4/14/05
adopted N/O

HB 215

Amendment 2 Weyhrauch

Page 3, line 8

Delete: "mailing"

Insert: "providing"

ALASKA STATE LEGISLATURE
House of Representatives

COMMITTEE ASSIGNMENTS:

RULES COMMITTEE, CHAIRMAN
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Representative Norman Rokeberg
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SPONSOR STATEMENT FOR HB 215
By: Representative Norman Rokeberg by Request

An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoptions of regulations by the board; and providing for an effective date.

The investments of the Alaska Permanent Fund are guided by a "legal list" contained in Alaska Statutes. The corporation's Board of Trustees recently engaged two consulting firms, Callan Associates and RV Kuhns, to review the impact of the legal list restrictions on the Fund's investment risk and returns.

What both firms found is that the Fund may be taking on greater risk without the promise of commensurate returns due to the investment restrictions in state statutes.

Modern investment theory focuses on the combined risk of a total portfolio, rather than the risk of each asset type. In our current environment, it is important to diversify a portfolio among assets that do not respond in the same way to similar market conditions, assets which aren't correlated in their performance. This better ensures a positive return for the Fund and lowers overall risk.

Under the current investment list, the Legislature must change the statutes to allow for new investment types. A small "basket clause" does allow up to 10% of the Fund to be invested in items not included in the legislative list, but with part of the basket already allocated, little room is available for new asset types or growth in existing assets beyond current limits.

Because the Constitution specifies that the Fund will be invested only in assets "specifically designated by law," the Legislature may not simply remove the legal list and direct the Trustees to invest under the Prudent Investor Rule alone. However, a recent Attorney General's opinion states that the Legislature is able to move the list to regulation, where the Trustees may make changes in a more timely fashion.

This legislation would make that change, granting the Board authority to establish and administer a legal investment list in regulation. Several important restrictions will be maintained in statute, including the requirement that all investments conform to the Prudent Investor Rule.

Giving the Board this flexibility will help ensure the continued health of the Fund and the ability to sustain distributions in perpetuity by allowing the Trustees to gain the full benefit of the investment professionals who work for the corporation, its managers and advisors.

For more information, please contact Laura Achee @ Alaska Permanent Fund Corporation, 465-2059.

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MEMORANDUM March 4, 2005

SUBJECT: Alaska Permanent Fund Corporation investments
(Work Order No. 24-LS0698)

TO: Representative Norman Rokeberg,
Chair, House Rules Committee
Attn: Heather Nobrega

FROM: Tamara Brandt Cook
Director TBC

This draft eliminates the statutory list of investments that the Alaska Permanent Fund Corporation currently follows in investing fund money and directs the Board of Trustees to adopt regulations identifying those investments. This approach may violate Art. IX, sec. 15 of the state constitution which requires the principal of the fund to "be used only for those income-producing investments specifically designated by law." Art. XII, sec. 11 states in part: "As used in this constitution, the terms 'by law' and 'by the legislature,' or variations of these terms, are used interchangeably when related to law-making powers." These two provisions raise the question of whether the duty imposed on the legislature to designate investments for the permanent fund is a non-delegable duty or one that may be delegated to an executive branch agency.

The Department of Law has considered this issue and concluded that the duty to designate investments under Art. IX, sec. 15 is delegable, as long as standards and proper safeguards for the exercise of that delegated duty are supplied in the statute making the delegation. (File No. 663-05-0141, February 15, 2005) It is stated at page 10 of the memorandum: "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." Both these recommendations are incorporated into this draft. Nonetheless, based upon the clear language of Art. IX, sec. 15, there remains some possibility that a court could find the duty to designate permanent fund investments to be non-delegable.

TBC:jad
05-132.jad

Enclosure

Alaska Permanent Fund Corporation
801 West 10th Street, Suite 302 Juneau, AK 99801
Tel: (907) 465-2047 Fax: (907) 586-2057

Analysis of House Bill 215
Prepared by APFC staff
March, 2005

This legislation removes the Permanent Fund's allowed investment list from statute and places it in regulation. Four key limits on investments would be retained in statute:

- Investments must be made under the Prudent Investor Rule
- The board may leverage assets only if there is no recourse to the Fund
- The board must maintain a diverse mix of assets
- In-state investments must have a risk and return comparable to other investment alternatives

Section 1 -

AS 37.13.120(a) - Requires the Alaska Permanent Fund Corporation Board of Trustees to adopt regulations that specify allowed investment types. Retains the requirement that investments conform to the Prudent Investor Rule and provides a definition for the standard that specifies the investment decisions be compared to those of other institutional investors.

AS 37.13.120(b) - This section is AS 37.13.120(e) under existing statute. Allows the corporation to leverage Fund assets as long as there is no recourse to the Fund and allows for direct leveraging. Previously assets could only be leveraged through a separate entity.

AS 37.13.120(c) - This section is a combination of AS 37.13.120(e) and (l) under existing statute. Requires the board to maintain a diverse mix of assets within the Fund. Also requires the board to make in-state investments if the investments have a risk level and expected return comparable to similar investments outside of the state and conform to the Prudent Investor Rule.

AS 37.13.120(d) - This section is AS 37.13.120(f) under existing statute. Allows the corporation ("board" in existing statute) to enter necessary contracts for managing the Fund. In a change from existing statute, the provision gives examples of some types of investment contracts.

AS 37.13.120(e) - Combines AS 37.13.120(d) under existing statute with new provisions. The new portion requires that proposed regulations be submitted in electronic form to the Legislative Budget and Audit Committee for comment before the regulations are adopted. The rest of the paragraph continues to require the board to submit investment reports to the LBA Committee at least quarterly.

Section 2 -
Adds new provisions regarding the adoption of regulations:

AS 37.13.206(a) Allows the board to adopt regulations, and requires the board to adopt regulations as specified in AS 37.13.120(a). Exempts the board from the provisions regarding the adoption of regulations contained in AS 44.62. This exception is recommended by the Department of Law because market changes could require faster action than is possible under standard regulation adoption guidelines. The AIDEA, AHFC and the Alaska Commission on Postsecondary Education all follow the abbreviated guidelines contained in this legislation.

AS 37.13.206(b) - Allows the board to adopt regulations by motion, resolution, or by means specified in the APFC's bylaws.

AS 37.13.206(c) - Requires public notice of proposed regulation change to be made at least 15 days before adoption, and outlines how that notice will be made.

AS 37.13.206(d) - Requires that the public notice include the time and place where the regulation change proceedings will take place.

AS 37.13.206(e) - Requires the board to allow public testimony on the proposed regulation change at the time of the proceedings.

AS 37.13.206(f) - Creates guidelines under which the board may make an emergency regulation change without conforming to the requirements under (c) - (e) of this section. Emergency regulations will expire after 120 days.

AS 37.13.206(g) - Specifies when regulation changes adopted under this section will take effect and requires regulation changes to be submitted to the Lt. Governor and the Administrative Regulation Review Committee.

