The State Board of Education (SBOE) proposes amendments to §§33.10, 33.15, 33.20, 33.25, 33.30, 33.35, and 33.60, concerning the statement of investment objectives, policies, and guidelines of the Texas Permanent School Fund (PSF). The proposed amendments would reorganize references to the PSF distribution policy, include references to new authority and duties assigned by the 86th Texas Legislature, 2019, and address permissible fixed income investments.

BACKGROUND INFORMATION AND JUSTIFICATION: In accordance with statute, the rules in 19 TAC Chapter 33 establish investment objectives, policies, and guidelines for the PSF. Legislation from the 86th Texas Legislature, 2019, made changes to the Texas Education Code (TEC) and the Texas Natural Resources Code that impact the PSF and the SBOE's authority and duties related to the PSF.

The proposed amendment to §33.10, Purposes of Texas Permanent School Fund Assets and the Statement of Investment Policy, would specify that one objective of the PSF distribution policy is to maintain the value of assets per student after adjusting for inflation, as stated in 19 TAC §33.15.

The proposed amendments to §33.15, Objectives; §33.20, Responsible Parties and Their Duties; §33.30, Standards of Performance; and §33.60, Performance and Review Procedures, would implement Senate Bill 608 and House Bill 4388, 86th Texas Legislature, 2019, by accounting for the creation of the Liquid Account within the PSF and the requirement that the SBOE and School Land Board send quarterly investment and financial reports to one other.

The proposed amendment to §33.25, Permissible and Restricted Investments and General Guidelines for Investment Managers, would allow for specific uses of U.S. Treasury futures and the acquisition of a limited percentage of speculative-grade rated securities in the fixed income portfolio to enhance portfolio management abilities.

The proposed amendment to §33.35, Guidelines for the Custodian and the Securities Lending Agent, would remove a reference to a credit ratings firm that is no longer providing the services.

The SBOE approved the proposed amendments for first reading and filing authorization at its November 15, 2019 meeting.

FISCAL IMPACT: Holland Timmins, executive administrator and chief investment officer of the Texas Permanent School Fund, has determined that for the first five-year period the proposal is in effect there are no additional costs to state or local government required to comply with the proposal.

LOCAL EMPLOYMENT IMPACT: The proposal has no effect on local economy; therefore, no local employment impact statement is required under Texas Government Code, §2001.022.

SMALL BUSINESS, MICROBUSINESS, AND RURAL COMMUNITY IMPACT: The proposal has no direct adverse economic impact for small businesses, microbusinesses, or rural communities; therefore, no regulatory flexibility analysis specified in Texas Government Code, §2006.002, is required.

COST INCREASE TO REGULATED PERSONS: The proposal does not impose a cost on regulated persons, another state agency, a special district, or a local government and, therefore, is not subject to Texas Government Code, §2001.0045.

TAKINGS IMPACT ASSESSMENT: The proposal does not impose a burden on private real property and, therefore, does not constitute a taking under Texas Government Code, §2007.043.

GOVERNMENT GROWTH IMPACT: TEA staff prepared a Government Growth Impact Statement assessment for this proposed rulemaking. The proposed rulemaking would expand the rules by adding provisions in alignment with recent statutory changes. The new provisions address the SBOE's responsibilities in relation to the PSF.

The proposed rulemaking would not create or eliminate a government program; would not require the creation of new employee positions or elimination of existing employee positions; would not require an increase or decrease in

future legislative appropriations to the agency; would not require an increase or decrease in fees paid to the agency; would not create a new regulation; would not limit or repeal an existing regulation; would not increase or decrease the number of individuals subject to its applicability; and would not positively or adversely affect the state's economy.

PUBLIC BENEFIT AND COST TO PERSONS: Mr. Timmins has determined that for each year of the first five years the proposal is in effect, the public benefit anticipated as a result of enforcing the proposal would be the update and clarification of provisions supporting the management and investment of the PSF. There is no anticipated economic cost to persons who are required to comply with the proposal.

DATA AND REPORTING IMPACT: The proposal would have no new data and reporting impact.

PRINCIPAL AND CLASSROOM TEACHER PAPERWORK REQUIREMENTS: TEA has determined that the proposal would not require a written report or other paperwork to be completed by a principal or classroom teacher.

PUBLIC COMMENTS: The public comment period on the proposal begins December 20, 2019, and ends January 24, 2020. A form for submitting public comments is available on the TEA website at https://tea.texas.gov/About_TEA/Laws_and_Rules/SBOE_Rules_(TAC)/Proposed_State_Board_of_Education_Rules/. Comments on the proposal may also be submitted to Cristina De La Fuente-Valadez, Rulemaking, Texas Education Agency, 1701 North Congress Avenue, Austin, Texas 78701. The SBOE will take registered oral and written comments on the proposal at the appropriate committee meeting in January 2020 in accordance with the SBOE board operating policies and procedures. A request for a public hearing on the proposal submitted under the Administrative Procedure Act must be received by the commissioner of education not more than 14 calendar days after notice of the proposal has been published in the *Texas Register* on December 20, 2019.

