

MORRISON & FOERSTER LLP

ATTORNEYS AT LAW

SAN FRANCISCO
LOS ANGELES
SACRAMENTO
ORANGE COUNTY
PALO ALTO
WALNUT CREEK
DENVER

2000 PENNSYLVANIA AVENUE, NW
WASHINGTON, D.C. 20006-1000
TELEPHONE (202) 887-1500
TELEFACSIMILE (202) 887-0761

NEW YORK
WASHINGTON, D.C.
LONDON
BRUSSELS
HONG KONG
SINGAPORE
TOKYO

Mifo Document
#1

March 3, 1999

Privileged and Confidential

Eric Wohlforth
Chair, Board of Trustees
Alaska Permanent Fund Corporation
P.O. Box 25500
Juneau, Alaska 99802-5500

Re: Transfer of Securities Pursuant to the Proposed Appropriation of \$4
Billion of Permanent Fund Income to the Constitutional Budget
Reserve Fund

Dear Mr. Wohlforth:

On behalf of the Board of Trustees of Alaska Permanent Fund Corporation ("APFC") you have requested our opinion on three questions regarding the transfer of securities from the Alaska Permanent Fund (the "Permanent Fund" or the "Fund") to the Constitutional Budget Reserve Fund to implement a proposed \$4 billion appropriation of income from the Fund by the Governor and Legislature.

Question One: What is the proper definition of principal in the Permanent Fund, and does the plan to identify securities for transfer described in the accompanying memorandum (the "Discussion") in any way involve the expenditure of principal which is prohibited by the Constitution?

Answer: Principal in the Alaska Permanent Fund is an amount equal to the amounts contributed to the Fund by constitutional dedication, statutory dedication, and appropriation. The amount representing the excess of total assets, less total liabilities, over principal are credited to the earnings reserve account. Accordingly, the plan to identify securities for transfer does not involve the prohibited expenditure of principal provided that at the time of transfer the value of the securities transferred does not exceed the amount then credited to the earnings reserve account in the Permanent Fund as determined under generally accepted accounting principles.

Question Two: Is there anything in the Constitution or the enabling act that would conflict with or prevent the plan described in the Discussion from being implemented as presently conceived?

MORRISON & FOERSTER LLP

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Two

Answer: No, provided that the proposed legislation described in the Discussion amends the statute to direct that the earnings reserve account shall be determined pursuant to generally accepted accounting principles, amends the net income provision to clarify that it pertains only to the computation of income available for distribution, and directs that the amount of principal remaining in the Permanent Fund be maintained inviolate.

Question Three: What fiduciary obligations are imposed upon the Board of Trustees of the APFC ("Board") when they undertake to identify specific securities within the portfolio of the Permanent Fund for transfer?

Answer: Although not trustees of a true trust, the Board will be subject to the duties of judgment and care imposed by the prudent investor rule — here imposed by statute — whenever they select securities to sell and reinvest. The magnitude of the proposed transaction may impose greater restrictions on their flexibility than would be imposed by the ordinary turnover of a smaller percentage of securities within the portfolio. The proposed alternative method of transferring an across the board "slice" of the Permanent Fund's assets in the form of a unit interest in the commingled investment pool would preserve the existing diversification and asset allocation. Their duty to incur only reasonable expenses would appear to be well served by the proposed in-kind transfer, absent other conflicting considerations. The Board's constitutional duty to preserve principal is not impaired, provided the legislation requiring the transfer directs that principal is not to be impaired by the transfer. The Board's fiduciary duties to the other entities whose funds it administers are essentially limited to those of an investment manager — to follow the statutory prudent investor rule and to account for the principal and income in accordance with the governing statutes of each entity.

In rendering this opinion and responding to your inquiries, we have considered such facts and circumstances as you, the Commissioner of Revenue, the Chief Financial Officer, and others within the staff of the APFC have made available to us that describe the pending legislation, as well as the existing accounting methodologies utilized by the Permanent Fund as described in a memorandum prepared by the Chief Financial Officer of the APFC. We have also relied on discussions with, and a memorandum describing, the Permanent Fund's outside accountant KPMG's accounting analysis of the proposed transaction. Both memoranda are attached to this letter. We have also considered such law as we deemed appropriate and have made assumptions as stated in the Discussion. We have relied primarily on secondary sources for legislative or constitutional history materials due to the apparent lack of original documents. Our review of the books and records of the APFC has been limited to the 1997 and 1998 Annual Reports. This opinion is based upon and subject to those facts and circumstances supplied to us and

MORRISON & FOERSTER LLP

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Three

the considerations and assumptions reflected in the Discussion. Unless otherwise defined herein, capitalized terms shall have the meaning contained in the Discussion.

This opinion has been reviewed by the Office of the Attorney General of the State of Alaska and it concurs in our conclusions. This letter responds only to the specific questions asked, and should not be relied upon for opinions on issues that were not specifically requested. This opinion is provided solely for the use of the Board of Trustees of AFPC and may be distributed only as it shall direct.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Morrison & Foerster", followed by the initials "MFW" in a smaller, more legible script.

Morrison & Foerster LLP

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Four

DISCUSSION

Discussion appears under the following headings:

I. Background	5
II. Constitutional Duty to Protect Principal	5
III. Character of Fund — Not a True Trust	6
IV. Relevant Fiduciary Principles	8
V. Definition of "Principal"	10
VI. The Meaning of Income	13
VII. Impact of a Transfer on Principal	16
VIII. Statute Inconsistent With GAAP	17
IX. Limited Fiduciary Duties Analyzed	19
A. Prudence in Investing	19
B. Duty to Minimize Expenses	20
C. Fiduciary Duty of Loyalty — to the State	20
D. Investments Managed on Behalf of Other Entities	20

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Five

I. Background

You have informed us that Governor Tony Knowles proposes to appropriate \$4 billion from the income of the Alaska Permanent Fund (the "Permanent Fund" or Fund"), Alaska Const. art. IX, 15, to the Constitutional Budget Reserve Fund, Alaska Const. art. IX, 17. The size of the proposed transfer would necessitate taking amounts equivalent to both realized and unrealized income from the earnings reserve account as it is determined under generally accepted accounting principles. Moreover, the actual sale of securities in order to realize up to \$4 billion in cash proceeds to transfer would entail large transaction costs. Accordingly, it has been proposed that investments of the Permanent Fund not be sold in order to realize income, but that specific securities equivalent in value up to the amount of income appropriated be identified and transferred in kind to the Constitutional Budget Reserve Fund. Under these circumstances, questions have arisen as to whether the existing constitutional and statutory framework would permit such an in-kind transfer.

