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April 5, 1988

Lawrence J. Carson II  
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STATEHOUSE MAIL

THIS CORRESPONDENCE IS A LEGAL GUIDELINE OF THE  
ATTORNEY GENERAL SUBMITTED FOR YOUR GUIDANCE

Re: Use of Directed Commissions and "Soft Dollars" to Pay  
Investment Expenses

Dear Mr. Carson:

This is in response to your request for advice regarding use of directed commissions and "soft dollars" to pay investment expenses of PERSI. You have asked for our review of a letter opinion of the Oregon Attorney General's Office on the subject. You have also asked us to address the use of investment expense funds to pay for travel, hotel and meal expenses incurred in investment activities such as investment research seminars.

SUMMARY

General trust principles permit trustees to utilize trust assets to pay for reasonable and necessary investment expenses for the effective investment of trust assets. Such expenses would include travel and related expenses which are reasonable and necessary for the effective investment of assets. However, the allocation of expenses between administrative and investment accounts is governed by Idaho Code § 59-1331.

That section creates an administrative account to pay administrative expenses of PERSI. The balance of funds are paid to the funding agent(s) "for investment and payment of investment expenses under its contract with the board." Thus,

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the statute contemplates that investment expenses will be paid from investment funds and administrative expenses will be paid from the administrative account.

The allocation of expenses between investment and administrative expenses should be considered carefully on a case-by-case basis. If, for example, an expense which the legislature considered to be within the administrative appropriation were paid from the investment account, the effect would be the payment of administrative expenditures beyond what was intended by the legislature. Accordingly, care must be taken in allocation of expenses consistent with legislative intent.

#### The Oregon Attorney General's Letter Opinion

Pursuant to your request, I have reviewed the January 8, 1988 letter opinion of the Oregon Attorney General's Office dealing with use of "soft dollars" to pay for investment expenses in general and travel expenses in particular. The opinion concludes that as a matter of general trust law, trustees may charge the trust for reasonable and necessary expenses incurred in the discharge of trust duties. These would include payment of travel expenses to attend investment seminars if it can be shown that the expenses are reasonable and necessary to the management of the investments of the trust.

The opinion also discusses the provisions of section 28(e) of the Securities and Exchange Act of 1934. That section was enacted to provide a "safe harbor" to those directing the brokerage who have investment discretion with respect to the transaction, and where the broker provides brokerage and research. It states in pertinent part:

[a] person who exercises investment discretion with respect to an account shall not be deemed to have acted unlawfully or to have breached a fiduciary duty under state or federal law solely by reason of his having caused an account to pay more than the lowest available commission if that person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided with respect to either the particular transaction or all the accounts as to which the person exercises investment discretion.

Regulations interpreting that section do not provide a "safe harbor" for payment of travel expenses. The regulations provide in pertinent part at 17 CFR 241.23170:

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Finally, where a money manager is invited to attend a research seminar or similar program, the cost of that seminar may be paid for with commission dollars. Non-research aspects of the trip, however, such as travel costs, hotel, meal and entertainment expenses, are not within the safe harbor.

. . . .

Section 28(e), however, cannot by its terms be violated. Thus, the fact that sponsor directed brokerage transactions are outside its protections does not necessarily mean that such transactions are illegal.

Most pension plans are governed principally by the provisions of ERISA. However, state retirement plans such as PERSI or the Oregon plan are not subject to ERISA. The permissible uses of investment funds by state plans are governed by state law. The Oregon letter opinion thus considered general trust law principles. It concluded that general trust law principles permit trustees to pay for reasonable and necessary investment expenses for the effective investment of trust assets. If travel is reasonable and necessary for effective investment under the particular circumstances, the Oregon opinion concludes that such travel expenses can be paid for with trust assets.

The Oregon letter opinion recommended that the "safe harbor" provisions be considered for general guidance. It recommended that expenses which go beyond the "safe harbor" provisions be considered on a case-by-case basis to determine if they are reasonable and necessary for the effective investment of trust assets. I concur in this advice. However, as discussed below, investment expenses in Idaho must also be paid in a manner consistent with Idaho Code § 59-1331.

#### The Idaho Statutes

Idaho Code § 59-1331 provides in pertinent part:

All moneys received from employers by the board on their account and on account of members shall be initially deposited in the clearing account. On or before the fifteenth of each month not more than one-twelfth (1/12) of the amount appropriated by the legislature to the board for that fiscal year shall be transferred to the administration account. Immediately after each transfer from the

clearing account to the administration account, the remaining balance in the clearing account shall be forwarded to the funding agent for investment and payment of investment expenses under its contract with the board.

. . . .

All moneys payable to the funding agent are hereby perpetually appropriated to the board, and shall not be included in its departmental budget. All moneys transferred to the administration account shall be available to the board for the payment of administrative expenses only to the extent so appropriated by the legislature.

The section provides that funds appropriated by the legislature to the administration account are available for payment of administrative expenses only to the extent so appropriated. It also provides that funds forwarded to the funding agent are available for "investment and payment of investment expenses under its contract with the board."

Pursuant to the statute, it is not pertinent whether funds are characterized as "soft dollars," rebates of directed commissions, or other investment funds held by the funding agent. None of these categories of investment funds or commission rights deriving therefrom are part of the administration account. Rather, they are funds or rights held by the funding agent for its investments and payment of investment expenses pursuant to its contract with the board. Accordingly, for purposes of the Idaho statute, both investment funds and commission rights are held by the funding agent and may be used to pay "investment expenses under its contract with the board."

The retirement statutes do not provide definitions of administrative expense or investment expense. Clearly, any item of projected expense included within the detailed administrative budget submitted to the legislature should not be charged as an investment expense. To do so would have the effect of increasing the amount available for payment of "administrative expenses" as contemplated by the legislature. On the other hand, items which are clearly investment expense such as manager evaluation services, which have always been charged as investment expense, should continue to be charged as investment expense. Between these extremes, there exists a substantial grey area.

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For example, a trip to Mellon Bank to improve custodial functions would appear to be a reasonable and necessary investment expense properly chargeable as such. Likewise, a trip for an investment seminar would appear to be a proper investment expense, provided proposed expenses of this type had not been included in the detailed administrative budget submitted to the legislature. On the other hand, a trip to a convention of pension administrators would appear to be more properly chargeable as administrative expense.

I would recommend adoption of guidelines for payment of investment expenses to provide operational uniformity in the charging of expenses. Otherwise, PERSI could be subjected to criticism that it is playing games with its administrative budget. It would seem that it is not as important precisely where the lines are drawn as that there be consistency in the process. With defined administrative versus investment expenses, the legislature can appropriate administrative funds in a manner which it considers proper. If investment versus administrative expenses are ill-defined, the legislature would have inadequate budget control and PERSI could be subject to substantial criticism.

Sincerely,

David G. High  
Deputy Attorney General  
Chief, Business Regulation  
and State Finance Division

DGH/scw