Section 3 - repeals AS 37.13.205, the statutes that allowed APFC to draft regulations under the provisions contained in AS 44.62.

Section 4 - effective date of January 1, 2006.

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.

> 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 d obligations of the United States Treasury, federal agency securities, certificates of d sit, 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 (Alask 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.

JLB:jn

Changes to Permanent Fund Statutes (AS. 37.13.120) to increase investment flexibility
Prepared by Alaska Permanent Fund Corporation staff
June, 2004

1980 – SB 161, Sponsored by Sen. Tim Kelly, Sen. George Hohman, Sen. Mike Colletta, and Sen. John Sackett
SB 161 created the Alaska Permanent Fund Corporation to manage the Permanent Fund and started the existing statutory list of allowed investments. This list extended beyond the Fund's initial investment limitation of Treasury bonds to include corporate bonds, certificate of deposits and bankers acceptances. The list initially allowed the Permanent Fund to invest in shares of savings and loan associations, but this provision has since been removed.

1982 – SB 684, sponsored by Gov. Jay Hammond
SB 684 allowed the Permanent Fund to invest in common stocks, partial ownership of real estate properties (not to exceed 40%), loans for commercial real estate and deposits of US dollars held overseas.

1989- HB 69, sponsored by Gov. Steve Cowper
HB 69 gave the APFC authority to invest in non-domestic (International) stocks and bonds.

1992 – SB 39, sponsored by the Senate Finance Committee
SB 39 gave the APFC authority to invest in A rated corporate bonds to a maximum of 5%. Prior to this change, the Fund could only be invested in bonds rated AA or higher.

1994 – HB 373, sponsored by the Legislative Budget and Audit Committee
HB 373 allowed the Fund to own up to 100% in real estate properties worth less than $150 million, and up to 67% in properties worth greater than $150 million.

1996 – HB 525, sponsored by the House Finance Committee
HB 525 gave the APFC authority to invest in corporate bonds rated BBB or higher.

1999 – HB 156, sponsored by the Legislative Budget and Audit Committee
HB 156 allowed the Fund to leverage real estate investments and be the sole owner of any qualified property. In addition the bill increased the asset allocation limit for stocks to 55% of the total market value of the Fund. HB 156 also created the "basket clause" that allows up to 5% of the Fund to be invested in alternative investments or to be applied to existing asset allocations to expand their limits.

2004 – SB 326, sponsored by the Legislative Budget and Audit Committee
SB 326 increased the "basket clause" allocation limit from 5 to 10 percent. The bill also provided clean-up language explicitly stating that the investments restricted under AS 37.13.120(h) and (j) are allowed under the basket clause.

2004 – SB 379, sponsored by Governor Frank Murkowski
SB 379 requires cause before one of the four public members of the Board of Trustees may be removed before the expiration of their term.

HB 215

REPORTED OUT

MAY 5 2005

SENATE FINANCE COMMITEE

SENATE FINANCE COMMITTEE REPORT

DATE: 5/4/05

FURTHER:

DATE TURNED IN TO OFFICE: 5 May 2005

Finance Committee considered CC FOR HOUSE BILL NO. 215(FIN)

HB 215 PERM FUND CORP. INVESTMENTS/REGULATIONS

"An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoption of regulations by the board; and providing for an effective date."

and recommends:

[ ] be **replaced** with _____ **CS** _____ (_____)

[ ] adopt **previous** _____ **CS** _____ (_____)

[ ] attached amendment(s)

[ ] adopt Letter of Intent by _____ Committee

[ ] further referral to _____ Committee

CS Senate Bill:
[ ] Same Title
[ ] New Title

SCS House Bill:
[ ] Same Title
[ ] Technical Title Change
[ ] New Title w/ SCR #_____

NEW FISCAL NOTE(S):

Department	Date	Fiscal	Ind.	Zero	FN#

PREVIOUS FISCAL NOTE(S):

Department	Date	Fiscal	Ind.	Zero	FN#
REV.	4/8/05			✓	#1

[ ] **APPROPRIATION - no fiscal note**

SIGNATURES AND RECOMMENDATIONS:	DO PASS	DO NOT PASS	NO REC	AMEND
			✓	
			✓	
			✓	
COCHAIR:	✓			
COCHAIR:	✓			

REPORTED OUT

MAY 5 2005

SENATE FINANCE COMMITEE

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: 1
Bill Version: HB 215
(H) Publish Date: 4/13/05

Revision Date/Time (Note if correction):
Dept. Affected: Revenue
Title: Perm Fund Corp. Investments/Regulations
RDU: AK Permanent Fund Corporation
Component: AK Permanent Fund Corporation
Sponsor: Representative Rokeberg
Requester: House State Affairs Committee
Component No.: 109

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES						
CHANGE IN REVENUES ( )						

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2005) cost: 0 0

Mark this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: *(Attach a separate page if necessary)*

HB 215 would move the Permanent Fund's allowed investment list from statute to regulation. APFC does not anticipate significant changes in staff workload or management fees as a result of this legislation

Prepared by: Michael Burns, Executive Director/CEO
Phone: 907-465-2047
Division: Alaska Permanent Fund Corporation
Date/Time: 04/08/05
Approved by:
Date: 4/8/2005
Agency:

(Revised 9/13/04 OMB)

COMMITTEE COPY

ALASKA STATE LEGISLATURE
House of Representatives

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Representative Norman Rokeberg
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SPONSOR STATEMENT FOR CSHB 215(FIN)
By: Representative Norman Rokeberg by Request

An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoptions of regulations by the board; and providing for an effective date.

The investments of the Alaska Permanent Fund are guided by a "legal list" contained in Alaska Statutes. The corporation's Board of Trustees recently engaged two consulting firms, Callan Associates and RV Kuhns, to review the impact of the legal list restrictions on the Fund's investment risk and returns.

What both firms found is that the Fund may be taking on greater risk without the promise of commensurate returns due to the investment restrictions in state statutes.

Modern investment theory focuses on the combined risk of a total portfolio, rather than the risk of each asset type. In our current environment, it is important to diversify a portfolio among assets that do not respond in the same way to similar market conditions, assets which aren't correlated in their performance. This better ensures a positive return for the Fund and lowers overall risk.

Under the current investment list, the Legislature must change the statutes to allow for new investment types. A small "basket clause" does allow up to 10% of the Fund to be invested in items not included in the legislative list, but with part of the basket already allocated, little room is available for new asset types or growth in existing assets beyond current limits.

Because the Constitution specifies that the Fund will be invested only in assets "specifically designated by law," the Legislature may not simply remove the legal list and direct the Trustees to invest under the Prudent Investor Rule alone. However, a recent Attorney General's opinion states that the Legislature is able to move the list to regulation, where the Trustees may make changes in a more timely fashion.

This legislation would make that change, granting the Board authority to establish and administer a legal investment list in regulation. Several important restrictions will be maintained in statute, including the requirement that all investments conform to the Prudent Investor Rule.

Giving the Board this flexibility will help ensure the continued health of the Fund and the ability to sustain distributions in perpetuity by allowing the Trustees to gain the full benefit of the investment professionals who work for the corporation, its managers and advisors.

