MEMORANDUM

STATE OF ALASKA
DEPARTMENT OF LAW

TO: Hon. Carl Brady, Chair
Board of Trustees
Alaska Permanent Fund Corporation

DATE: February 15, 2005

FILE NO: 663-05-0141

TEL. NO: 465-3600

FROM: James L. Baldwin
Senior Assistant Attorney General
Opinions, Appeals and Ethics

SUBJECT: Power of the Legislature to authorize Board of Trustees of Alaska Permanent Fund Corporation to designate investment subject only to the Prudent Investor Rule

The Alaska Permanent Fund Corporation ("the Corporation") requested an opinion on whether the requirement in the Alaska Constitution that investments of the Alaska Permanent Fund ("the permanent fund") be "specifically designated by law" would allow the legislature to further delegate this power of designation to the board of trustees of the permanent fund. The board of trustees is investigating the legal consequences if they were to be given discretion over exercise of the power of designation subject only to the prudent investor rule.

Introduction.

Our advice on this question depends on the interpretation of a phrase in article IX, section 15 of the Alaska Constitution. Section 15 authorizes the establishment of the Alaska Permanent Fund. In pertinent part, the section requires that certain petroleum-related revenue be placed in a permanent fund, "the principal of which shall be used only for those income-producing investments specifically designated by law" as eligible for permanent fund investments. (Emphasis added). You desire to know whether the constitutional requirement that investments be "specifically designated by law" can be interpreted to permit the legislature to give to the board of trustees the power to make investments, not according to a list of investments established in AS 37.13.120 (hereinafter "the legal list"), but rather according to an exercise of discretion consistent with the prudent investor rule.

Short answer:

The legislature may delegate the power to designate investments to the board of trustees subject to the limitations explained in this memorandum.

Legislative History.

The legislative history of the constitutional provision we have been asked to construe provides some evidence that will assist in establishing a meaning. The permanent fund amendment was originally introduced by Governor Jay Hammond.[1] Even though the original approach gained passage in the House of Representatives during the First Session of the Ninth Alaska State Legislature, the governor offered a sponsor substitute the following year. The sponsor substitute proposed creation of a single dedicated fund to receive a stream of revenue from petroleum revenue sources.[2]

In his letter transmitting the sponsor substitute to presiding officers of each house of the legislature, Governor Hammond said:

> The principal of the fund would be used only for investment in income-producing investments which the legislature would establish and change to meet current investment needs of the State.[3]

As introduced, the substitute resolution was silent concerning designation of permissible investments for the permanent fund. However, Governor Hammond's letter mentioned the legislature's role in setting the kinds of investments that would be appropriate for permanent fund principal. Apparently, he believed that this role was implied within the wording of the substitute version. During legislative hearings on the resolution, amendments were adopted in the House Finance and Judiciary Committees that expressly provided that investments will be designated by law.

The House Finance Committee reported out the resolution with amendments.[4] As a part of these amendments, the Finance Committee provided that investments of

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1 HJR 39 (9th Alaska State Legislature, First Sess.).

2 SSHJR 39 (9th Alaska State Legislature, Second Sess.).

3 1976 House J. at 39 (January 15, 1976).

4 1976 House J. at 541 (March 10, 1976).

principal ". . . shall be established by law".[5] In the House Judiciary Committee, the finance amendments were accepted and incorporated in the Judiciary Committee Substitute with the word "established" deleted and the words "specifically designated" inserted in its place.[6] This wording remained unchanged during subsequent hearings on the resolution and became the wording ratified by the people at the 1976 general election.

During discussion in the House Judiciary Committee, the stated intent of the provision requiring specific designation was to avoid having the permanent fund become a source of capitalization for existing state loan programs. At that time, revolving loan programs had provisions that enabled the sale or transfer of notes and other evidences of debt to the state treasury and public employee and teachers retirement funds. The proceeds of sale would then provide more money to make loans and thereby create constantly revolving loan enterprises.[7]

In a "Joint Chairman's Report" of the House Finance and Judiciary Committees, the intent of Governor Hammond was repeated that permanent fund money would be placed in "investments which the legislature would establish and change from time to time to meet the needs of the state."[8] Based on the foregoing, it does not appear that the legislature meant that individual investments must be specifically designated before the permanent fund can be invested. Rather, there must be an express authorization of the investment of permanent fund money in a particular manner. This distinction is important. The language of the resolution was not intended to require approval of individual investments but rather to prevent the possibility that authority to make an investment could be provided by or implied from a statute unrelated to the permanent fund. The authority to invest must be specific to the permanent fund and was not intended to include the investment of surplus state money in general.