STATUTORY AUTHORITY. The amendments are proposed under Texas Constitution, Article VII, §5(a), which authorizes the State Board of Education (SBOE) to make distributions from the Permanent School Fund (PSF) to the available school fund with certain limits; Texas Constitution, Article VII, §5(f), which authorizes the SBOE to manage and invest the PSF according to the prudent investor standard and make investments it deems appropriate; Texas Education Code (TEC), §43.001, which describes the PSF as a perpetual endowment; TEC, §43.0052, as added by HB 4388, 86th Texas Legislature, 2019, and Texas Natural Resources Code, §32.068 and §51.414, as added by HB 4388, which created the Liquid Account within the PSF to be managed by the SBOE and require the SBOE and School Land Board to send quarterly investment and financial reports to the other; and Texas Natural Resources Code, §32.012, as amended by SB 608, 86th Texas Legislature, 2019, and §32.0161, as added by SB 608, which require the SBOE to submit to the governor a list of six nominees for each of two positions on the School Land Board and require the SBOE and the School Land Board to hold a joint annual public meeting to discuss the PSF.

CROSS REFERENCE TO STATUTE. The amendments implement Texas Constitution, Article VII, §5(a) and (f); Texas Education Code (TEC), §43.001; TEC, §43.0052, as added by House Bill (HB) 4388, 86th Texas Legislature, 2019; and Texas Natural Resources Code, §32.012, as amended by Senate Bill 608, 86th Texas Legislature, 2019; §32.0161, as added by SB 608, 86th Texas Legislature, 2019; and §32.068 and §51.414, as added by HB 4388, 86th Texas Legislature, 2019.

<rule>

§33.10. Purposes of Texas Permanent School Fund Assets and the Statement of Investment Policy.

(a) The purpose of the Texas Permanent School Fund (PSF), as defined by the Texas Constitution, shall be to support and maintain an efficient system of public free schools. The State Board of Education (SBOE) views the PSF as a perpetual institution. Consistent with its perpetual nature, the PSF shall be an endowment fund with a long-term investment horizon. The SBOE shall strive to manage the PSF consistently with respect to the following: generating income for the benefit of the public free schools of Texas, the real growth of the corpus of the PSF, protecting capital, and balancing the needs of present and future generations of Texas school children. The PSF will strive to maintain intergenerational equity by

attempting to pay out a constant distribution and maintain the value of assets per student after adjusting for inflation.

(b) The purposes of the investment policy statement are to:

(1) specify the investment objectives, policies, and guidelines the SBOE considers appropriate and prudent, considering the needs of the PSF, and to comply with the Texas Constitution by directing PSF assets;

(2) establish SBOE performance criteria for an investment manager;

(3) communicate the investment objectives, guidelines, and performance criteria to the SBOE, PSF investment staff and managers, and all other parties;

(4) guide the ongoing oversight of PSF investment and test compliance with the Texas Constitution and other applicable statutes;

(5) document that the SBOE is fulfilling its responsibilities for managing PSF investments solely in the interests of the PSF;

(6) document that the SBOE is fulfilling its responsibilities under Texas law; and

(7) provide transparency and accountability to the citizens of Texas.

§33.15. Objectives.

(a) Investment objectives.

(1) Investment objectives have been formulated based on the following considerations:

(A) the anticipated financial needs of the Texas public free school system in light of expected future contributions to the Texas Permanent School Fund (PSF);

(B) the need to preserve capital;

(C) the risk tolerance set by the State Board of Education (SBOE) and the need for diversification;

(D) observations about historical rates of return on various asset classes;

(E) assumptions about current and projected capital market and general economic conditions and expected levels of inflation;

(F) the need to maintain liquidity in the PSF Liquid Account;

(G) [~~(F)~~] the need to invest according to the prudent person rule; and

(H) [~~(G)~~] the need to document investment objectives, guidelines, and performance standards.

(2) Investment objectives represent desired results and are long-term in nature, covering typical market cycles of three to five years. Any shortfall in meeting the objectives should be explainable in terms of general economic and capital market conditions and asset allocation.

(3) The investment objectives are consistent with generally accepted standards of fiduciary responsibility.

(4) Under the provisions of this chapter, investment managers shall have discretion and authority to implement security selection and timing.

(b) Goal and objectives for the PSF.

(1) Goal. The goal of the SBOE for the PSF shall be to invest for the benefit of current and future generations of Texans consistent with the safety of principal, in light of the strategic asset allocation plan adopted. To achieve this goal, PSF investment shall be carefully administered at all times.

(2) Objectives.

(A) The preservation and safety of principal shall be a primary consideration in PSF investment.

(B) Fixed income securities shall be purchased at the highest total return consistent with the preservation and safety of principal.

(C) To the extent possible, the PSF management shall hedge against inflation.

(D) Securities, except investments for cash management purposes, shall be selected for investment on the basis of long-term investment merits rather than short-term gains.

(c) Investment rate of return and risk objectives.

(1) Because the education needs of the future generations of Texas school children are long-term in nature, the return objective of the PSF shall also be long-term and focused on fairly balancing the benefits between the current generation and future generations while preserving the real per capita value of the PSF.

(2) Investment rates of return shall adhere to the Chartered Financial Analyst (CFA) Institute Global Investment Performance Standards (GIPS) guidelines in calculating and reporting investment performance return information.