For more information, please contact Laura Achee @ Alaska Permanent Fund Corporation, 465-2059.

Alaska Permanent Fund Corporation
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Analysis of CSHB 215 (FIN)
Prepared by APFC staff
April 15, 2005

This legislation removes the Permanent Fund's allowed investment list from statute and places it in regulation. Four key limits on investments would be retained in statute:

- Investments must be made under the Pruden. Investor Rule
- The board may leverage assets only if there is no recourse to the Fu ıd
- The board must maintain a diverse mix of assets
- In-state investments must have a risk and return comparable to other investment alternatives

Section 1 -

AS 37.13.120(a) - Requires the Alaska Permanent Fund Corporation Board of Trustees to adopt regulations that specify allowed investment types. Retains the requirement that investments conform to the Prudent Investor Rule and provides a definition for the standard that specifies the investment decisions be compared to those of other institutional investors.

AS 37.13.120(b) - This section is AS 37.13.120(e) under existing statute. Allows the corporation to leverage Fund assets as long as there is no recourse to the Fund and allows for direct levera ing. Previously assets could only be leveraged through a separate entity.

AS 37.13.120(c) - This section is a combination of AS 37.13.120(c) and (l) under existing statute. Requires the board to maintain a diverse mix of assets within the Fund. Also requires the board to make in-state investments if the investments have a risk level and expected return comparable to similar investments outside of the state and conform to the Prudent Investor Rule.

AS 37.13.120(d) - This section is AS 37.13.120(f) under existing statute. Allows the corporation ("board" in existing statute) to enter necessary contracts for managing the Fund. In a change from existing statute, the provision gives examples of some types of investment contracts.

AS 37.13.120(e) - Combines AS 37.13.120(d) under existing statute with new provisions. The new portion requires that proposed regulations be submitted in electronic form to the Legislative Budget and Audit Committee for comment before the regulations are adopted. The rest of the paragraph continues to require the board to submit investment reports to the LBA Committee at least quarterly.

Section 2 -
Adds new provisions regarding the adoption of regulations:

AS 37.13.206(a) Allows the board to adopt regulations, and requires the board to adopt regulations as specified in AS 37.13.120(a). Exempts the board from the provisions regarding the adoption of regulations contained in AS 44.62. This exception is recommended by the Department of Law because market changes could require faster action than is possible under standard regulation adoption guidelines. The AIDEA, AHFC and the Alaska Commission on Postsecondary Education all follow the abbreviated guidelines contained in this legislation.

AS 37.13.206(b) - Allows the board to adopt regulations by motion, resolution, or by means specified in the APFC's bylaws.

AS 37.13.206(c) - Requires public notice of proposed regulation change to be made at least 15 days before adoption, and outlines how that notice will be made.

AS 37.13.206(d) - Requires that the public notice include the time and place where the regulation change proceedings will take place.

AS 37.13.206(e) - Requires the board to allow public testimony on the proposed regulation change at the time of the proceedings.

AS 37.13.206(f) - Creates guidelines under which the board may make an emergency regulation change without conforming to the requirements under (c) - (e) of this section. Emergency regulations will expire after 120 days.

AS 37.13.206(g) - Specifies when regulation changes adopted under this section will take effect and requires regulation changes to be submitted to the Lt. Governor and the Administrative Regulation Review Committee.

Section 3 - repeals AS 37.13.205, the statutes that allowed APFC to draft regulations under the provisions contained in AS 44.62.

Section 4 - Allows the Board to adopt regulations prior to the effective date of section 1, although the regulations will not take effect until January 1, 2006.

Section 5 - Allows an immediate effective date for sections 2 and 3, which provide new procedures for drafting APFC regulations.

Section 6 - Effective date for section 1, which repeals the statutory legal investment list on January 1, 2006.

ALASKA STATE LEGISLATURE
House of Representatives

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Representative Norman Rokeberg
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EXPLANATION OF CHANGES FOR CSHB 215(FIN)
By: Representative Norman Rokeberg by Request

An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoptions of regulations by the board; and providing for an effective date.

The following changes were made in House Finance:

1. Page 3, Line 8:
   Deleted "mailing"
   Inserted "providing"

2. Page 4, Line 13:
   Provided for the Alaska Permanent Fund Corporation to begin work immediately on the adoption of the regulations. The regulations however will not take effect until the other provisions of the bill take effect on January 1, 2006.

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 chan 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.

> 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.

JLB:jn

governor may not participate in board business and may not be counted for purposes of establishing a quorum after the member receives written notice of removal from the governor.

(b) A vacancy on the board shall be promptly filled by appointment by the governor. An appointee to a vacancy shall hold office for the balance of the term for which the appointee's predecessor on the board was appointed.

(c) A vacancy on the board does not impair the authority of a quorum of the board to exercise all the powers and perform all the duties of the board. (§ 5 ch 18 SLA 1980; am § 3 ch 81 SLA 1982; am § 1 ch 75 SLA 2004)

Effect of amendments. — The 2004 amendment, effective June 17, 2004, inserted "public" and "only for cause" in the first sentence of subsection (a).

Legislative history reports. — For governor's transmittal letter for ch. 75, SLA 2004 (SB 379), which made an amendment to (a) of this section, see 2004 Senate Journal 2660-2661.

Sec. 37.13.080. Quorum and voting. Four members of the board constitute a quorum for the transaction of business and the exercise of the powers and duties of the board. Action may be taken only upon affirmative vote of a majority of the full membership of the board. (§ 5 ch 18 SLA 1980; am § 6 ch 134 SLA 1992)

Sec. 37.13.090. Compensation of board members. Public members of the board receive an honorarium of $400 for each day spent at a meeting of the board or at a meeting of a subcommittee of the board or at a public meeting as a representative of the board. Members of the board are entitled to per diem and travel allowances as provided by law for members of state boards and commissions. (§ 5 ch 18 SLA 1980; am § 4 ch 81 SLA 1982)

Sec. 37.13.100. Corporation staff. The board may employ and determine the salary of an executive director. The executive director may, with the approval of the board, select and employ additional staff as necessary. An employee of the corporation, including the executive director, may not be a member of the board. The executive director and the other employees of the board are in the exempt service under AS 39.25. (§ 5 ch 18 SLA 1980)

Sec. 37.13.110. Conflicts of interest. (a) Members of the board, the executive director, and investment officers of the corporation are subject to the provisions of AS 39.50.

(b) If a member of the board or an employee of the corporation acquires, owns, or controls an interest, direct or indirect, in an entity or project in which fund assets are invested, the member shall immediately disclose the interest to the board. The disclosure is a matter of public record and shall be included in the minutes of the board meeting next following the disclosure. (§ 5 ch 18 SLA 1980; am § 7 ch 134 SLA 1992)

Sec. 37.13.120. Investment responsibilities of the board. (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.

(b) The fund assets shall only be used for income-producing investments.

(c) The board shall maintain a reasonable diversification among investments unless under the circumstances it is clearly prudent not to do so.