The attorney general addressed the requirement to specify permanent fund investments in a 1977 opinion. This office concluded that the legislature's power to designate investments

> is not plenary but rather is limited by the express terms of the amendment on the one hand and by implied trust concepts on the other. In other words,

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5 *Id.*

6 1976 House J. at 684 (March 24, 1976).

7 *See e.g.*; former AS 03.10.054 (Agricultural Revolving Loan Fund); AS 16.10.330 (Commercial Fishing Loans); AS 16.10.550 (Fishery Enhancement Loans); AS 44.33.370 (Residential Care Facility Loans).

8 1976 House J. at 684.

HB 215

Amendment 2 Weyhrauch

Page 3, line 8

Delete: "mailing"

Insert: "providing"

> the legislature may designate only income-producing investments and may not designate imprudent, income-producing investments or provide for imprudent administration of the fund principal. To the extent, if any that it did, the managers of the fund would nevertheless remain under a duty to make only prudent income-producing investments and to provide a prudent administration.[9]

When investment powers were first implemented for the corporation by the legislature in 1980, there was an express intent to "establish a trust held to a more restricted list of investments than most other fiduciary trusts including the Alaska State Pension Funds."[10] In accomplishing that result, the legislature believed that it was establishing a legal list statute that had "a minimum of investment restrictions yet provides a very definite and certain framework."[11] Since 1980, the legislature has expanded the legal list of permitted investments a number of times.[12]

The Delegation Doctrine.

We believe that the courts would interpret the Alaska Constitution to permit the legislature to delegate its power to designate specific investments to the board of

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9 1976 Inf. Op Att'y Gen. at 2 (Sept. 16; J66-107-78).

10 1980 Senate J. at 671.

11 *Id.*

12 The legal list set out in AS 37.13.120 originally authorized investment in direct obligations of the United States Treasury, federal agency securities, certificates of deposit, high-grade corporate bonds, quality short-term investments, and federally guaranteed loans. There was direction given to prefer Alaska investments as long as they met the standards of quality set out in law. Specifically, deposits could be made in Alaska banks, mutual savings banks, savings and loan associations, and credit unions. Residential real estate (owner-occupied single family dwellings, duplexes, and condominiums) could also be purchased if the mortgage was privately insured by a company doing business in Alaska. In 1982 the legal list was expanded to include investment equities. The legal list has since been expanded at least five more times by the legislature: in 1989 to include investments in non-U.S. securities; in 1992 to include A-rated corporate bonds; in 1994 to expand permissible real estate investments; in 1999 to make a variety of adjustments to the legal list, to authorize up to five percent of the fund to be invested in other prudent investments not specifically included in the list (the "basket clause"), and to increase the allocation limit placed on equity investments; and in 2004, the five percent limit on the basket clause was increased to ten percent.

trustees.[13] The scope of a delegation permitted under the wording of the constitution is the question at hand. The legislature would have some latitude in constructing a workable framework for the investment authority of the board of trustees. However, the legislature must establish standards under which the board of trustees would exercise discretion in making its investment decisions. Based on past construction and legislative history, these standards must, at a minimum, be appropriate for a fiduciary relationship and tailored specifically for the permanent fund. Too broad of a grant of power without standards for the exercise of discretion would amount to an invalid delegation of the legislature's power to designate investments.[14] In *Fairbanks North Star Borough,* the court outlined the method for evaluating the validity of a purported delegation of legislative power:

> The essential inquiry is whether the specified guidance sufficiently marks the field within which the administrator is to act so that it may be known whether he has kept within it in compliance with the legislative will.[15]

The "field" is limited by attaching standards or conditions to the delegated powers under which the administrators are obliged to act in the performance of the powers. The court summed up its holdings on the delegation doctrine as follows:

> Review of our decisions which have addressed delegation issues leads to the observation that whether one employs explicit or implicit standards, '[t]he basic purpose behind the nondelegation doctrine is sound:

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[13] *See Boehl v. Sabre Jet Room, Inc.*, 349 P.2d 585, 588 (Alaska 1960) (declaring that the delegation of state legislative powers is not unconstitutional; "a strict theory of separation of powers ignores [the] realities and the practical necessities of government. . . . The real question, then, is not whether there may be delegation. Rather, it is how far the legislature may go in delegating power to an agency . . ."); *Walker v. Alaska State Mortgage Ass'n*, 416 P.2d 245, 254 (Alaska 1966) (holding that creation of Alaska State Mortgage Association was not an unconstitutional delegation of legislative authority to provide for public health and welfare); *DeArmond v. Alaska State Dev. Corp.*, 376 P.2d 717, 722-23 (Alaska 1962) (finding that creation of the Alaska State Development Corporation which provided development loans to businesses was not an improper delegation of legislative authority).