(3) The overall risk level of PSF assets in terms of potential for price fluctuation shall not be extreme and risk variances shall be acceptable in the context of the overall goals and objectives for the investment of the PSF assets. The primary means of achieving such a risk profile are:

(A) a broad diversification among asset classes that react as independently as possible through varying economic and market circumstances;

(B) careful control of risk level within each asset class by avoiding over-concentration and not taking extreme positions against the market indices; and

(C) a degree of emphasis on stable growth.

(4) Over time, the volatility of returns (or risk) for the total fund, as measured by standard deviation of investment returns, should be comparable to investments in market indices in the proportion in which the PSF invests.

(5) The rate of return objective of the total PSF fund shall be to earn, over time, an average annual total rate of return that meets or exceeds the rate of return of a composite benchmark index, consisting of representative benchmark indices for the asset classes in which the PSF is invested that are aggregated in proportion to the strategic target asset allocation of the total PSF fund as determined by the SBOE, while maintaining an acceptable risk level compared to that of the composite benchmark index.

(6) The rate of return objective of each asset class in which the PSF is invested, other than the short-term cash fund, shall be to earn, over time, an average annual average rate of return that meets or exceeds that of a representative benchmark index for such asset class in U.S. dollars, combining dividends, capital appreciation, income, and interest income, as applicable, while maintaining an acceptable risk level compared to that of the representative benchmark index.

(7) The objective of the short-term cash fund shall be to provide liquidity for the timely payment of security transactions, while earning a competitive return. The expected return, over time, shall meet or exceed that of the representative benchmark index, while maintaining an acceptable risk level compared to that of the representative benchmark index.

(8) The objective of the PSF Liquid Account shall be to maintain liquidity for the needs of the School Land Board while earning a competitive return. The expected return, over time, shall meet or exceed that of the representative benchmark index while maintaining an acceptable risk level compared to that of the representative benchmark index.

(9) [~~(8)~~] Notwithstanding the risk parameters specified in paragraphs (4)-(6) of this subsection, consideration shall be given to marginal risk variances exceeding the representative benchmark indices if returns are commensurate with the risk levels of the respective portfolios.

(d) Asset allocation policy.

(1) The SBOE shall adopt and implement a strategic asset allocation plan based on a well diversified, balanced investment approach that uses a broad range of asset classes indicated by the following characteristics of the PSF:

(A) the long-term nature of the PSF;

(B) the spending policy of the PSF;

(C) the relatively low liquidity requirements of the PSF;

(D) the investment preferences and risk tolerance of the SBOE;

(E) the liquidity mandates under the Texas Natural Resources Code, Chapter 51, Subchapter I;

(F) [~~(E)~~] the rate of return objectives; and

(G) [~~(F)~~] the diversification objectives of the PSF, specified in the Texas Constitution, Article VII, §5(d), the Texas Education Code, Chapter 43, and the provisions of this chapter.

(2) The strategic asset allocation plan shall contain guideline percentages, at market value of the total fund's assets, to be invested in various asset classes. The guideline percentages will include both a target percentage and an acceptable strategic range for each asset class, recognizing that the target mix may not be attainable at a specific point in time since actual asset allocation will be dictated by current and anticipated market conditions, as well as the overall directions of the SBOE.

(3) The SBOE Committee on School Finance/Permanent School Fund, with the advice of the PSF investment staff, shall review the provisions of this section at least annually and, as needed, rebalance the assets of the portfolio according to the asset allocation rebalancing procedure specified in the PSF Investment Procedures Manual. The SBOE Committee on School Finance/Permanent School Fund shall consider the industry diversification and the percentage allocation within the following asset classes:

(A) domestic equities;

(B) international equities;

(C) emerging market equities;

(D) domestic fixed income;

(E) emerging market debt local currency;

(F) real estate;

(G) private equity;

(H) absolute return;

(I) real return;

(J) risk parity;

(K) cash; and

(L) other asset classes as approved by the SBOE.

(4) To the extent practicable, investments shall not exceed the strategic ranges the SBOE establishes for each asset class, recognizing the inability to actively reduce allocations to certain asset classes.

(5) Periodically, the SBOE shall allocate segments of the total fund to each investment manager and specify guidelines, investment objectives, and standards of performance that apply to those assets.

§33.20. Responsible Parties and Their Duties.

(a) The Texas Constitution, Article VII, §§1-8, establish [~~establishes~~] the Available School Fund, the Texas Permanent School Fund (PSF), and the State Board of Education (SBOE), and specify [~~specifies~~] the standard of care SBOE members must exercise in managing PSF assets. In addition, the constitution directs the legislature to establish suitable provisions for supporting and maintaining an efficient public free school system, defines the composition of the PSF and the Available School Fund, and requires the SBOE to set aside sufficient funds to provide free instructional materials for the use of children attending the public free schools of this state.

(b) The Texas Natural Resources Code, Chapter 51, Subchapter I, creates the PSF Liquid Account within the PSF to be invested in liquid assets and managed by the SBOE in the same manner it manages the PSF.

(c) [~~(b)~~] The SBOE shall be responsible for overseeing all aspects of the PSF and may contract with any of the following parties, whose duties and responsibilities are as follows.

(1) An external investment manager is a Person the SBOE retains by contract to manage and invest a portion of the PSF assets under specified guidelines.

(2) A custodian is an organization, normally a financial company, the SBOE retains to safe keep, and provide accurate and timely reports of, PSF assets.