II. Constitutional Duty to Protect Principal

In anticipation of a great wave of revenue from Alaska's oil resources and with a historical recognition of the boom and bust nature of natural resource exploitation, the Constitution of the State of Alaska was amended by public referendum in 1976 to dedicate a portion of the State's natural resource revenues to the Alaska Permanent Fund. That same constitutional mandate required that the principal of the fund "shall be used only for income-producing investments specifically designated by law as eligible for permanent fund investments." Alaska Const. art. IX, 15. However, "[a]ll income from the permanent fund shall be deposited in the general fund unless otherwise provided by law." *Id.* This section has been interpreted to safeguard the principal of the fund by removing it from the power of legislative appropriation. Williams v. Zobel, 619 P.2d 448, 453 (Alaska 1980) ("the constitutional provision establishing the fund places the principal of the fund beyond the Legislature's appropriation power, which can be exercised only over earnings derived from the fund"), *rev'd on different grounds*, 457 U.S. 55 (1982).

The constitutional and legislative history are replete with discussions of the meaning and intent of a "permanent" fund. The consensus appears to have been that the principal could never be touched, but was to be invested in perpetuity. As a result, moneys dedicated or appropriated to the Permanent Fund cannot be withdrawn. See Helgath & Bibb, The Alaska Permanent Fund; Legislative History Intent and Operations (Alaska State Senate, January 1986) at 30-33.

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Six

III. Character of Fund — Not a True Trust.

As a predicate to our analysis, the legal status and character of the Permanent Fund must be established. Upon analysis, we conclude that the Permanent Fund does not have the fundamental characteristics of a true private or public trust fund.

First, the Constitution does not actually create a trust. Rather, the enumerated state revenues are placed in a dedicated fund called a permanent fund. This constitutional provision is an express exception to another constitutional provision which prohibits the dedication of state proceeds "to any special purpose, except as provided in section 15 of this article [the Permanent Fund]". Alaska Const. art. IX, §7. And indeed, no specific trust purposes are enumerated —rather, all income is to be deposited into the state's general fund to be expended as the legislature sees fit. Alaska Const. art. IX, 15.

Moreover, simply calling the Board "trustees" does not create a trust. "It is not enough, however, that a statute purports to create a trust: A state cannot magically transform ordinary agents, contractors, or sellers into fiduciaries by the simple incantation of the terms "trust" or "fiduciary." See In re Khai Tran, 151 F.3d 339, 342 (5th Cir. 1998).

In this case, the trustees are not designated as trustees of a trust fund but rather constitute the Board of a public corporation created under a statutory charter, AS 37.13.040, and required by the Constitution to be closely tied to the executive branch. See Alaska Const. art. III, §22. Indeed, the Alaska Attorney General has frequently issued legal opinions that the APFC is a state agency, and that its Board officers and employees are subject to the same laws and immunity as other state officials. See, e.g., 1982 Op. (Inf.) Atty. Gen. Alaska, File No. 366-269-83 (Dec. 2, 1983).

Despite the obligation to take care when handling the Fund's investments in order to preserve the safety of capital as well as produce income, AS 37.13.120, "all income" from the Fund is specifically made subject to disposition "by law," and hence is subject to appropriation by the Legislature.

In this instance, the Constitution mandates that the Fund produce income not for beneficiaries of the Fund but for the "general fund" of the State of Alaska or for such other purposes as the Legislature shall direct. Thus, unlike a trust, the Board does not manage Fund assets for beneficiaries, present and future. Rather, it manages the Fund to generate income for distribution as the Legislature, not the Board, directs. Because the disposition of income is subject to the control of the Legislature, which may choose to either distribute it (favoring current recipients) or add it to principal for reinvestment (favoring future generations), the balance between the interests of current and future

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Seven

generations is determined by the Legislature, not the Board. Because the determination of the distribution of income is constitutionally reserved to the Legislature, the Alaska Permanent Fund, at least with regard to the disposition of income, is more properly characterized as an investment fund rather than a classical trust fund.

Consequently, the "trustees" of the Permanent Fund do not have the customary trustee's obligations to balance the investments of the trust so as to avoid overgeneration of income for current beneficiaries at the expense of future beneficiaries. The trustees of a classical trust would be required to invest and distribute income in such a manner as to balance the needs of present and future beneficiaries. See *Restatement (Second) of Trusts* 183 cmt. a (duty to deal impartially with the beneficiaries of a trust whether they are entitled to their interests "simultaneously or successively") and §232 (duty to the successive beneficiaries to act "with due regard to their respective interests"); 3A Fratcher, *Scott on Trusts* (4th ed. 1998) §232 at 5-7.

Because the Constitution leaves the distribution of income to subsequent direction by law, the Fund differs from a true trust that creates a class or classes of beneficiaries with a legally enforceable entitlement to income. If a true trust with regard to income had been created in a legal sense, its ascertainable beneficiaries (a necessary component of any trust, see *Restatement (Second) of Trusts* 112 (1959) ("Definite Beneficiary Necessary")) would have enforceable legal rights against the trust and a legal entitlement to their dividends. However, both Alaska and federal courts have rejected any such notion of absolute entitlement. In *Exxon Corp. v. Heinze*, 792 F. Supp. 72,75 (D. Alaska 1992), the court stated that "The right to a dividend is a matter of legislative grace, not entitlement." The Court observed that no individual owns an interest, or has a cause of action to protect his expectancy regarding future dividends. See also *Underwood v. State*, 881 P.2d 322, 327 & n.7 (Alaska 1994) (no Alaskan has a vested right to a dividend, which is a creature of the Legislature and can be abolished at any time); *Beattie v. United States*, 635 F. Supp. 481, 491 (D. Alaska 1986), *aff'd sub nom. Griesen v. United States*, 831 F.2d 916 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988) ("The people do not 'own' the natural resources nor the proceeds from the same nor the Alaska Permanent Fund. . . . In adopting their constitution, the people of the State of Alaska have very clearly constituted the State as owner of the natural resources which give rise to the fund [Permanent Fund] in question."); *State v. Anthony*, 810 P.2d 155, 158 (Alaska 1991). Indeed, the IRS has ruled that current distributions, i.e., dividend payments, are not distributions of Permanent Fund income, but rather are distributions of State funds. Rev. Rul. 90-56, 1990-2 C.B. 103 (1990).

