment vehicles received from your office in April of 2006.

<sup>5</sup> Some investments are directly managed by contracted firms in the same manner as a mutual fund manager. Others are structured as a "manager of managers" or "fund of funds", where the investment manager or fund selected by the Board consists of a composite of investments of other managers or funds, such as hedge funds, which the managers select using their expertise in accordance with the Board's policy decisions.

<sup>6</sup> Employees of the Texas Education Agency perform all administrative functions for the PSF investment assets as directed by Board policy.

individual alternative asset investments<sup>7</sup> held in investment vehicles that are separate legal entities (specifically, limited liability corporations, or “LLCs”). In addition, the Board in the future may wish to consider directing PSF staff to make and/or manage other private market investments through other types of investment vehicles, such as limited partnerships.

In addition to selection of investments, direct management of these types of investment vehicles could require the PSF staff, acting as the manager of the entity (whether LLC, limited partner, or other) in accordance with the process adopted by the Board, to select investment service providers for the investment entity. These service providers would contract directly with the separate investment entity and provide various administrative services, including, for example, third party fund administration (such as accounting, record-keeping, account reporting, and other related services), auditing, and insurance.

Because of the nature of investment markets, it will sometimes not be feasible or desirable to engage in a competitive procurement process to make individual investments in certain asset classes such as private equity, hedge fund limited partnerships (domestic and foreign), commodities, or real estate, or to select investment managers for such asset classes. In many of those asset classes, the most successful and thus the more desirable managers with whom the Board would wish to invest are unlikely to respond to a public solicitation, or the paucity of time available to make a decision on a desired investment will not allow for a public solicitation. Furthermore, the need for service providers for investment vehicles utilized in these asset classes arises as a result of an investment selected by the Board. The investment service providers are selected and contracted through the particular investment vehicle and are investment-related expenses paid from the investment itself.

My questions involve the impact, if any, of state competitive procurement processes on that type of individual investment selection and related administrative services. The purchase of goods and services by a state agency is typically conducted under the authority of Chapter 2155 of the Texas Government Code. Investments fit neither the definition of a good nor a service under Texas Government Code §2155.001(1) and (2). Additionally, the purchase of an investment would not be considered a professional or consulting service as contemplated by Chapter 2254 of the Texas Government Code.

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<sup>7</sup> Archived broadcasts of Board meetings are available at <http://www.tea.state.tx.us/index4.aspx?id=1156>. The proposed “strategic relationship” to transition some investment decisions away from external managers has been discussed at the July, September and November 2011 Board meetings, as well as January, April and July 2012 meetings. The most detailed discussion took place in meetings of the Committee on School Finance/Permanent School Fund at those meetings.

Texas Government Code §2256.003 authorizes certain entities of government to purchase, sell, and invest its funds and funds under its control. An agency that has the authority to invest directly “may pay for authorized securities purchased from or through a member in good standing of the National Association of Securities Dealers or from or through a national or state bank on receiving an invoice from the seller of the securities showing that the securities have been purchased by the board or agency and that the amount to be paid for the securities is just, due, and unpaid<sup>8</sup>.” We understand the provisions of Chapter 2256 to authorize state agencies to purchase publicly-traded securities without utilizing a competitive process. However, some of the alternative investments considered by the Board may not be available for purchase in the manner contemplated by that statute.

It is our understanding that Article VII, Section 5(f) directly authorizes the selection of an investment by the Board without regard to state competitive procedures by authorizing “any kind of investment” to be made “through procedures and subject to restrictions [the Board] establishes”. We believe this direct grant of investment discretion by the Texas Constitution allows the Board to select investments, investment managers, and providers of administrative services related to investments, directly or through staff, for the PSF without engaging in a competitive process, to the extent such a process might otherwise be required by statute<sup>9</sup>. TEA staff would provide the internal expertise to assist the Board in its fact gathering and evaluation process, make recommendations to the Board, and execute such transactions, but the policy and decision-making authority would remain with the Board.

My first question is whether the Board, after exercising its discretionary fiduciary duty to select particular investments, may select and purchase individual investments, directly or through staff, without conducting a competitive process in the manner required by the State Purchasing and General Services Act (Tex. Gov. Code §§ 2151 et seq.).

My second question is whether the Board may contract with investment managers, directly or through staff, to select investments on behalf of the PSF without conducting a competitive process in the manner required by the State Purchasing and General Services Act (Tex. Gov. Code §§ 2151 et seq.).

My third question is whether the Board may authorize PSF staff, as part of its management of private investment vehicles (such as LLCs and limited

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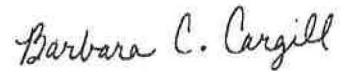
<sup>8</sup> Section 2256.053, Texas Government Code.

<sup>9</sup> The Board’s investment discretion is, of course, limited by the “prudent person rule” also contained within Article VII, Section 5(f). See, Attorney General’s Opinion GA-0871 (2011). For purposes of this request, please assume that individual investments selected by the Board would meet that standard.

partnerships), to select and contract with investment service providers (such as third party administrators and auditors) on behalf of those vehicles, without conducting a competitive process in the manner required by the State Purchasing and General Services Act (Tex. Gov. Code §§ 2151 et seq.).

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

Sincerely,

A handwritten signature in cursive script that reads "Barbara C. Cargill".

Barbara Cargill  
Chair, Texas State Board of Education

cc: Members, Texas State Board of Education  
Michael L. Williams, Commissioner of Education