(3) A consultant is a Person the SBOE retains to advise the SBOE on PSF matters based on professional expertise.

(4) Investment Counsel is a Person retained under criteria specified in the PSF Investment Procedures Manual to advise PSF investment staff and the SBOE Committee on School Finance/Permanent School Fund within the policy framework established by the SBOE. Investment Counsel may be assigned such tasks as asset allocation reviews, manager searches, performance analysis, recommendations on spending policy, performance reporting, and benchmarking and research related to the management of PSF assets, with any such assigned tasks to be performed in consultation with PSF staff.

(5) A performance measurement consultant is a Person retained to provide the SBOE Committee on School Finance/Permanent School Fund an analysis of the PSF portfolio performance. The outside portfolio performance measurement service firm shall perform the analysis on a quarterly or as-needed basis. Quarterly reports shall be distributed to each member of the SBOE Committee on School Finance/Permanent School Fund and Investment Counsel, and a representative of the firm shall be available as necessary to brief the committee.

(6) The State Auditor's Office is an independent state agency that performs an annual financial audit of the Texas Education Agency (TEA) at the direction of the Texas Legislature. The financial audit, conducted according to generally accepted auditing standards, is designed to test compliance with generally accepted accounting principles. The state auditor performs tests of the transactions of the PSF Investment Office as part of this annual audit, including compliance with governing statutes and SBOE policies and directives. The TEA Internal Audit Division will participate in the audit process by participating in entrance and exit conferences, being provided copies of all reports and management letters furnished by the external auditor, and having access to the external auditor's audit programs and working papers.

(7) The SBOE may retain independent external auditors to review the PSF accounts annually or on an as-needed basis. The TEA Internal Audit Division will participate in the audit process by participating in entrance and exit conferences, being provided copies of all reports and management letters furnished by the external auditor, and having access to the external auditor's audit programs and working papers.

(d) [~~(c)~~] The SBOE shall meet on a regular or as-needed basis to conduct the affairs of the PSF.

(e) [~~(d)~~] In case of emergency or urgent public necessity, the SBOE Committee on School Finance/Permanent School Fund or the SBOE, as appropriate, may hold an emergency meeting under the Texas Government Code, §551.045.

(f) [~~(e)~~] The SBOE shall have the following exclusive duties:

(1) determining the strategic asset allocation mix between asset classes based on the attending economic conditions and the PSF goals and objectives , including determining the separate asset allocation for the PSF Liquid Account based on the specific goals and objectives for investing the PSF Liquid Account ;

(2) ratifying all investment transactions pertaining to the purchase, sale, or reinvestment of assets by all internal and external investment managers for the current reporting period;

(3) appointing members to the SBOE Investment Advisory Committee;

(4) approving the selection of, and all contracts with, external investment managers, financial advisors, Investment Counsel, financial or other consultants, or other external professionals retained to help the SBOE invest PSF assets;

(5) approving the selection of, and the performance measurement contract with, a well-recognized and reputable firm retained to evaluate and analyze PSF investment results. The service shall compare investment results to the written investment objectives of the SBOE and also compare the investment of the PSF with the investment of other public and private funds against market indices and by managerial style;

(6) setting policies, objectives, and guidelines for investing PSF assets; [~~and~~]

(7) submitting a list of six nominees for any vacant position on the School Land Board to the Texas Governor for consideration; and

(8) [~~(7)~~] representing the PSF to the state.

(g) [~~(f)~~] The SBOE may establish committees to administer the affairs of the PSF. The duties and responsibilities of any committee established shall be specified in the PSF Investment Procedures Manual.

(h) [~~(g)~~] The PSF shall have an executive administrator, with a staff to be adjusted as necessary, who functions directly with the SBOE through the SBOE Committee on School Finance/Permanent School Fund concerning investment matters, and who functions as part of the internal operation under the commissioner of education. At all times, the PSF executive administrator and staff shall invest PSF assets as directed by the SBOE according to the Texas Constitution and all other applicable Texas statutes, as amended, and SBOE rules governing the operation of the PSF. The PSF staff shall:

(1) administer the PSF, including investing and managing assets and contracting in connection therewith, according to SBOE goals and objectives;

(2) execute all directives, policies, and procedures from the SBOE and the SBOE Committee on School Finance/Permanent School Fund;

(3) keep records and provide a continuous and accurate accounting of all PSF transactions, revenues, and expenses and provide reports on the status of the PSF portfolio;

(4) advise any officials, investment firms, or other interested parties about the powers, limitations, and prohibitions regarding PSF investments that have been placed on the SBOE or PSF investment staff by statutes, attorney general opinions and court decisions, or by SBOE policies and operating procedures;

(5) continuously research all internally managed securities held by the PSF and report to the SBOE Committee on School Finance/Permanent School Fund and the SBOE any information requested, including reports and statistics on the PSF, for the purpose of administering the PSF;

(6) establish and maintain a procedures manual that implements this section to be approved by the SBOE;

(7) make recommendations regarding investment and policy matters to the SBOE Committee on School Finance/Permanent School Fund and the SBOE, except for formal recommendations for benchmarks for internally managed PSF asset classes, which duties the Committee will assign to

an appropriate third party who will present such recommendations after consultation with PSF staff; and

(8) establish and maintain accounting policies and internal control procedures concerning all receipts, disbursements and investments of the PSF, according to the procedures adopted by the SBOE.