Likewise, there is no class of remainder beneficiaries who ultimately would receive the principal of the trust. In contrast, under a private trust, "[a]lmost every trustee finds that the trust terms require him to pay or apply income to or for a

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Eight

temporary beneficiary, and to distribute principal to one or more beneficiaries prior to or upon termination of the trust." G. Bogert, Trusts and Trustees, (rev. 2d ed.) Ch. 39, §816, at p. 339. The constitutional history plainly indicates that the Permanent Fund was to be exactly that — *permanent*. "Unlike most trusts, the principal may not be reached whatever, either now or in the future. No one has a future right to principal." Helgath & Bibb, The Alaska Permanent Fund: Legislative History, Intent, and Operations (Alaska State Senate, January 1986), at 32 (quoting State of Alaska Department of Law Letter to Representative Clark Grucning (Aug. 31, 1977)).

These facts, which distinguish the Permanent Fund from a true trust, are reinforced when considering other public trusts, each of which imposes duties on the trustees not only to manage the fund, but also to distribute the income to specified classes of beneficiaries. The state statutes reflect that the Alaska Legislature has either established or has inherited from Congress legislative authority over legal trust funds in other contexts. See, e.g., Public School Trust Fund, AS 37.14.110-37.14.170; Alaska Children's Trust, AS 37.14.200-37.14.270; Mental Health Trust, AS 37.14.001-37.14.099. When it was intended that such state funds have a more traditional trust character, they were designated trust funds with duties to identifiable beneficiaries. For example, the enabling act for the Mental Health Trust specifies that the trust has beneficiaries, and charges the trustees with duties towards the beneficiaries. AS 37.14.007(b).

We conclude therefore that the Permanent Fund is an investment fund, not a true trust fund.¹ Indeed, to a great extent it is *sui generis*, and not readily susceptible to analogies or traditional concepts. Compare *Beattie v. United States*, 635 F. Supp. 481 (D. Alaska 1986), *aff'd sub nom. Griksen v. United States*, 831 F.2d 916 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

IV. Relevant Fiduciary Principles

¹ We note that in 1997 the Government Accounting Standards Board circulated an Exposure Draft of "Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments", which would require reporting from dual perspectives at both the entity-wide perspective and at the fund perspective. These financial reporting standards would define a new type of fund, Permanent Funds. These funds would consist of certain funds previously classified as Nonexpendable Trust Funds. This category would be included in the proprietary fund category, although such Permanent Funds presented at the fund perspective level would be presented in the entity-wide financial statements as governmental activities. The Permanent Fund category would include funds that are legally restricted to the extent that only earnings and not principal may be used for purposes that support the reporting government's programs (i.e., for the benefit of the public).

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Nine

Despite the foregoing, trust law has some relevance to interpreting the statutory and constitutional obligations of the Permanent Fund. The Legislature has imposed certain statutory fiduciary obligations upon the Fund that are rooted in trust law. See *Restatement (Second) of Trusts* §2, cmt. b (1959) ("Fiduciary Relation") (limiting the duty of a fiduciary to act for the benefit of another "within the scope of the relation"); *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86, 63 S Ct. 454, 458, 87 L. Ed. 626, 632 (1942) (opinion of Frankfurter, J.) ("To say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"); A. Scott, "The Fiduciary Principle," 37 Calif. L. Rev. 541 (1949) ("Some fiduciary relationships are undoubtedly more intense than others. The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty.")

In this instance, the Board's fiduciary duties are provided by statute, which specifically imposes the prudent investor rule on the Board, admonishing it to "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 the probable safety of capital as well as probable income." AS 37.13.120.

Here, the fiduciary duty of the Board is limited to preservation of principal and money management; the Governor and Legislature are in charge of distribution of income. This Board is obligated to manage the investments of the principal by the prudent investor rule, a rule traditionally applicable to trusts. It is charged with a paramount duty to preserve principal, again a fundamental trust law concept.

We believe that in analyzing the questions presented here, a Court would look to the plain language of the Constitution and implementing legislation, their purpose and intent, the decisional law of the state, and to the past practice of the responsible administrative agencies. See G. Bogert, *Trusts and Trustees*, (rev. 2d ed.) §816 at p. 340 ("the best criterion for making decisions [as to what is principal] is the practical treatment of the topic by the courts or legislatures.") And secondarily, when faced with the duty to interpret the applicable provisions of law absent controlling statutory or constitutional guidance, the Alaska courts also will look to basic trust law principles for analogies to guide their rulings.

A fundamental rule of trust law is that a trustee has such powers as are specifically conferred by the terms of the trust. The expression "terms of the trust" is here used in the broad sense, *Restatement (Second) of Trusts* 186, and frequently

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Ten

includes statutory terms such as the prudent investor rule. A basic rule of trust construction is that the courts will interpret the trust documents in such a way as to implement the intent of the creator of the trust. Similarly, when the courts come to interpret and apply legislation, they construe legislation in accord with the legislative purposes. By either standard, the primary focus will be to determine what was intended. The statutory and constitutional provisions — the “terms of the trust” — will govern over general default rules of trust law, which will be applied only where the terms are silent. With these distinctions in mind, we turn to the relevant sections of the Alaska Constitution and the Alaska statutes.

V. Definition of “Principal”

The starting point for a definition of principal is the fundamental distinction between principal and income. Trust law divides the assets of a trust between the mutually exclusive categories of principal and income. Black's Law Dictionary (5th ed. 1979) defines “principal” as “property as opposed to income. The term is often used to designate the corpus of a trust.” The Revised Uniform Principal and Income Act (“RUPIA”), which Alaska has adopted for *private trusts*, defines principal as: “The property that has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or accumulated for an income beneficiary.” AS 13.38.020(b). By contrast, income is defined as: “The return in money or property derived from the use of principal, including” AS 13.38.020 (a). Even in private trusts, however, the terms of the trust may override the classic treatment of principal and interest by specific direction. AS 13.38.020(a); see *Restatement (Second) of Trusts* §§232-233.

Neither the Alaska Constitution, the statutes, nor the decided cases announce a comprehensive definition of the “principal” of the Permanent Fund, although they prescribe that certain amounts be dedicated or allocated to the Fund's principal. The statutes have defined “income” in different ways at various times which provides some guidance because what is income is not principal and what is not principal must be income. For the reasons stated below, we believe that a coherent definition of principal nevertheless may be derived from the Alaska Constitution and statutes, which is supported by analogy from trust law.