(d) The board shall submit long-range and quarterly investment reports to the Legislative Budget and Audit Committee.

(e) The corporation may not borrow money or guarantee from principal of the fund the obligations of others except as provided in this subsection. With respect to investments of the fund, the corporation may, through an entity in which the investment is made, borrow money if the borrowing is without recourse to the corporation and the fund.

(f) The board may enter into and enforce all contracts necessary, convenient or desirable for purposes of the corporation.

(g) Subject to the limitations contained in this section, the board may invest fund assets at the competitive national market rates or prices that are applicable to each investment only in

(1) obligations of, or obligations insured by or guaranteed by, the United States or agencies or instrumentalities of the United States;

(2) obligations secured by reserves paid in by the United States or agencies or instrumentalities of the United States or obligations of corporations in which the United States is a shareholder or member;

(3) certificates of deposit and term deposits of United States domestic banks that are members of the Federal Deposit Insurance Corporation and that may be readily sold in a secondary market at prices reflecting fair value or that are fully secured at all times as to payment of principal and interest as described in (m) of this section;

(4) certificates of deposit and term deposits of federally chartered savings and loan associations in Alaska that are fully secured at all times as to payments of principal and interest as described in (m) of this section;

(5) certificates of deposit and term deposits of mutual savings banks in Alaska that are fully secured at all times as to payments of principal and interest as described in (m) of this section;

(6) fixed-term certificates of indebtedness of federally insured credit unions in Alaska that are fully secured at all times as to payments of principal and interest as described in (m) of this section;

(7) debt instruments that have been issued by domestic entities and that are rated investment grade, or debt instruments of comparable quality issued by nondomestic entities;

(8) short-term

(A) promissory notes that have been issued by domestic entities and that are rated investment grade; or

(B) promissory notes of comparable quality issued by nondomestic entities, the interest on which may be payable in either United States dollars or nondomestic currencies;

(9) bankers' acceptances drawn on and accepted by United States banks each of which has a combined capital and surplus aggregating at least $200,000,000;

(10) repurchase agreements, the securities underlying the agreements being any of the items in (1) — (6) of this subsection;

(11) the portions of business and industrial loans made under the Rural Development Act of 1972 that are guaranteed by the Farmers Home Administration;

(12) the guaranteed portion of Farmers Home Administration loans;

(13) notes secured by mortgages granting a first lien on residential real estate improved by completed buildings if the mortgages are insured by a private mortgage insurance corporation that is authorized to do business in this state and has combined capital and surplus aggregating at least $20,000,000 and if loan-to-value ratios do not exceed 90 percent; however, mortgage insurance is not necessary for residential loans having a loan-to-value ratio of less than 70 percent and the minimum coverage of other residential loans shall be 10 percent for those having a loan-to-value ratio greater than 70 percent but less than 90 percent and 20 percent for those having a loan-to-value ratio of 90 percent;

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(14) preferred and common stock and other equity interests in entities organized in the United States;

(15) certificates of deposit, term deposits, or bankers' acceptances, that are issued by a United States or nondomestic bank or trust company located outside of the United States and are denominated in United States or nondomestic currency if either (A) they may be readily sold in a secondary market at prices reflecting fair value, or (B) the issuing bank or trust company has capital, surplus, and retained earnings at the date of issue equaling at least $500,000,000; investments made under this paragraph are not subject to the collateral requirements for domestic certificates under (m) of this section;

(16) equity interests in, and debt obligations secured by mortgages granting a first lien on, real estate if the real estate is located in the United States, is professionally managed, and is

(A) improved by completed and substantially rented buildings; or

(B) located within the market area of real property in which the fund holds an existing interest and is acquired

(i) for the purpose of creating or adding to a portfolio of similar properties; or

(ii) to retain or service the needs of existing tenants;

(17) securities of nondomestic governments and nondomestic government agencies, the principal of, or interest on, which is payable in either United States dollars or nondomestic currencies;

(18) securities of other nondomestic entities whose dividends, if any, may be payable in either United States dollars or nondomestic currencies;

(19) taxable municipal or state debt instruments that are rated investment grade;

(20) shares in a money market or short-term investment fund that has either collateral securities of a type authorized elsewhere in this section as acceptable collateral or securities of similar quality to those authorized elsewhere in this section as acceptable collateral;

(21) interests in a titleholding entity, real estate investment trust, real estate operating company, or other entity whose assets consist predominantly of

(A) equity interests in real property or debt obligations secured by mortgages granting a lien on real property, so long as the property is of a type in which the corporation is otherwise permitted to invest fund assets under this subsection; or

(B) interests in other entities in which the corporation is permitted to invest fund assets under this paragraph.

(h) The board may enter into future contracts for the sale of investments purchased under (g) of this section, or for the sale of nondomestic currencies, only for the purpose of hedging an existing equivalent ownership position in these investments or as a means of implementing asset allocation strategies.

(i) The fund may at no time own more than five percent of the voting stock of a corporation unless the issuing corporation is an entity in which the Alaska Permanent Fund Corporation is permitted to invest fund assets under (g)(21) of this section. Domestic stocks, except for bank and insurance company stocks and stocks of corporations in which the Alaska Permanent Fund Corporation is permitted to invest fund assets under (g)(21) of this section, must be listed at the date of purchase on an exchange registered with the Securities and Exchange Commission. Except as otherwise permitted under (k) of this section, at the time of each investment, the aggregate investment of the fund in each stated category of investment may not exceed the following stated percentage of the total investments of the fund:

(1) mortgages under (g)(13) of this section — 15 percent;

(2) real estate investments under (g)(16) and (21) of this section — 15 percent;

(3) certificates of deposit, term deposit, or bankers' acceptances under (g)(15) of this section — 20 percent;

(4) interests in domestic and nondomestic entities under (g)(14) and (18) of this section — 55 percent.

(j) The assets of the fund may not be used for the purchase of debt instruments of a corporation or other entity upon which any regular interest payment has been defaulted within five years before purchase, except debt instruments never in default but which have been outstanding for less than five years.

(k) The board shall establish and from time to time as necessary modify guidelines for the investment of the assets of the fund. Before adoption of any guidelines, the guidelines shall be reported to the Legislative Budget and Audit Committee for review and comment. Notwithstanding (g), (h), and (j) of this section or the percentage investment limitations under (i) of this section and so long as doing so satisfies the prudent-investor rule under (a) of this section, the board may invest up to 10 percent of the total assets of the fund in either or a combination of the following:

(1) other types of investments not specifically listed in (g) of this section;

(2) categories of investment subject to the percentage investment limitations established in (i) of this section, even though investing additional assets in a category will cause the aggregate investment in the category to exceed the applicable percentage limitation.

(*l*) The board shall invest the assets of the fund in in-state investments to the extent in-state investments are available if the in-state investments

(1) have a risk level and expected yield comparable to alternate investment opportunities; and

(2) are included in the list of permissible investments in (g) of this section.