(i) The SBOE delegates to the SBOE Committee on School Finance/Permanent School Fund, to which it has delegated certain powers and duties relating to the investment of the PSF, the responsibility of representing the SBOE at the joint annual meeting between the School Land Board and the SBOE under Texas Natural Resources Code, §32.0161. The chairs of the SBOE and the SBOE Committee on School Finance/Permanent School Fund shall be responsible for coordinating the joint annual meeting between the School Land Board and the SBOE.

§33.25. Permissible and Restricted Investments and General Guidelines for Investment Managers.

(a) Permissible investments. Any investment that satisfies the prudence standard, is consistent with the Fund's investment policy and portfolio objectives, and is used in executing investment strategies approved by the State Board of Education (SBOE).

(b) Prohibited transactions and restrictions. Except as provided in subsection (a) of this section or as approved or delegated by the SBOE, the following prohibited transactions and restrictions apply to all Texas Permanent School Fund (PSF) investment managers with respect to the investment or handling of PSF assets, except as otherwise noted:

(1) short sales of any kind except for U.S. Treasury futures for purposes of hedging fixed income portfolios ;

(2) purchasing letter or restricted stock;

(3) buying or selling on margin;

(4) engaging in purchasing or writing options or similar transactions;

[~~(5) purchasing or selling futures on commodities contracts;~~]

(5) [~~(6)~~] borrowing by pledging or otherwise encumbering PSF assets;

(6) [~~(7)~~] purchasing the equity or debt securities of the PSF investment manager's own organization or an affiliated organization;

(7) [~~(8)~~] engaging in any purchasing transaction, after which the cumulative market value of common stock in a single corporation exceeds 2.5% of the PSF total market value or 5.0% of the manager's total portfolio market value;

(8) [~~(9)~~] engaging in any purchasing transaction, after which the cumulative number of shares of common stock in a single corporation held by the PSF exceeds 5.0% of the outstanding voting stock of that issuer;

(9) [~~(10)~~] engaging in any purchasing transaction, after which the cumulative market value of fixed income securities or cash equivalent securities in a single corporation (excluding the U.S. government, its federal agencies, and government sponsored enterprises) exceeds 2.5% of the PSF total market value or 5.0% of the investment manager's total portfolio market value with the PSF;

(10) [~~(11)~~] purchasing tax exempt bonds;

(11) [~~(12)~~] purchasing guaranteed investment contracts (GICs) from an insurance company or bank investment contracts (BICs) from a bank not rated at least AAA by Standard & Poor's or Moody's;

(12) [~~(13)~~] purchasing any publicly traded fixed income security not rated investment grade by Standard & Poor's (BBB-), Moody's (Baa3), or Fitch (BBB-), subject to the provisions of the PSF Investment Procedures Manual and the following restrictions:

(A) when ratings are provided by the three rating agencies, the middle rating shall be used;

(B) when ratings are provided by two ratings agencies, the lower rating is used; or

(C) when a rating is provided by one rating agency, the sole rating is used;

(13) [~~(14)~~] purchasing short-term money market instruments rated below A-1 by Standard & Poor's or P-1 by Moody's;

(14) [~~(15)~~] engaging in any transaction that results in unrelated business taxable income (excluding current holdings);

(15) [~~(16)~~] engaging in any transaction considered a "prohibited transaction" under the Internal Revenue Code or the Employee Retirement Income Security Act (ERISA);

(16) [~~(17)~~] purchasing precious metals or other commodities;

(17) [~~(18)~~] engaging in any transaction that would leverage a manager's position;

(18) [~~(19)~~] lending securities owned by the PSF, but held in custody by another party, such as a bank custodian, to any other party for any purpose, unless lending securities according to a separate written agreement the SBOE approved; and

(19) [~~(20)~~] purchasing fixed income securities without a stated par value amount due at maturity.

(c) General guidelines for investment managers.

(1) Each investment manager retained to manage a portion of PSF assets shall be aware of, and operate within, the provisions of this chapter and all applicable Texas statutes.

(2) As fiduciaries of the PSF, investment managers shall discharge their duties solely in the interests of the PSF according to the prudent expert rule, engaging in activities that include the following.

(A) Diversification. Each manager's portfolio should be appropriately diversified within its applicable asset class.

(B) Securities trading.

(i) Each manager shall send copies of each transaction record to the PSF investment staff and custodians.

(ii) Each manager shall be required to reconcile the accounts under management on a monthly basis with the PSF investment staff and custodians.

(iii) Each manager shall be responsible for complying fully with PSF policies for trading securities and selecting brokerage firms, as specified in §33.40 of this title (relating to Trading and Brokerage Policy). In particular, the emphasis of security trading shall be on best execution; that is, the highest proceeds to the PSF and the lowest costs, net of all transaction expenses. Placing orders shall be based on the financial viability of the brokerage firm and the assurance of prompt and efficient execution.

(iv) The SBOE shall require each external manager to indemnify the PSF for all failed trades not due to the negligence of the PSF or its custodian in instances where the selection of the broker dealer is not in compliance with §33.40 of this title (relating to Trading and Brokerage Policy).

(C) Acknowledgments in writing.