The drafters of the Constitutional clause that established the Permanent Fund had an overriding concern with the preservation of principal for the production of income for future generations. See Free Conf. Comm. Rept. for SB 161, p.1 (May 4, 1979). This duty was recognized by the Legislature when it enacted provisions to inflation-proof the principal of the fund, and is recognized by the Trustees themselves in managing their

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Eleven

investments. Alaska Permanent Fund Corporation, 1997 Annual Report, p. 1. Classically, the principal of a trust, or its "corpus," is the amount set aside to fund the trust when it is first created or "settled." Extending this principle to the Permanent Fund, the principal of the Fund clearly includes the amounts constitutionally dedicated to the Fund, that is, at least twenty-five percent of:

- mineral lease rentals,
- royalties,
- royalty sale proceeds, and
- federal mineral revenue sharing payments and bonuses.

Alaska Const. art. IX, 15.

In addition, such additional funds as the Legislature has directed to the Fund also constitute its principal. By statute, the Legislature has increased the constitutionally dedicated amounts from certain mineral leases to fifty percent of the enumerated revenues. AS 37.10.010. The Legislature also has enacted provisions further dedicating amounts for inflation-proofing pursuant to the statute, AS 37.13.145 (c), and transferring settlement earnings to principal, AS 37.13.145(d). And from time to time, the Legislature has appropriated additional amounts specifically to principal. *See* AS 37.13.010(a)(3). *See, e.g.,* 1983 Op. Atty. Gen. Alaska No. 234 (Sept. 23, 1983) (discussing inflation proofing — reflects consistent legislative view that principal is limited to monthly deposits of these enumerated revenues plus specific appropriations to principal).

This definition of principal is consistent also with the core concepts of trust law. The principal of a private trust would be the amount that the settler of a trust set aside for the future.

In a private trust, however, some portion of earnings also would be directed to principal absent specific direction from the trust document. For example, the Restatement of Trusts and the Uniform Act provide definitions of how profits, gains, dividends and interest should be allocated between principal and income. By implication, these authorities prescribe what increments of profit from investments shall be added to principal. For example, unless otherwise provided by the terms of a private trust, realized capital gains would be added back to the principal of the trust. This allocation is necessary in the private trust context because of the need to balance the interests of current and remainder beneficiaries.

The governing law for the Permanent Fund, however, does not look to private trust law principles for guidance, but rather establishes a different treatment for gains,

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Twelve

whether realized or unrealized.² First, under the Constitution, all income from the Permanent Fund is directed to the general fund of Alaska and is not added back to principal unless the Legislature directs otherwise. Alaska Const. art. IX 15. Indeed, the Constitution expressly directs that principal be used "only for income-producing investments", Alaska Const. Art. IX, 15; it does not require that any portion of it be used for principal-producing investments. The legislative history of the constitutional Permanent Fund provision indicates that the legislative intent behind the constitutional mandate depositing all income into the general fund was to give "future legislatures the maximum flexibility in using the fund's earnings—ranging from adding to fund principal to paying out a dividend...." Joint Comm. Rept. on HJR 39, 1976 House Journal, p. 635.

The history of legislative direction and control over gains and losses further supports the conclusion that they are allocable to income. The statutory scheme does not rely on traditional trust definitions of income or principal, but rather focuses on whether a particular inflow of money is to be considered "net income" under generally accepted accounting principles. AS 37.13.140. Thus under the statute, a capital gain of the Permanent Fund is allocated to income, not to principal. AS 37.13.140. Consequently, the Legislature's definitions of income reinforce the conclusion that principal consists exclusively of the constitutionally and statutorily-mandated sums plus additional legislative appropriations.

A related question is whether principal of the Permanent Fund consists of an identified, specific set of assets. We believe not. The sums set aside for the Permanent

² We believe a court would recognize that when the Legislature intended to incorporate specific provisions of private trust law, it chose precise language to do so. For example, other state trust funds have provisions that require that realized revenues, depending on their character as gains, losses, interest or dividends, are allocated to either principal, which must be preserved, or income which may be expended by the legislature for any public purpose. To illustrate, the enabling act for the Mental Health Trust expressly provides that principal and income are to be determined according to the guidelines applicable to private trusts. AS 37.14.031(d), citing AS 13.38 (the Revised Uniform Principal and Income Act). The governing statutes for the Public School Trust Fund, the Alaska Children's Trust, and the Alaska Heritage Endowment Fund all expressly provide that (1) income does not include capital gains or losses realized on principal, and (2) capital gains or losses realized on the principal shall be retained in the respective trust funds perpetually for investment as additions to principal. AS 37.14.110(e)(Public School Trust Fund); AS 37.14.240(a) (Alaska Children's Trust); AS 37.14.530(a) (Alaska Heritage Endowment Fund). In contrast, the Permanent Fund enabling act, as amended by the legislature, defines net income to include all realized income (regardless of its character as gain, dividend or interest), and excludes only *unrealized* gains or losses. AS 37.13.140.

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Thirteen

Fund are cash revenues from identified resources and activities, which are invested in income-producing investments. This is not like a public land trust, for example, where the principal consists of specifically identifiable or tangible assets. Cash, by definition, is fungible — one dollar has no different character than any other dollar. The Permanent Fund principal cannot be traced to specific investments separate and apart from the investments representing reinvested earnings. Thus principal is an aggregate amount, consisting of the sum of all constitutional dedications, statutory transfers from income, and legislative appropriations. So long as the Permanent Fund records and separately accounts for these sums, the amount of principal has been identified. However, principal is not specifically identified to particular assets.

VI. The Meaning of Income

To answer the question of whether and when an invasion of principal could occur, we must consider the definition of income. The first statutory definition of income was found in section 37.13.140 ("Income") and its companion provision, section 37.13.130 ("Gains and Losses"). Income was then defined as "Interest received in a year." Under section 37.13.130, the net gains from the sale of securities were to be added to principal, which was intended to help offset the effects of inflation. Free Conf. Comm. Rept. for SB161, p.2 (May 4, 1979).³ It also provided that an amount equal to net losses from such sales should be deducted from income and added to principal, which was intended to protect the principal from erosion. *Id.* No specific legislative direction of such net gains to principal would have been necessary or possible if net gains were not otherwise included in income, and hence subject to legislative control.

Section 37.13.130 was repealed in 1982. At that time, section 37.13.140 was amended. Although the Section is titled "Income," it begins by discussing "Net Income." It does not define net income but directs that it be computed annually "in accordance with generally accepted accounting principles, excluding any unrealized gains or losses." Section 37.13.145, titled "Disposition of Income," also does not define income directly, but rather provides that "Income from the fund shall be deposited by the corporation into the [earnings reserve] account as soon as it is received."

³ This language reflects the Permanent Fund's statutory investment limitations. At the time, the Board lacked the power to invest in equities; the securities in question presumably would be bonds and other interest bearing investments such as mortgages.