(m) Certificates of deposit or the equivalent instruments that are not of a quality that may be readily sold in a secondary market at prices reflecting fair value must be secured by a pledge as collateral of

(1) investments authorized for the fund under (g)(1), (2), (4), or (8) — (10) of this section;

(2) obligations of the state or instrumentalities of the state that are rated at least "A" by a major bond rating service and have a demonstrated secondary market;

(3) the guaranteed portion of Federal Small Business Administration loans;

(4) the portion of first lien real estate mortgages guaranteed by the federal Department of Veterans Affairs; or

(5) notes secured by mortgages granting a first lien on commercial or residential real estate improved by completed buildings if the originating financial institution retains at least 25 percent of the mortgage until maturity.

(n) Investments or obligations pledged as collateral under (m) of this section must have value at least equal to the face value of the certificates of deposit being secured. The board may require substitution of collateral in order to ensure continued satisfaction of the requirements set out in (m) of this section.

(o) For purposes of (g) of this section, "investment grade" means a Standard & Poor's Corporation rating BBB or better, or Moody's Investors Service, Inc., rating of Baa or better, including a rating with a "+" or "-" designation or other variations that occur within these ratings, or a comparable rating by another nationally recognized rating organization.

(p) For purposes of applying the percentage investment limitations established in (i) of this section, if the board determines that a particular form of investment authorized under (g) of this section may appropriately be classified in more than one category of investment, it may elect the category to which that form of investment is assigned. (§ 5 ch 18 SLA 1980; am §§ 5 — 7 ch 81 SLA 1982; am § 1 ch 83 SLA 1986; am §§ 1 — 6 ch 4 SLA 1989; am §§ 8 — 17 ch 134 SLA 1992; am § 1 ch 56 SLA 1994; am §§ 1 — 4 ch 104 SLA 1996; am §§ 1 — 7 ch 60 SLA 1999; am §§ 1, 2 ch 74 SLA 2004)

Effect of amendments. — The 2004 amendment, effective June 17, 2004, in subsection (e), deleted "real property" before "investments" and, in subsection (k), added the reference to "(h), and (j)" and substituted "10" for "five."

Legislative history reports. — For Senate letter

of intent related to the 1989 amendments to this section by ch. 4, SLA 1989 (CSHB 69(SA)), see 1989 Senate Journal 621.

Sec. 37.13.130. Gains and losses. [Repealed, § 13 ch 81 SLA 1982.]

Sec. 37.13.140. Income. Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. 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. (§ 5 ch 18 SLA 1980; am § 8 ch 81 SLA 1982; am § 1 ch 28 SLA 1986; am § 18 ch 134 SLA 1992)

Sec. 37.13.145. Disposition of income. (a) The earnings reserve account is established as a separate account in the fund. 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.

(b) At the end of each fiscal year, the corporation shall transfer from the earnings reserve account to the dividend fund established under AS 43.23.045, 50 percent of the income available for distribution under AS 37.13.140.

(c) After the transfer under (b) of this section, the corporation shall transfer from the earnings reserve account to the principal of the fund an amount sufficient to offset the effect of inflation on principal of the fund during that fiscal year. The corporation shall calculate the amount to transfer to the principal under this subsection by

(1) computing the average of the monthly United States Consumer Price Index for all urban consumers for each of the two previous calendar years;

(2) computing the percentage change between the first and second calendar year average; and

(3) applying that rate to the value of the principal of the fund on the last day of the fiscal year just ended.

(d) Notwithstanding (b) of this section, income earned on money awarded in or received as a result of State v. Amerada Hess, et al., 1JU-77-847 Civ. (Superior Court, First Judicial District), including settlement, summary judgment, or adjustment to a royalty-in-kind contract that is tied to the outcome of this case, or interest earned on the money, or on the earnings of the money shall be treated in the same manner as other income of the Alaska permanent fund, except that it is not available for distribution to the dividend fund, and shall be annually deposited into the principal of the Alaska permanent fund. (§ 9 ch 81 SLA 1982; am § 2 ch 28 SLA 1986; am § 19 ch 134 SLA 1992)

Conditional repeal of subsection (d). — Under § 28, ch. 134, SLA 1992, subsection (d) "is repealed on the day that the revisor of statutes certifies to the legislature that the Alaska Supreme Court has made a final determination that, in the absence of AS 43.23.045(e), repealed by sec. 29 of this Act, or AS 37.13.145(d), added by sec. 19 of this Act, no judge or juror is disqualified from serving as a judge or juror solely because the judge or juror may qualify to receive a permanent fund dividend."

NOTES TO DECISIONS

Stated in State, Dep't of Revenue v. Costo, 858 P.2d 621 (Alaska 1993); Exxon Corp. v. Heinze, 32 F.3d 1309 (9th Cir. 1994)

Sec. 37.13.150. Corporation budget. The revenue generated by the fund's investments must be identified as the source of the operating budget of the corporation in the

Alaska Permanent Fund Corporation
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Alaska Permanent Fund's current statutory investment limitations in AS 37.13.120:

- May only invest in asset types included in statutory list
- Investment grade bonds (BBB or better)– no limit
- Stocks – 55%
- Real estate – 15%
- Mortgages – 15%
- Certificates of deposit – 15%
- 10% alternative investment "basket clause": allows up to 10% of the Fund to invest outside of the allowed investment list, including hedge funds, venture capital or an increase in the above limits.

Changes to Permanent Fund Statutes (AS. 37.13.120) to increase investment flexibility
Prepared by Alaska Permanent Fund Corporation staff
June, 2004

1980 – SB 161, Sponsored by Sen. Tim Kelly, Sen. George Hohman, Sen. Mike Colletta, and Sen. John Sacket
SB 161 created the Alaska Permanent Fund Corporation to manage the Permanent Fund and started the existing statutory list of allowed investments. This list extended beyond the Fund's initial investment limitation of Treasury bonds to include corporate bonds, certificate of deposits and bankers acceptances. The list initially allowed the Permanent Fund to invest in shares of savings and loan associations, but this provision has since been removed.

1982 – SB 684, sponsored by Gov. Jay Hammond
SB 684 allowed the Permanent Fund to invest in common stocks, partial ownership of real estate properties (not to exceed 40%), loans for commercial real estate and deposits of US dollars held overseas.

1989- HB 69, sponsored by Gov. Steve Cowper
HB 69 gave the APFC authority to invest in non-domestic (International) stocks and bonds.

1992 – SB 39, sponsored by the Senate Finance Committee
SB 39 gave the APFC authority to invest in A rated corporate bonds to a maximum of 5%. Prior to this change, the Fund could only be invested in bonds rated AA or higher.

1994 – HB 373, sponsored by the Legislative Budget and Audit Committee
HB 373 allowed the Fund to own up to 100% in real estate properties worth less than $150 million, and up to 67% in properties worth greater than $150 million.

1996 – HB 525, sponsored by the House Finance Committee
HB 525 gave the APFC authority to invest in corporate bonds rated BBB or higher.