(i) Each external investment manager retained by the PSF must be a person, firm, or corporation registered as an investment adviser under the Investment Adviser Act of 1940, a bank as defined in the Act, or an insurance company qualified to do business in more than one state, and must acknowledge its fiduciary responsibility in writing. A firm registered with the Securities and Exchange Commission (SEC) must annually provide a copy of its Form ADV, Section II.

(ii) The SBOE may require each external manager to obtain coverage for errors and omissions in an amount set by the SBOE, but the coverage shall be at least the greater of $500,000 or 1.0% of the assets managed, not exceeding $10 million.

The coverage should be specific as to the assets of the PSF. The manager shall annually provide evidence in writing of the existence of the coverage.

(iii) Each external manager may be required by the SBOE to obtain fidelity bonds, fiduciary liability insurance, or both.

(iv) Each manager shall acknowledge in writing receiving a copy of, and agreeing to comply with, the provisions of this chapter.

(D) Discretionary investment authority. Subject to the provisions of this chapter, any investment manager of marketable securities or other investments, retained by the PSF, shall have full discretionary investment authority over the assets for which the manager is responsible. Specialist advisors and investment managers retained for alternative asset investments may have a varying degree of discretionary authority, which will be outlined in contract documentation.

(d) Reporting procedures for investment managers. The investment manager shall:

(1) prepare a monthly and quarterly report for delivery to the SBOE, the SBOE Committee on School Finance/Permanent School Fund, and the PSF investment staff that shall include, in the appropriate format, items requested by the SBOE. The monthly reports shall briefly cover the firm's economic review; a review of recent and anticipated investment activity; a summary of major changes that have occurred in the investment markets and in the portfolio, particularly since the last report; and a summary of the key characteristics of the PSF portfolio. Quarterly reports shall comprehensively cover the same information as monthly reports but shall also include any changes in the firm's structure, professional team, or product offerings; a detail of the portfolio holdings; and transactions for the period. Periodically, the PSF investment staff shall provide the investment manager a detailed description of, and format for, these reports;

(2) when requested by the SBOE Committee on School Finance/Permanent School Fund, make a presentation describing the professionals retained for the PSF, the investment process used for the PSF portfolio under the manager's responsibility, and any related issues;

(3) when requested by the PSF investment staff, meet to discuss the management of the portfolio, new developments, and any related matters; and

(4) implement a specific investment process for the PSF. The manager shall describe the process and its underlying philosophy in an attachment to its investment management agreement with the PSF and manage according to this process until the PSF and manager agree in writing to any change.

§33.30. Standards of Performance.

(a) The State Board of Education (SBOE) Committee on School Finance/Permanent School Fund shall set and maintain performance standards for the total Texas Permanent School Fund (PSF) <u>and separately for the PSF Liquid Account</u> , for each asset class in which the assets of the PSF <u>and the PSF Liquid Account</u> are invested, and for all investment managers based on criteria that include the following:

(1) time horizon;

(2) real rate of return;

(3) representative benchmark index;

(4) volatility of returns (or risk), as measured by standard deviation; and

(5) universe comparison.

(b) The SBOE Committee on School Finance/Permanent School Fund shall develop and implement the procedures necessary to establish and recommend to the SBOE the performance standards criteria.

(c) Performance standards shall be included in the PSF Investment Procedures Manual.

§33.35. Guidelines for the Custodian and the Securities Lending Agent.

Completing custodial and security lending functions in an accurate and timely manner is necessary for effective investment management and accurate records.

(1) A custodian shall have the following responsibilities regarding the segments of the funds for which the custodian is responsible.

(A) Provide complete custody and depository services for the designated accounts.

(B) Provide for investment of any cash on a daily basis to avoid uninvested amounts.

(C) Implement the investment actions in a timely and effective manner as directed by the investment managers.

(D) Collect all realizable income and principal and properly report the information on the periodic statements to the Texas Permanent School Fund (PSF) investment staff, the investment managers, or other appropriate parties.

(E) Provide monthly and annual accounting statements, as well as on-line, real-time accounting, that includes all transactions. Accounting shall be based on accurate security values for cost and market value and provided within a time frame acceptable to the State Board of Education (SBOE).

(F) Report to the PSF investment staff situations in which security pricing is either not possible or subject to considerable uncertainty.

(G) Distribute all proxy voting materials in a timely manner.

(H) Provide research and assistance to the SBOE and the PSF investment staff on all issues related to accounting and administration.

(I) Confirm that the depth of resources and personnel associated with the designated funds are comparable to those of the nation's leading custodial banks.

(2) A securities lending agent for the PSF shall have the following responsibilities.

(A) Provide complete transaction reporting for the designated funds.

(B) Provide a monthly accounting, as well as on-line, real-time accounting for securities lending transactions, based on accurate security values.

(C) Report to the PSF investment staff any irregular situation that is outside the standard of practice for securities lending or inconsistent with the provisions of the securities lending agreement.

(D) Implement a securities lending program for the PSF in a manner that does not impair any rights of the PSF by virtue of PSF ownership in securities.

(E) As requested, provide research and assistance to the SBOE and the PSF investment staff on all issues related to accounting and administration.

(F) Provide indemnification to the PSF satisfactory to the SBOE in the event of default on securities lending transactions.

(G) Fully disclose all revenues and other fees associated with the securities lending program.