⁴ A later amendment clarified that income from the earnings reserve account is also included within income. 1992 SLA Ch. 134, §19.

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Fourteen

Section 37.13.140 references generally accepted accounting principles for the determination of net income. At the time section 37.13.140 was first adopted, generally accepted accounting principles did not recognize unrealized gains or losses in income. In 1997, the Governmental Accounting Standards Board ("GASB") adopted Statement No. 31 ("GASB 31"). That standard requires that unrealized gains (or losses) be taken into account in determining net income. Consistent with the adoption of GASB 31, the Permanent Fund for reporting purposes now periodically marks to market its investment portfolio and reflects unrealized gains and losses in its statement of revenues and expenses.

The statutory reference to the definition of net income provided by generally accepted accounting principles, in turn, poses several interpretative issues. First, is there a difference between income and net income for statutory purposes? Second, given the change over time in generally accepted accounting principles ("GAAP"), has the statutory language become internally inconsistent or can it be reconciled with GAAP?

Is there a viable distinction between "income" and "net income" for purposes of section 37.13.140 or section 37.13.145 or both? Standard accounting texts recognize the concepts of gross and net income; income, however, can be one or the other depending upon the context. Gross income, however, is income before expenses, i.e. is equivalent to gross revenues. Net income, in turn, is defined to be what is generally conceived of as profit. One standard accounting text defines net income as "the net increase in net assets (owners' equity) of the firm, assuming no new capital contributions by the owners or dividend distributions by the business." Williams, Stanga, Holder, Intermediate Accounting (1984). Thus, net income as typically understood for accounting purposes is consistent with the broader GASB 31 definition although not consistent with the definition of section 37.13.140.

One might argue that a distinction between income and net income is supported by the difference between the title of section 37.13.140 — "Income" — and the use of the term "net income" in the statutory language itself. We do not believe a court would favor this view. A common principle of statutory and contract interpretation is to disregard section titles. Sutherland Stat. Const. §47.14 (5th ed. 1992 & 1998 Supp.). The only reference within section 37.13.140 to "income" other than "net income" is the term "income available for distribution," defined as a percentage of net income for the last five fiscal years. This usage of "income" is not inconsistent with the usage of "net income" in that section.

Although it could also be argued that the statute adopts the determination of net income under generally accepted accounting principles, this incorporated definition must be read as modified by the plain text of section 37.13.140, which expressly

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Fifteen

excludes from net income unrealized gains and losses. The available legislative history suggests that the Legislature made a conscious decision to reject inclusion of unrealized gains and losses in the determination of net income for dividend purposes.³ Moreover, this reading of "net income" is consistent with the use of "income" in section 37.13.145(a) — "income" appears to be limited to that which can be "deposited . . . as soon as it is received," i.e., cash or realized income. Finally, it is inconceivable that the Legislature could allow a nongovernmental party ("GASB") the discretion to decide in the future what is net income for purposes of calculating the payment of State funds without creating a potential improper delegation of legislative power.

The inconsistency between GAAP and the statutory definition of income is further exacerbated by the discrepancy between the earnings reserve account as it is computed under generally accepted accounting principles ("the GAAP earnings reserve account") and the statutory earnings reserve account described in section 37.13.145(a). The statute establishes the earnings reserve account as a separate account in the Fund. It then states, however, that "income from the fund shall be deposited by the corporation into the account as soon as it is received." AS 37.13.145(a). The obvious implication is that the statutory earnings reserve account includes only realized income. This language made sense in an era when generally accepted accounting principles also required earnings to be realized before being treated as income and included in an earnings reserve account. However, this statutory provision is inconsistent with current generally accepted accounting principles.

Because unrealized gains and losses are now taken into income for accounting purposes, the earnings reserve account used for accounting purposes (the "GAAP earnings reserve account") contains both realized and unrealized gains and losses. That is, the GAAP earnings reserve account used for accounting purposes now contains all

³ The legislative history of the 1982 amendments to AS 37.13.140 suggests that the sponsors of the amendment were aware of the potential that such an inconsistency might develop between the statutory exclusion of unrealized gains and losses and GAAP. The Governor's transmittal letter for the amendment observes that the provision was consistent with GAAP at that time. The Governor, however, notes that "we are advised that the GAAP may be revised to allow inclusion of unrealized gains and losses while computing net income. While it is important for sound management to know the market value of the fund, this concern is satisfied by the reporting requirement of AS 37.13.170. The Board of Trustees has determined, and I concur, that since the amount of income available for distribution is fixed by statute and may not be altered by the Board, it is imperative for sound management of the Fund to ensure the exclusion of unrealized gains and losses when computing distributable income." Letter from Gov. Jay Hammond, regarding Sponsor Substitute for Senate Bill No. 684, 1982 Senate Journal 494, 496 (March 9, 1982).

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Sixteen

income of the Permanent Fund as that concept is defined by generally accepted accounting principles. At any point in time, then, the assets of the Fund are divided between the GAAP earnings reserve account and the principal.

VII. Impact of a Transfer on Principal

When would an invasion of principal occur? An invasion of principal would occur if a proposed pay-out from the Fund exceeded the current balance of the earnings reserve account. Past Permanent Fund dividend pay-outs have not tested this limitation because they were constrained by the limitation of section 37.13.140 against including unrealized gains and losses in income. In other words, the Permanent Fund had a cushion of retained earnings (consisting of unrealized gains and losses) that, in an accounting sense, protected it against coming close to an invasion of principal.⁶ After adoption of GASB 31, an invasion of principal would occur if the amount transferred or paid out of the earnings reserve account exceeded the balance in the account, which balance now includes both realized and unrealized gains and losses due to the operation of GASB 31.⁷

We have been advised, and we have assumed for purposes of our opinion, that the past practice of the legislature, the State, the APFC, and its accountants and outside auditors — since the inception of the Fund — has been to treat principal as a balance of the accumulated sum equal to the value of the total assets contributed to the Fund by constitutional dedication, Alaska Const. art. IX, 15, statutory dedication, AS 37.13.010, 37.13.145; see AS 37.13.020, and legislative appropriation. We have also been advised, and we have assumed for purposes of this opinion, that principal is not specifically attributed to any particular asset in the Fund, but is maintained as a balance amount in the Fund as a whole. Accordingly, under the present accounting methodology, the

⁶ Another protection is found in section 37.13.145(b), which provides that only 50% of the income available for distribution is transferred to the dividend fund.