1999 – HB 156, sponsored by the Legislative Budget and Audit Committee
HB 156 allowed the Fund to leverage real estate investments and be the sole owner of any qualified property. In addition the bill increased the asset allocation limit for stocks to 55% of the total market value of the Fund. HB 156 also created the "basket clause" that allows up to 5% of the Fund to be invested in alternative investments or to be applied to existing asset allocations to expand their limits.

2004 – SB 326, sponsored by the Legislative Budget and Audit Committee
SB 326 increased the "basket clause" allocation limit from 5 to 10 percent. The bill also provided clean-up language explicitly stating that the investments restricted under AS 37.13.120(h) and (j) are allowed under the basket clause.

2004 – SB 379, sponsored by Governor Frank Murkowski
SB 379 requires cause before one of the four public members of the Board of Trustees may be removed before the expiration of their term.

Alaska Permanent Fund Corporation

Reducing Risk, Increasing Return

Background

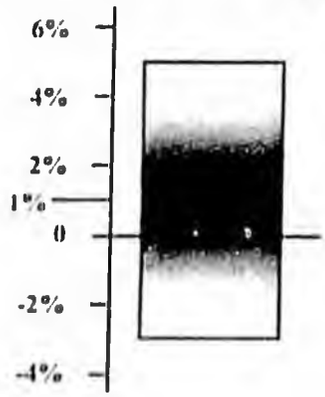
AS 37.13.120 contains a "legal list" of allowed investments for the Alaska Permanent Fund.

The Board of Trustees recently asked two consulting firms, Callan Associates and RV Kuhns, to determine the list's impact on the Fund's potential investment returns and risk. These firms found that the Fund may be taking on greater risk without the promise of commensurate returns under the restrictions in the legal list.

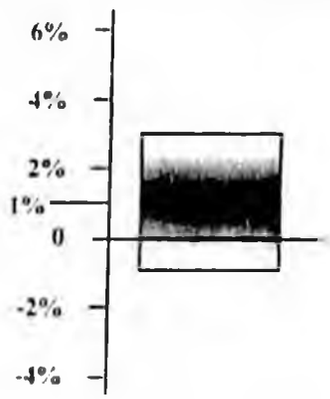
What is risk? Standard deviation? Volatility?

Risk is defined as the measurable possibility of losing value on an investment. It is expressed as the standard deviation above and below the return, the range of possible returns. In the example on the left, 4% is the standard deviation.

Expected return of 1% ± 4%



Expected return of 1% ± 2%

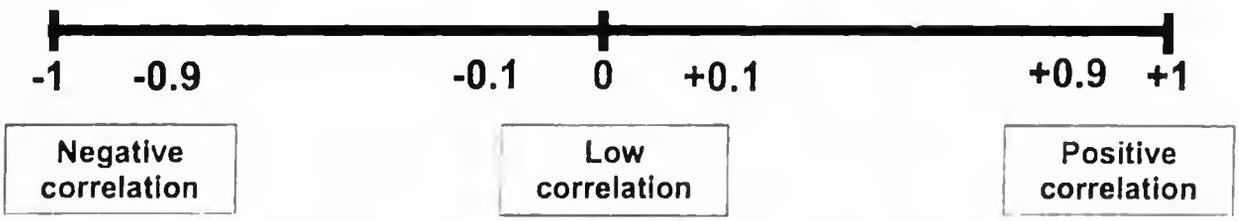


Volatility describes the level of risk for investments, from individual securities to investment strategies to a total portfolio. The returns on highly volatile investments can swing wildly, while the expected returns for less volatile investments will fall into a more narrow range. In the examples above, the figure on the left shows greater volatility and risk than the figure on the right.

What is correlation?

Correlation is a statistical measure of the relationship between two different assets, describing whether or not they move in tandem under various market conditions.

This relationship is expressed with a number between plus one (perfect positive correlation) and minus one (perfect negative correlation). Positively correlated investments usually rise and fall together, while negatively correlated investments move in opposite directions.



Investments with a low correlation (a correlation value close to zero) do not move in relationship to each other. The less correlated the assets, the less able we are to predict how these investments will perform in relation to each other.

Diversifying assets among negatively correlated investments can increase the likelihood of stable performance under various market conditions. Investing in assets with low correlation to each other can lower total portfolio risk even further.

Modern portfolio theory

In the past, institutional portfolios were managed by assessing the individual risk for each asset type. Investments that were considered too risky would not be included in the portfolio.

This is similar to how many individual investors approach their personal retirement portfolios. When the investor is young, they are open to more risk and can invest in more volatile assets. As they approach retirement age and the eventual payout of earnings, it becomes more important to protect the value of the portfolio and the investor shifts to less risky assets.

However, institutional funds have different characteristics than a retirement account. Institutional funds must be protected for the long term, while providing annual payouts. As markets have changed, this has created a modern portfolio theory that focuses more on spreading investments across non-correlated assets than focusing on the individual risk of each asset type. Managing investments in this manner can lower the overall risk of the portfolio, even while the fund is invested in assets that are considered risky.

How does this work?

The following hypothetical examples show how the correlation between assets can affect the overall risk for a portfolio.

Portfolio A is invested in race horses and race tracks.

	Race horses	Race tracks
Return	10.0%	7.0%
Std. deviation (risk)	12.0%	8.0%

Correlation between assets: .90

Portfolio B is invested in Beanie Babies and fine art.

	Beanie Babies	Fine art
Return	10.0%	7.0%
Std. deviation (risk)	13.2%	8.8%

Correlation between assets: .10

While the assets in each portfolio have corresponding returns, they have different risk levels and different correlations. When they are weighted the same, which portfolio has the greater total risk?