(H) Comply with restrictions on types of securities lending transactions or eligible investments of cash collateral or any other restrictions imposed by the SBOE or the PSF investment staff. Unless the SBOE gives its written approval, the following guidelines apply to the PSF Securities Lending Program. Cash collateral reinvestment guidelines must meet the following standards.

(i) Permissible investments.

(I) U.S. Government and U.S. Agencies, under the following criteria:

(-a-) any security issued by or fully guaranteed as to payment of principal and interest by the U.S. Government or a U.S. Government Agency or sponsored Agency, and eligible for transfer via Federal Reserve Bank book entry, Depository Trust Company book entry, and/or Participants Trust Company book entry;

(-b-) maximum 397-day maturity on fixed rate;

(-c-) maximum three-year maturity on floating rate, with maximum reset period of 94 days and use a standard repricing index such as London InterBank Offered Rate (LIBOR), Federal Funds, Treasury Bills, or commercial paper; and

(-d-) no maximum dollar limit.

(II) Bank obligations, under the following criteria:

(-a-) time deposits with maximum 60-day maturity on fixed rate or three-year maturity for floating rate, with maximum reset period of 60 days and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills, or commercial paper;

(-b-) negotiable Certificates of Deposit with maximum 397-day maturity on fixed rate or three-year maturity for floating rate, with maximum reset period of 94 days and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills, or commercial paper;

(-c-) bank notes with maximum 397-day maturity on fixed rate or three-year maturity on floating rate, with maximum reset period of 94 days and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills, or commercial paper;

(-d-) bankers acceptances with maximum 45-day maturity;

(-e-) issued by banks with at least $25 billion in assets and, for floating rate bank obligations with a maturity greater than 397 days, a long-term rating of AA2 and AA by Moody's Investor Service and Standard & Poor's Corporation at time of purchase; and, for fixed rate or floating rate bank obligations with a remaining maturity of 397 days or less, a short-term rating of "Tier 1" as defined in clause (ii)(IV) of this subparagraph or, for such bank obligations without a short-term rating, an issuer rating of Tier 1. In addition, placements can be made in branches within the following countries:

(-1-) Canada;

(-2-) France;

(-3-) United Kingdom; and

(-4-) United States; and

(-f-) dollar limit maximum per institution of 5.0% of investment portfolio at time of purchase.

(III) Commercial paper, under the following criteria:

(-a-) dollar limit maximum per issuer of 5.0% of investment portfolio at time of purchase including any other obligations of that issuer as established in subclause (II)(-d-) of this clause. If

backed 100% by bank Letter of Credit, then dollar limit is applied against the issuing bank;

(-b-) must be rated "Tier 1" as defined in clause (ii)(IV) of this subparagraph; and

(-c-) maximum 397-day maturity.

(IV) Asset backed commercial paper, under the following criteria:

(-a-) dollar limit maximum per issuer of 5.0% of investment portfolio;

(-b-) must be rated "Tier 1" as defined in clause (ii)(IV) of this subparagraph; and

(-c-) maximum 397-day maturity.

(V) Asset backed securities, under the following criteria:

(-a-) maximum 397-day weighted average life on fixed rate;

(-b-) maximum three-year weighted average life on floating rate, with maximum reset period of 94 days and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills, or commercial paper; and

(-c-) rated Aaa and AAA by Moody's Investor Service and Standard & Poor's Corporation at time of purchase. One AAA rating may suffice if only rated by one Nationally Recognized Securities Rating Organization (NRSRO).

(VI) Corporate debt (other than commercial paper), under the following criteria:

(-a-) must be senior debt;

(-b-) maximum 397-day maturity on fixed rate;

(-c-) maximum three-year maturity on floating rate, with maximum reset period of 94 days and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills, or commercial paper;

(-d-) for floating rate corporate obligations with a maturity greater than 397 days, a long-term rating of AA2 and AA by Moody's Investor Service and Standard & Poor's Corporation at time of purchase; and, for fixed rate or floating rate corporate obligations with a remaining maturity of 397 days or less, a short-term rating of "Tier 1" as defined in clause (ii)(IV) of this subparagraph or, for such corporate obligations without a short-term rating, an issuer rating of Tier 1; and

(-e-) dollar limit maximum per issuer of 5.0% of investment portfolio at time of purchase, including any other obligations of that issuer.

(VII) Reverse repurchase agreements, under the following criteria:

(-a-) counterparty must be "Tier 1" rated as defined in clause (ii)(IV) of this subparagraph for fixed rate and AA2 and AA by Moody's Investor Service and Standard & Poor's Corporation for floating rate or be a "Primary Dealer" in

Government Securities as per the New York Federal Reserve Bank;

(-b-) underlying collateral may be any security permitted for direct investment;

(-c-) lending agent or a third party custodian must hold collateral under tri-party agreement;

(-d-) collateral must be marked to market daily and maintained at the following margin levels : [:]

(-1-) U.S. Government, U.S. Government Agency, sponsored Agency, International Organization at 100%;

(-2-) Certificate of Deposits, Bankers Acceptance, bank notes, commercial paper at 102% under one year to maturity and rated at least "Tier 1" as defined in clause (ii)(IV) of this subparagraph; and

(-3-) corporate debt (other than commercial paper) at 105% rated at least AA2/AA or better by Moody's Investor Service and Standard & Poor's Corporation at time of purchase;

(-e-) due to daily margin maintenance, dollar limits and maturity limits of underlying collateral are waived, except with respect to the maturity limit in subclause (II)(-d-) of this clause;

(-f-) maximum 180-day maturity; and

(-g-) dollar limit for total reverse repurchase agreements is the greater of $300 million or 15% of value of cash collateral portfolio with one counterparty at time of purchase.