[14] *See State v. Fairbanks North Star Borough*, 736 P.2d 1140 (Alaska 1987)(governor's statutory power to reduce or withhold appropriations held invalid on two grounds: delegation without standards and violation of separation of powers).

[15] 736 P.2d at 1143 (quoting *Synar v. United States*, 626 F. Supp. 1374, 1383-89 (D.D.C. 1986)(quoting *Yakus v. United States*, 321 U.S. 414, 426 (1944) (quotation marks omitted).

> Administrators should not have unguided and uncontrolled discretionary power to govern as they see fit.'[16]

Based on the *Fairbanks North Slope Borough* case, the legislature should set limits on the amount of discretion that would be afforded to the board of trustees. However, in the absence of a court decision specifically on this question, it is not possible to give absolute certainty as to the validity of one set of standards over another. The Alaska Supreme Court approaches disputes involving delegated powers on a case-by-case basis by measuring the validity of standards according to a sliding scale.

> . . . [t]he constitutionality of a delegation is determined on the basis of the scope of the power delegated and the specificity of the standards to govern its exercise. When the scope increases to immense proportions the standards must be correspondingly more precise.[17]

In *Fairbanks North Star Borough,* the court invalidated a statute that purported to convey a significant part of the legislature's power to the governor to amend appropriations. The delegation of power to the governor to impound or reduce enacted appropriations was characterized as a broad grant of power requiring precise standards limiting administrative discretion. The delegation failed because there was a total absence of a standard for performance of the delegated powers. Delegation of investment authority over a substantial amount of the state's wealth is significant but it arguably is not of "immense" proportions. The power to designate investments has been delegated to the Alaska State Pension Investment Board for a substantial amount of retirement funds without much in the way of detail other than recitation of the prudent investor rule set out in AS 37.10.071(c).[18]

In *Walker v. Alaska State Mortgage Ass'n,*[19] the court explained that the complexity of the subject matter also affects the detail needed in standards governing the exercise of a delegated power. In *Walker,* the court found that standards for delegated power over a secondary marketing facility for housing mortgages need not be detailed in order to be found valid. The determination of appropriate investments in today's market is arguably a similarly complex subject that would allow a less precise set of standards

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16 *Municipality of Anchorage v. Anchorage Police Department Employee Ass'n,* 839 P.2d 1080, 1086 (Alaska 1992)(quoting 1 K. Davis, Administrative Law, § 3:15, at 206).

17 *Fairbanks North Star Borough,* 736 P.2d at 1143.

18 *See* AS 14.25.180(c), and AS 39.35.080.

19 416 P.2d 245, 254 (Alaska 1966)

for the exercise of discretion. Thus, it appears that court precedent would support a broadly stated delegation of investment authority to the board of trustees.

The Alaska Supreme Court uses a method of reviewing standards for the exercise of delegated power which does not focus on the precision of the standards but rather on whether they effectively prevent the arbitrary exercise of the delegated power. When it first employed this method, the court cited with approval the following advice on measuring the effect of limits on administrative discretion:

> The focus should not be exclusively on standards; it should be on the totality of protections against arbitrariness, including both safeguards and standards. The key should no longer be statutory words; it should be the protections the administrators in fact provide, irrespective of what the statutes say or fail to say. The focus of judicial inquiries thus should shift from statutory standards to administrative safeguards and administrative standards. As soon as that shift is accomplished, the protections should grow beyond the nondelegation doctrine to a much broader requirement, judicially enforced, that as far as is practicable administrators must structure their discretionary power through appropriate safeguards and must confine and guide their discretionary power through standards, principles, and rules.[20]

The foregoing instructs us that the validity of any legislation proposing a delegation of investment authority heavily depends on an evaluation of the safeguards applied by the legislature to prevent arbitrary administrative decision-making.

Municipality of Anchorage concerned the validity of the Anchorage Municipal Assembly's delegation of power to a private arbitrator to make final and binding determinations in certain labor contract disputes. The court characterized this as "a fairly narrow area, albeit an important one, ..."[21] The court also acknowledged there were a panoply of implied standards that created "an elaborate and detailed structure which guides the arbitrator's decisions and guards against arbitrary action . . ."[22] Principally for these reasons the court held the delegation to be valid. In a subsequent case, the court

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20 *Municipality of Anchorage v. Anchorage Police Department Employee Ass'n,* 839 P.2d 1080, 1086 n.12 (Alaska 1992)(quoting 1 K. Davis, Administrative Law, §3:15, at 206-07).