Portfolio A

Race horses = 56% of portfolio

Race tracks = 44% of portfolio

Expected return is 8.68%

Standard deviation (risk) 10.00%

Portfolio B

Beanie Babies = 56% of portfolio

Fine art = 44% of portfolio

Expected return is 8.69%

Standard deviation (risk) 8.70%

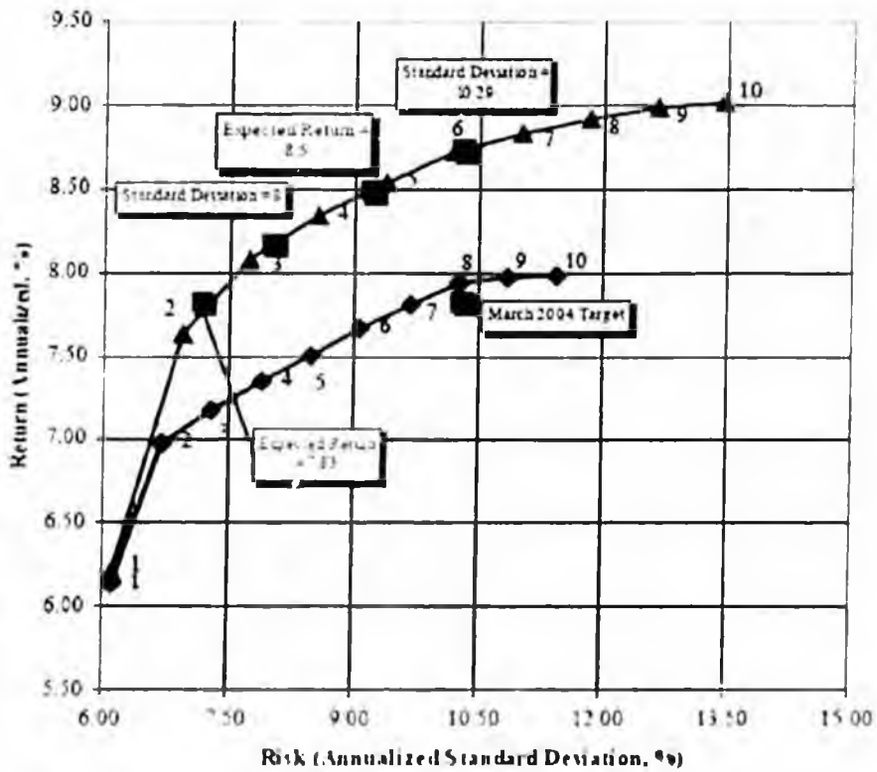
The portfolio using higher risk investments was able to achieve a lower overall risk for equal returns because it used investments that are less correlated.

Where is the Permanent Fund?

The following chart shows potential risk and return for various portfolios under the Fund's current investment restrictions (blue line), and under the Prudent Investor Rule alone (red line). The underlying asset allocations for the main points of this chart are shown on the next page.

The chart demonstrates that under the Prudent Investor Rule, the Fund could potentially earn the same return as the current portfolio (March 2004 target) with more than 3% less risk (Expected Return = 7.83). Or, for the same risk the Fund could earn almost 1% more return (Standard Deviation = 10.29).

Efficient Frontier



The Trustees understand the Legislature's need to balance risk and return for the Fund. While an aggressive rate of growth may be desired by some, others may find it more important to lower the Fund's risk while maintaining a reasonable rate of return.

Increasing the Fund's investment options would allow the Trustees greater flexibility in managing the Fund for the benefit of all Alaskans, whether it is for greater return, lower risk or both This is especially important as the Legislature begins to contemplate the use of Fund earnings for more than just the dividend program.

How would the Trustees use that flexibility?

The statutory list prevents investments in newer high risk assets such as broad emerging market debt, high yield bonds and certain forms of real estate investments. These assets, while considered risky on their own, can lower the overall risk of a portfolio through low correlation with other asset types.

These asset types are fairly easy to describe, and with time could be added to the statutory list with Legislative approval. However, by the time they are added, the investment opportunity may have closed, leaving the Permanent Fund out in the cold.

As the investment world seeks new ways to improve returns in increasingly efficient markets, investors are creating new strategies that mix multiple investment options or asset types within a single investment mandate. Absolute return strategies, an alternative asset type that the Fund currently invests in under the 10% basket clause, are portfolios that invest for an absolute target return using the most promising investment opportunities available. These portfolios are defined by their return targets, not by the assets they hold.

Asset Classes	March 2004 Target	Expected Return = 7.83	Standard Deviation = 10.29	Standard Deviation = 8	Expected Return = 8.5
Large Cap US Equity	30	20	20	20	20
Small/Mid Cap US Equity	7	5	5	5	5
International Equity	16	10	10	10	10
Emerging Markets	2	0	6	0	4
Fixed Income	28	20	20	20	20
Non-US Fixed Income	4	5	0	5	1
Real Estate	6	15	14	15	15
REITs	4	0	0	0	0
Private Equity	2	0	10	4	6
Absolute Return	1	10	5	10	9
Cash Equivalents	0	0	0	0	0
Commodities	0	5	5	5	5
Convertibles	0	0	0	0	0
High Yield	0	0	0	0	0
Real Return	0	1	0	1	0
Timber	0	5	5	5	5
TIPS	0	4	0	0	0
Total	100	100	100	100	100

This new wave of investment practice does not fit well within the rigid structure of a legal list. If the Fund's legal list were moved to regulation as suggested by a recent Attorney General's opinion, it would still require that these strategies have some form of definition. However, the less cumbersome regulatory process would allow Trustees to craft and modify regulatory definitions of alternative investment strategies.

The Prudent Investor Rule

STATE/TERRITORY ADOPTIONS* of the PRUDENT INVESTOR ACT

Alaska (ASPIB)	Maryland **	Pennsylvania
Arizona	Michigan	Rhode Island
Arkansas	Minnesota	South Carolina
California	Missouri	South Dakota
Colorado	Montana	Tennessee
Connecticut	Nebraska	Texas
District of Columbia	Nevada	Utah
Hawaii	New Hampshire	U.S. Virgin Islands
Idaho	New Jersey	Vermont
Illinois	New Mexico	Virginia
Indiana	North Carolina	Washington
Iowa	North Dakota	West Virginia
Kansas	Ohio	Wisconsin
Maine	Oklahoma	Wyoming
Massachusetts	Oregon	

* *Source is National Conference of Commissioners on Uniform State Laws*

** *Substantially Similar*

The Prudent Investor Rule is a legal standard that requires the APFC Board of Trustees to act as a prudent institutional investor would when making investment decisions. Alaska statutes require that the Board follow the Prudent Investor Rule in addition to the other statutory investment restrictions.

The Permanent Fund's peers—state pension funds and large institutional endowment funds—have been moving away from legal investment lists. Instead, they are simply required to conform to the Prudent Investor Rule.

New York and New Mexico are both seeking legislative approval to expand the investment flexibility for their state pension funds.

What can we do?

The Constitution says that the Alaska Permanent Fund will be invested in assets "specifically designated by law." This prevents the Legislature from removing the legal list and simply requiring that all Fund investments conform to the Prudent Investor Rule. However, a recent Attorney General's opinion says the Legislature may delegate authority to the Board of Trustees to create a list of allowed investments in regulation. A regulatory list may be amended more quickly than statutes, allowing the Trustees the flexibility to respond to changes in the investment world.

Legislation drafted at the request of the Trustees would allow the list to be moved to regulation, while maintaining key restrictions in statute. The most important of these restrictions is the requirement that all Fund investments conform to the Prudent Investor Rule.

The Alaska Permanent Fund Corporation thanks Michael O'Leary of Callan Associates, and Russ Kuhns, Rebecca Gratsinger, and Jim Voytko of RV Kuhns, for their assistance in producing this handout.

Alaska Budget Report
April 14, 2005, Vol. 15, No. 13

PERMANENT FUND

H. State Affairs moves bill to lift limits on PF investments

Legislators appear inclined to give the Alaska Permanent Fund Corporation board of trustees freedom to invest in whatever they choose, provided in doing so they act like a "prudent investor." HB 215 would lift the statutory restrictions on how much of the corporation's portfolio can be invested in different asset classes, such as stocks, bonds and real estate [see **Trustees seek loosening of investment limits,** *ALASKA BUDGET REPORT*, January 20, 2005].

"The statutory list is impeding our progress," Mike Burns, executive director of the Alaska Permanent Fund Corporation, testified at an April 12 House State Affairs Committee hearing.