⁷ A logical question occurs. What if most of the balance of the earnings reserve account were paid out and some time later the stock market suffered a major correction? In that hypothetical situation, the value of the earnings reserve account would turn negative. Would that negative balance, be offset against the principal balance and if so, would that constitute an invasion of principal? The answer is negative. An invasion of principal would occur where the Permanent Fund had attempted action to pay out more than the balance of the earnings reserve account. It would not occur where, after a payout, the balance of that fund turned negative. The critical difference is between an action of the trustees and the natural fluctuation of the investment markets. One is an action over which the trustees have control; the market fluctuation is not.

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Seventeen

excess of market value of total assets over principal, less total liabilities, is credited to the earnings reserve account. Accordingly, when a dividend is paid, principal always remains in the Fund and is not impaired when specific securities are sold and the entire proceeds transferred out of the earnings reserve account. So long as the value of the assets remaining in the Fund less the total liabilities at the time of the transfer is greater than the principal balance amount, the decrease in assets in the Fund caused by the transfer is balanced by a decrease in the balance attributed to the earnings reserve account, leaving the principal balance unimpaired.

Because the actual sale of securities and the transfer of the proceeds of such a sale would not result in any impairment of principal so long as the value of the remaining assets of the Fund (less total liabilities) exceed the principal balance, it is our opinion that the direct transfer of those assets at their fair market value also does not impair principal, provided that at the time of transfer the value of the securities transferred does not exceed the amount in the Permanent Fund earnings reserve account as determined under generally accepted accounting principles.

VIII. Statute Inconsistent With GAAP

The statutory framework for the Fund distinguishes the treatment given to realized and unrealized income. Section 37.13.140 provides, "Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses." For a period of time only the statutory net income consisting of net realized gains was credited to the earnings reserve account established by section 37.13.145(a), which provides, "Income from the fund shall be deposited into the [earnings reserve] account as soon as it is received. Money in the account shall be invested in [authorized] investments...." However, with the adoption of GASB 31, the chief financial officer of the APFC began valuing investments at market on a monthly basis and crediting unrealized net earnings to the balance of the earnings reserve account for financial reporting purposes. Accordingly, for financial reporting purposes, the earnings reserve account now holds both realized and unrealized net gains in the income that has been credited to it.

The statutory definition of net income in section 37.13.140 requires both adherence to generally accepted accounting principles, which requires marking assets to market value, and the exclusion of unrealized market gains and losses. This conflict creates problems with regard to whether or not the "income" of the Fund that must be deposited in the earnings reserve account, and from which the legislative appropriation shall come, should properly include unrealized gains and losses. One possible solution to the problem would be to simply sell the securities, which would convert any

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Eighteen

unrealized gains or losses attributable to those securities into actual realized gains credited to the earnings reserve account that could then be transferred to the Constitutional Budget Reserve Fund. The difficulty with this approach is that selling securities on the open market generates additional expenses in the form of brokerage commissions and other transaction costs. If the securities could be transferred in kind at their fair market value, the Fund would be spared the expenses associated with the sales, and hence more Fund assets would be preserved. The difficulty is that it is not clear that the "income" held in the earnings reserve account under section 37.13.145(a) properly includes the unrealized gains and losses not included in "net income" under section 37.13.140.

Because the ambiguity has been created by section 37.13.140, it may be remedied the same way — by amending the statute to conform to generally accepted accounting principles to provide that income held in the earnings reserve account shall include both realized and unrealized gains and losses.⁸ (As income, the amounts in the earnings reserve account are subject to disposition as directed by statute without invading principal. Any proposed legislation should further direct that the principal shall be maintained inviolate.

If the statute is amended as described above, then a transfer of \$4 billion of securities from the Permanent Fund to the Constitutional Budget Reserve Fund can occur without either affecting the dividend or requiring the realization of the gain associated with the particular securities that are transferred. Our conclusion is premised upon not only the amendment of the statute as described above, but also the advice that we have received from the Permanent Fund's accountants ("KPMG") that this transfer would be a one time non-standard, non-recurring event, which would be treated by the accountants as a residual equity transfer and permissible under generally accepted accounting principles as such. The consequence of this transfer would be that the earnings reserve account, assuming that it had more than \$4 billion of realized and unrealized gains and losses, as well as other income, would be reduced by \$4 billion as would the assets of the Fund. We are advised by KPMG that the particular unrealized gain that, in a theoretical sense, could be identified to the transferred securities would not be realized, and thus would have no immediate impact on the dividend calculation. Any impact on future dividends would be the result of the reduced amount of investments in the Fund, as well as any limitation on future pay-outs imposed by the

Amend statute
then

⁸ To maintain the legislature's intent that the dividend shall be based on a measure of distributable income that excludes unrealized gains and losses, a companion amendment to Section 37.14.140 should clarify that the calculation of net income under that section is solely for the purpose of calculating the dividend.

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Nineteen

decreased level of income in the earnings reserve account. The Constitutional Budget Reserve Fund would receive these securities at the fair market value on the date of transfer.

IX. Limited Fiduciary Duties Analyzed

In carrying out the proposed transfer, the Board will be subject to the same duties of prudence and care that apply whenever it selects securities to sell and reinvests; although the magnitude of the proposed transaction will impose greater restrictions on its flexibility than would be imposed by the ordinary turnover of a smaller percentage of securities within the portfolio. The duty to incur only reasonable expenses would appear to be well served by the proposed in-kind transfer, absent other conflicting considerations. The limited duty of impartiality and the duty to preserve principal are not impaired provided that the Board's acts are directed by the legislation requiring the transfer.

A. Prudence in Investing

The Board has adopted policies that pay careful attention to and comply with the concepts of diversification, asset allocation, and "total return" — the latter defined as "the realized income plus the net change in unrealized gains and losses. Realized income includes interest, dividends, real estate cash flow and realized capital gains." Alaska Permanent Fund Corporation, 1997 Annual Report, p. 3 note. The proposal does pay attention to total return, but reduces equity allocation and therefore diversification until rebuilt by future receipts and investments. However, this is a function of the fact that the unrealized gains and losses that are being transferred are due, in very large part, to appreciation in equities. The change in asset allocation is therefore a function of where the unrealized gains and losses to be transferred occur, not the consequence of a deliberate investment choice by the Board.

The Board will need to exercise care when selecting the stocks to be transferred to make sure that it has evaluated the impact of its divestiture program both on the overall risk of its portfolio, and on the investment policies that it has chosen in constructing its current equities portfolio.