21 *Id.* at 1086-89.

22 *Id.*

explained that *Municipality of Anchorage* suggests "the delegation doctrine should be animated more by due process concerns than by separation of powers principles."[23]

We next consider whether the prudent investor rule would serve as an appropriate limit on the delegated investment power.

The Prudent Investor Rule as a Standard for Delegated Investment Power.

The prudent institutional investor rule provides a detailed structure to guide the decisions of the board of trustees and others with fiduciary investment responsibility.[24] The rule has been established since 1994 when it was codified in the Restatement of Trusts (Third).[25] The board of trustees have been subject to a form of the prudent investor rule since 1980 when AS 37.13.120(a) was enacted.[26] The rule applies to investment decisions made within the constraints of the legal list.[27] The prudent investor rule serves as a limitation on the actions of applicable fiduciaries. Under the Restatement, the prudence standard is one of conduct and not a test of the result of performance of a specific investment. The focus of inquiry by a court is how the fiduciary acted in his or her selection of the investment and not whether the investments succeeded or failed.[28] The prudent investor rule, not constrained by a legal list, would operate to determine whether the individual trustees, at the time they specified an

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23 *Usibelli Coal Mine, Inc., v. State,* 912 P.2d 1134, 1144, n.15.

24 Restatement (Third) of Trusts, subsec. 277 *et. seq*.

25 The rule was made applicable to the administration of private trusts in the state in May of 1998. It is set out in detail in AS 13.36.225 – 13.36.290.

26 AS 37.13.120 provides:

> (a) The prudent-investor rule shall be applied by the board in the management and investment of fund assets. The prudent-investor rule as applied to investments of the fund means that in making investments the board shall exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.

27 AS 37.13.120(g).

28 *See, Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (C.A 5Tex. 1999)(ERISA implemented by regulations establishing the prudent investor rule).

investment for the permanent fund, used the appropriate methods to investigate the merits of the investment and to structure the investment to achieve the best result. In our opinion, adoption of the prudent investor rule, standing alone, by law would provide an extensive set of instructions to guide investment decisions of the board of trustees. The prudent investor rule is equivalent to the express and implied standards applicable to arbitrators found acceptable in *Municipality of Anchorage.* The prudent investor rule has withstood the test of time by requiring a process that guards against arbitrary exercise of power.

Any legislation to enact an effective standard must be in harmony with the wording of the Alaska Constitution requiring that investments be "specifically designated by law." In order to formalize the designation of prudent investments, we believe that the legislature should, by statute, provide that the designation of investments must be exercised by the adoption of administrative regulations by the board of trustees. The statute providing the specific authority to adopt regulations would be a delegation of authority from the legislature to the board of trustees to set policy and to act in the place of the legislature. Such regulations are reviewed by a court as if they have the effect of law.[29] By using this method to specify investments for the permanent fund, the delegation would be textually correct insofar as the Alaska Constitution's command that investments be "specifically designated by law." The asset classes of permitted investments could be set out in regulations.[30] In recognition of the need to respond to short term changes in markets, the legislature could establish an abbreviated adoption process for these regulations. This has been done for other financial enterprises of the state.[31]

Regulation adoption procedures have ingrained due process safeguards and protections against arbitrariness. By specifying investments by regulation, the board of trustees would follow an adoption procedure specified in law that requires adequate public notice and opportunity to comment.

Conclusion.

In our opinion, the legislature may delegate to the board of trustees the power to designate investments for the permanent fund. The statute making this delegation must incorporate adequate due process safeguards against arbitrary exercise of the delegated

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29 *Kelly v. Zamarello*, 486 P.2d 906, 911 (Alaska 1971).

30 Under this approach, the legal list set out in AS 37.13.120 would be repealed and adopted in administrative regulations.

31 *See*, AS 44.88.085 (Alaska Industrial and Development Authority), and AS 18.56.088 (Alaska Housing Finance Corporation).

power and must contain adequate standards for the exercise of the delegated power. In order to satisfy the foregoing conditions, we recommend that the legislature consider authorizing the board of trustees to specify investments by the adoption of regulations. We further recommend that the legislature provide standards for the exercise of this regulatory power by requiring that the investment decisions formalized in the regulations comply with the prudent investor rule.

We hope the foregoing will assist the board of trustees in determining the validity and scope of legislation that would propose a delegation of investment power conditioned on exercise consistent with the prudent investor rule.

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