(VIII) Foreign sovereign debt, under the following criteria:

(-a-) any security issued by or fully guaranteed as to payment of principal and interest by a foreign government whose sovereign debt is rated AA2/AA or better by Moody's Investor Service and Standard & Poor's Corporation at time of purchase. Securities must be delivered to Lending Agent or a third party under a Tri-Party agreement;

(-b-) dollar limit maximum per issuer or guarantor of 2.5% of investment portfolio; and

(-c-) maximum maturity of 397 days.

(IX) Short Term Investment Fund (STIF) and/or Registered Mutual Funds, under the following criteria:

(-a-) funds must comprise investments similar to those that would otherwise be approved for securities lending investment under the provisions of this subparagraph, not invest in derivatives, and not re-hypothecate assets;

(-b-) lender must approve each fund in writing and only upon receipt of offering documents and qualified letter; and

(-c-) fund must have an objective of a constant share price of one dollar.

(ii) Investment parameters.

(I) Maximum weighted average maturity of investment portfolio must be 180 days.

(II) Maximum weighted average interest rate exposure of investment portfolio must be 60 days.

(III) All investments must be U.S. dollar-denominated.

(IV) "Tier 1" credit quality is defined as the highest short-term rating category by the following NRSROs:

(-a-) Standard & Poor's;

(-b-) Moody's Investors Service; and

(-c-) Fitch Investors Service . [~~; and~~]

[~~(-d-) Duff & Phelps, LLC.~~]

(V) At time of purchase all investments must be rated in the highest short-term numerical category by at least two NRSROs, one of which must be either Standard & Poor's or Moody's Investors Service.

(VI) Issuer's ratings cannot be on negative credit watch at the time of purchase.

(VII) Interest and principal only (IO, PO) stripped mortgages are not permitted.

(VIII) Mortgage backed securities are not permitted.

(IX) Complex derivative or structured securities, including, but not limited to the following are not permitted:

(-a-) inverse floating rate notes;

(-b-) defined range floating rate notes;

(-c-) trigger notes; and

(-d-) set-up notes.

(I) Provide a copy of the investment policy governing the custodian's securities lending program, as amended, to the PSF investment staff.

(J) Confirm that the depth of resources and personnel associated with the designated funds are comparable to those of the nation's leading securities lending agents.

§33.60. Performance and Review Procedures.

As requested by the State Board of Education (SBOE) or Texas Permanent School Fund (PSF) investment staff, evaluation and periodic investment reports shall supply critical information on a continuing basis, such as the amount of trading activity, investment performance, cash positions, diversification ratios, rates of return, and other perspectives of the portfolios. The reports shall address compliance with investment policy guidelines.

(1) Performance measurements. The SBOE Committee on School Finance/Permanent School Fund shall review the quarterly performance of each portfolio of the PSF in terms of the provisions of this chapter. The investment performance review shall include comparisons with representative benchmark indices, a broad universe of investment managers, and the consumer price index. A time-weighted return formula (which minimizes the effect of contributions and withdrawals) shall be used for investment return analysis. The review also may include quarterly performance analysis and comparisons of retained firms. The services of an outside, independent consulting firm that provides performance measurement and evaluation shall be retained.

(2) Meeting and reports. Upon request, the SBOE Committee on School Finance/Permanent School Fund shall meet with the PSF investment managers and custodian to review their responsibilities, the PSF portfolio, and investment results in terms of the provisions of this chapter.

(3) Reports to the School Land Board. Each quarter, the SBOE shall provide the School Land Board a financial report on the portion of the PSF assets and funds for which the SBOE is responsible in accordance with Texas Natural Resources Code, §43.0052.

(4) [~~(3)~~] Review and modification of investment policy statement. The SBOE Committee on School Finance/Permanent School Fund shall review the provisions of this chapter at least once a year to determine if modifications are necessary or desirable. Upon approval by the SBOE, any modifications shall be promptly reported to all investment managers and other responsible parties.

(5) [~~(4)~~] Compliance with this chapter and Texas statutes. Annually, the SBOE Committee on School Finance/Permanent School Fund shall confirm that the PSF and each of its managed portfolios have complied with the provisions of this chapter concerning exclusions imposed by the SBOE, proxy voting, and trading and brokerage selection.

(6) [~~(5)~~] Significant events. The SBOE must be notified promptly if any of the following events occur within the custodian or external investment manager organizations:

(A) any event that is likely to adversely impact to a significant degree the management, professionalism, integrity, or financial position of the custodian or investment manager. A custodian must report the loss of an account of $500 million or more. An investment manager must report the loss of an account of $25 million or more;

(B) a loss of one or more key people;

(C) a significant change in investment philosophy;

(D) the addition of a new portfolio manager on the sponsor's account;

(E) a change in ownership or control, through any means, of the custodian or investment manager; or

(F) any violation of policy.