We understand that one methodology under consideration as an alternative to selecting assets for transfer would be to implement the proposed transfer by transferring to the Constitutional Budget Reserve Fund a percentage across-the-board "slice" of the Permanent Fund's assets, representing \$4 billion in value. The Constitutional Budget Reserve Fund would become a unit holder in the combined funds' investment pool, similar to the interests held by the Alaska Mental Health Trust, the Alaska Science and

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Twenty

Technology Foundation, and the International Trade and Business Endowment. See Discussion Part IX.D. below. This proposal would not disturb the asset allocation or diversification of the investment pool, nor would it impose unnecessary costs.

B. Duty to Minimize Expenses

A trustee must "incur only costs that are reasonable in amount and appropriate to the investment responsibility of the trusteeship." *Restatement (Third) of Trusts* §227(c)(3) (1992)(prudent investor rule). One of the clear advantages of an indexed approach to equity investments is that stock turnover is very low, thereby minimizing the losses that would otherwise occur in the form of commissions paid to brokers to execute trades. The need to sell stocks in order to generate cash proceeds to transfer decreases this advantage to the indexing investment strategy. However, the proposed direction of an in-kind transfer is clearly compatible with the duty to minimize costs, because it should substantially reduce the transaction costs that would otherwise attend the selling of a significant proportion of the Fund's equity portfolio.

C. Fiduciary Duty of Loyalty — to the State

The *Restatement (Second) of Trusts* §2, cmt. b (1957) states: "b. *Fiduciary relation*. A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation." Here, the Board's duty is owed, not to specific beneficiaries, but to the State for which it manages the Permanent Fund in accordance with the statutes.

Here, the terms of the Constitution specifically reserve the disposition of "all income" to direction by the State "by law." Alaska Const. art. IX, 15. The removal of \$4 billion in trust assets cannot help but reduce the amount to be available in the future for dividends because the lesser amounts to be invested will, all other things being equal, result in lower absolute amounts of income realized on those investments even if the current rate of return is maintained. However, the duties of this Board do not extend to distribution of income except as directed by law. Accordingly, no duty of loyalty within the scope of the discretion given to these trustees is implicated by the transfer itself.

D. Investments Managed on Behalf of Other Entities

Separately, there may be impartiality issues vis-à-vis the other state funds that invest through the Permanent Fund that will need to be handled to make sure that whatever interests they may have are kept whole. By statute, the Alaska Mental Health Trust (AS 37.13.300, 37.14.001 - 37.14.099), the Alaska Science and Technology Foundation Endowment (AS 37.17.010 - 37.17.110), and the International Trade and

Eric Wohlförth
Chair, Board of Trustees
March 3, 1999
Page Twenty-One

Business Endowment (AS 37.17.440)(collectively referred to hereafter as "other funds") are invested by the APFC under the same investment authority as the Permanent Fund is managed. Alaska Permanent Fund Corporation, 1998 Annual Report, "Alaska's Future," p. 39 ("1998 Annual Report").

The assets of the other funds are commingled with the assets of the Permanent Fund for investment purposes. Earnings are separately allocated to the other funds on the basis of unit and fractional shares, which have undivided beneficial interests in the commingled assets equal to the proportion that such shares bear to the total units outstanding. Unit shares are credited to the other funds on the basis of amounts contributed to the investment pool. The following represents the other funds' shares of the commingled assets:

	6/30/1998	1997
Alaska Science and Technology Endowment Fund	\$ 129,092,000	\$ 128,565,000
Alaska Mental Health Trust Fund	299,356,000	267,553,000
International Trade and Business Endowment Fund	5,710,000	
TOTAL OF OTHER MANAGED FUNDS	\$ 434,158,000	\$ 396,118,000

It is apparent from a review of the respective enabling statutes that the APFC Board, acting only as investment manager of each of the respective funds, has only limited fiduciary responsibilities. For example, the cash principal of the Mental Health Trust Fund shall be retained perpetually in the fund for investment by the APFC under the prudent investor rule. AS 37.14.033, 37.14.035, AS 37.13.300. Net income of the fund shall be transferred to the mental health trust settlement income account at the end of each fiscal year and may be utilized only "by the Alaska Mental Health Trust Authority for purposes listed in AS 37.14.041". AS 37.13.035.

Similarly, the Science and Technology Foundation Endowment shall be held and invested by the APFC subject to the prudent investor rule, but net income shall be distributed by grants under Title 37, Chapter 17 rather than by the APFC. AS 37.17.020(b). The International Trade and Business Endowment also was established within, and is administered by, the Alaska Science and Technology Foundation, AS 37.17.440(a), 37.17.010(b)(3), although it is invested by the APFC subject to the prudent investor rule, AS 37.17.440(b).

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Twenty-Two

Thus, the responsibilities for operational employment of the funds and distribution to the beneficiaries rest with the trustees and directors of the respective entities, and such fiduciary responsibilities as exist for the APFC Board are limited to those existing "within the scope of the [investment] relationship." *Restatement (Second) of Trusts*, § 2, comment b (1959).

Since the funds are permissibly commingled with the other assets of the Fund for investment purposes, the Board will adequately discharge its fiduciary responsibility with respect to these funds by continuing to follow the prudent investor rule (AS 37.13.120), by maintaining impartial treatment as to each of the separate funds through the undivided beneficial interests of each of the funds in the fashion described above, and by segregating income of other funds as required by particular provisions of the particular statutes relating to each fund. The Mental Health Trust enabling act requires that "The net income of the fund shall be determined by the Alaska Permanent Fund Corporation in the same manner the corporation determines the net income of the Alaska permanent fund under AS 37.13.140," AS 37.14.031(c), and then that "net income of the fund shall be transferred by the corporation to the mental health trust settlement income account at the end of each fiscal year." AS 37.14.035(b). Similarly, the "net income from the [Alaska Science and Technology Foundation] endowment shall be distributed under AS 37.17.010 - 37.17.110 and 37.17.225," i.e., under the control of that endowment's Board of Directors to make grants or other distributions of endowment income, and "not [as] net income available for distribution under AS 37.13.140." AS 37.17.020(b) Therefore, inasmuch as the special funds require the APFC Board to account separately for the net income of each fund, the Board must do so in such a way as not to impair the income due the subsidiary fund because of the Board's substantial transfer to the Constitutional Budget Reserve Fund.

In summary on this point, apart from investing according to the prudent investor rule (imposed by statute on all assets under its management), and accounting for principal and income under the terms of the particular statutes whose funds are being administered by it, the APFC Board has no other duties under the circumstances of the proposed legislation. The proposed legislation should have no special effect on commingled funds different from its effect on the other assets held by the Board since its effect will be distributed proportionately among each and all of the funds it holds for investment.

MORRISON & FOERSTER LLP

M E M O R A N D U M

TO: Kathy Porterfield

CC: Peter Bushre
James BaldwinFROM: Robert Loeffler
Linda Arnsbarger
Michael Toumanoff
Joseph Wyatt

DATE: March 2, 1999

FILE: 14507/85

RE: Summary of Feb. 24, 1999 Discussion Regarding Accounting for Fund Transfers

This is to summarize the discussion on February 24, 1999 between Kathy Porterfield, Peter Bushre, James Baldwin, Robert Loeffler, Joe Wyatt, Michael Toumanoff, and Linda Arnsbarger regarding the proposed recommendations as to the proper accounting for a fund transfer. The facts we discussed involved the possible one-time transfer of \$4 billion in cash or securities from the Alaska Permanent Fund to the Constitutional Budget Reserve Fund. We asked Kathy to discuss the accounting treatment for such a transfer. Kathy responded that her answer was premised on the fact that both are state funds, and the proposed transfer is a one-time transfer. She discussed two options with regard to transfers in general.

One, which was not discussed at length, was to reflect the transfer in the income statements, which would have an immediate and substantial impact on the dividend.

The second approach, which we understood to be the appropriate accounting treatment, was to reflect the transfer as an adjustment to retained earnings, here the earnings reserve account, which would not have an immediate impact on the dividend. We understand that the accounting literature would permit the second approach, described as a "residual equity transfer" if it is a one-time transfer between two state funds, so long as it is legal to do so.

With respect to the legal question, Kathy identified one statutory barrier to this second treatment. AS 37.13.145(a) establishes the earnings reserve account, and states that "Income from the fund shall be *deposited* by the corporation into the account as soon as it is *received*." This provision literally appears to limit the earnings reserve account to realized cash income. In other words, as a matter of law, the unrealized gains are not in the earnings reserve account.

We asked Kathy to consider the following hypothetical: First, assume that AS 37.13.145 is amended to provide that the earnings reserve account is calculated in accordance with generally accepted accounting principles. Then assume that, on a one-time basis, \$4 billion in securities are transferred from the Permanent Fund to another state fund. Assume that the transferred securities have \$1 billion in unrealized gains associated with them. Assume that, prior to the transfer, the earnings reserve account is \$5 billion. Kathy agreed that the assets of the fund would be reduced by \$4 billion, and the earnings reserve account would be reduced by

MORRISON & FOERSTER LLP

the amount of \$4 billion (leaving \$1 billion in the account). The CBRF would take the securities at their market value.

In KPMG's view, under the second approach, the transfer of \$4 billion in assets with an associated \$1 billion in unrealized gain associated with the assets would not result in any realization of gain, and thus would have no immediate impact on the dividend calculation. Any impact on future dividends would be the result of the reduced amount of investments in the fund, as well as any limitation on future pay-outs imposed by the decreased level of income in the earnings reserve account.

We explored how this reduction in the earnings reserve account would follow through for statutory purposes in calculating a dividend in subsequent years. (Our concern was how, under the statutory accounting method, to ensure that the component of the transferred earnings reserve that represented transferred unrealized gains would not be double counted in determining realized gains in later years for purposes of the statutory dividend calculation.) Kathy agreed that if, in the subsequent year, the fund had \$3 billion in realized income, and the calculated income available for distribution exceeded the earnings reserve account, the amount of the dividend still could not exceed \$1 billion, or the amount in the earnings reserve account, because to pay out more would be to invade principal. In other words, \$2 billion of that year's realized income would nevertheless be unavailable for a dividend distribution in the current year.

Kathy and Peter clarified that the earnings reserve account for statutory purposes is not, by definition, the same as the earnings reserve account for accounting purposes under current GAAP. The accounting earnings reserve account represents only residual equity, not income.

We asked Kathy Porterfield and Peter Bushro to review a draft of this memorandum, dated February 24, 1999, and to let us know whether this summary accurately reflects the description they provided to us.

Kathy Porterfield has reviewed this memorandum, made revisions, and has confirmed in a telephone conversation with James Baldwin and Linda Arnsbarger on March 2, 1999 that this revised summary accurately reflects the description she provided to us.

DOL Document
#2FISCAL PLAN AMENDMENTS

1. The governor has introduced a bill proposing to transfer \$4 billion from the earnings reserve account of the Alaska Permanent Fund to capitalize the Constitutional Budget Reserve Fund.
2. A proposal has been under consideration to make the transfer in a way that will avoid the necessity of selling a large amount in securities to raise the money.

These sales will cost the permanent fund a substantial amount in transaction fees (estimated in excess of \$20 million) owed to brokers and other securities dealers.
3. The plan involves either the transfer to the CBRF of in-kind securities worth \$4 billion, or an undivided interest in the permanent fund worth \$4 billion. Counsel to the Alaska Permanent Fund Corporation was engaged to provide independent legal advice concerning implementation of this in-kind transfer plan.
4. Legal counsel determined that a one-time, in-kind transfer could be validly implemented if certain statutory amendments were made by the legislature to make it clear that income of the permanent fund is determined exclusively by generally accepted accounting principles.
5. By establishing these principles in statute, there would be no legal questions concerning whether the appreciated value of securities owned by the permanent fund can be made available for distribution by the board of trustees as income.
6. If these amendments are enacted, legal counsel advises that a transfer of unrealized earnings of the permanent fund will not

constitute an appropriation from the principal of the permanent fund; and

that such a transfer will not violate a fiduciary duty owed by the board of trustees of the Alaska Permanent Fund.
7. The legal opinion also relies on the advice of auditors of the Alaska Permanent Fund that such a one-time transfer of \$4 billion in permanent fund income would not cause an increase in the permanent fund dividend payable in the year of the transfer.

"Draft Legislation" Document
#3

* Section __, AS 37.13.140 is amended to read:

Sec. 37.14.140. **Income.** Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. For the purpose of calculating the income available for distribution, net [NET] income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals 21 percent of the net income of the fund for the last five fiscal years, including the fiscal year just ended, but may not exceed [NET INCOME OF THE FUND FOR THE FISCAL YEAR JUST ENDED PLUS] the balance in the earnings reserve account described in AS 37.13.145.

* Sec. __, AS 37.13.145(a) is amended to read:

(a) The earnings reserve account is established as a separate account in the fund. The balance of the earnings reserve account shall be determined according to generally accepted accounting principles. [INCOME FROM THE FUND SHALL BE DEPOSITED BY THE CORPORATION INTO THE ACCOUNT AS SOON AS IT IS RECEIVED.] Money in the account shall be invested in investments authorized under AS 37.13.120.