The measure moved out of State Affairs, its first committee, after a perfunctory hearing and few questions. Reps. Berta Gardner, Bob Lynn, Jim Elkins, Jay Ramras and Chair Paul Seaton all recommended the bill "do pass." Rep. Carl Gatto signed "no recommendation."

Anchorage Republican Rep. Norman Rokeberg introduced HB 215 at the request of the trustees, picking up co-sponsors Ethan Berkowitz, a Democrat, and Republican Mike Hawker. The bill is scheduled for a hearing today in House Finance.

"Increasing the fund's investment options would allow the trustees greater flexibility," APFC officials said in a background paper distributed to legislators. "This is especially important as the Legislature begins to contemplate the use of fund earnings for more than just the dividend program."

At the State Affairs hearing Gardner asked Burns if anyone might be opposed to the measure.

"The only reluctance I have heard from people is that maybe you should take this in steps," said Burns.

Burns apparently hadn't vetted the proposal with Tom Williams, the former state revenue commissioner and a founding permanent fund trustee, who served on the board from 1980 to 1982.

"The statutory authority is not only an opportunity, but a refuge," said Williams in a recent interview. "The trustees can say no to certain kinds of investments by pointing to the statute and saying no." He said the statutory limitations protect the trustees from public pressure to make popular but possibly ill-advised investments.

It's also an issue of representative government, Williams said, noting that the trustees—overwhelmingly white males in their 50s and older—are far less diverse than the elected

Legislature; the six trustees work on behalf of the people but are not representative of the people, he said.

The weight of opinion, however, seems against Williams' view. Robert Storer, who retired last year as executive director of the fund, likes the idea, as does Ed Rasmuson, retired head of the former National Bank of Alaska and the son of the late Elmer Rasmuson, the first chair of the APFC board of trustees.

"The Legislature has done a real disservice to the permanent fund by shackling its ability to make investments," said Ed Rasmuson, who also chairs the Rasmuson Foundation.

"Statutory lists are products of the '70s," said Storer. "There are very few public funds that have a statutory list anymore."

In place of the statutory limitations on the $30-billion fund's asset mix, HB 215 would set the prudent-investor rule as the standard for investment decisions, allowing the trustees to adopt regulations defining what that means in practice. The prudent-investor rule directs an investor to exercise the same judgment and care that an institutional investor of ordinary prudence would exercise.

No longer would state law limit the portfolio to a maximum of 55 percent in stocks, 15 percent in real estate, 15 percent in mortgages and such.

"The statutory list prevents investments in newer, high-risk assets such as broad emerging-market debt, high-yield bonds and certain forms of real estate investments," the fund said in its background paper. "This new wave of investment practice does not fit well within the rigid structure of a legal list."

Without the restrictions, the fund's investment opportunities could expand to include non-liquid, longer-term investments and additional private-equity stakes, Burns said. "People are looking in a lot of different directions."

It's all about spreading risk. "These assets, while considerably risky on their own, can lower the overall risk of a portfolio through low correlation with other asset types," according to the fund. That low correlation — the low likelihood that investments would move in the same direction at the same time — would help the fund diversify its asset mix, which the trustees and most investment authorities say is a good thing.

"The closer we can move to letting the trustees make the decisions, the better," Berkowitz said.

"I think it's inappropriate for the permanent fund management to be artificially constrained by statutory decisions that could prevent them from making the best economic decisions," Hawker said.

"The management of our permanent fund has proven itself time and time again to perform in the upper echelons of investors ... and I don't think we can say the same for our Legislature," he said.

The performance of the permanent fund has not been as stellar as Hawker implies. According to Callan and Associates, Inc., which monitors performance for APFC and many other large funds, the permanent fund ranks below the median when compared with other large public funds—with 60 percent of such funds performing better over the 11.5 years since Callan started tabulating the data. APFC officials say the statutory constraints were responsible for keeping the fund from performing better.

Although the proposal to lift the statutory limitations has been under discussion for several years, this is the first time it has been presented to legislators. Trustees usually go to the Legislative Budget and Audit Committee to carry their bills, but this time, for reasons that aren't entirely clear, APFC officials asked Rokeberg to carry the bill.

When it was first constituted in the late 1970s, the fund was given a very narrow list of legal investments—top-rated bonds, certificates of deposit and some residential real estate mortgages, said John Shively, former chief of staff to Gov. Bill Sheffield in the mid-1980s and a fund trustee under Gov. Tony Knowles in 1999-2000.

Those limitations lasted until 1982, when the Legislature expanded the list to include stocks. Lawmakers again expanded the list in 1989 to allow investment in non-U.S. securities; in 1992 to include lower-rate corporate bonds; and in 1994 for additional real estate investments.

In 1999 the Legislature approved the so-called "basket clause," allowing the trustees to invest up to 5 percent of the fund's assets in investment categories that would otherwise exceed the statutory limits—or in investments not specifically listed in statute. Last year lawmakers expanded the "basket clause" to 10 percent. The trustees had asked for 15 percent [see **S. Finance approves bigger "basket" for PF investment flexibility**, *ALASKA BUDGET REPORT*, March 31, 2004].

"Clearly, the progression has been in that direction," toward more flexibility, Shively said.

There are no similar limitations on the Alaska State Pension Investment Board, which manages funds for the public employees' and teachers' retirement systems and several other small retirement accounts. The pension board is governed in statute by the prudent-investor rule.

Since 1980, in addition to the legal list of permissible investments, the permanent fund has also been required to follow the prudent-investor rule. Language in HB 215 would specify, "The prudent-investor rule as applied to investment activity of the fund means that the corporation shall exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary prudence, discretion and intelligence exercises in the designation and management of large investments entrusted to it."

The legislation would not change the statutory direction that the fund "maintain a reasonable diversification among investments," nor would it change language allowing managers to make in-state investments as long as the in-state opportunities' risk level and expected return are comparable to other investments.

A February 15 attorney general's memorandum addressed whether it is constitutionally permissible for the Legislature to do away with the statutory investment list, given that the Alaska Constitution limits the fund's investments to those "specifically designated by law." The 10-page memo by Assistant Attorney General Jim Baldwin concludes that adoption of the prudent-investor rule in statute would meet the constitutional requirement; a specific list of investment limitations is not necessary.

Though several lawmakers last year tried to move legislation allowing the permanent fund to make loans for a state-owned North Slope natural gas pipeline project, no one connected with the bill this session has mentioned that possibility [see **House committee bill allows APFC to invest in gas pipeline,** *ALASKA BUDGET REPORT*, March 17, 2004].

Investing any significant amount of money in such a multibillion-dollar project would violate the prudent-investor rule, Hawker said. "It would so overweight the portfolio into a risk concentration."

Storer, then the executive director of APFC, made similar remarks last year in House State Affairs. He said a loan to the Alaska Natural Gas Development Authority likely would be "below investment grade," as defined by national debt rating agencies, and the most the fund could invest in the gas project without violating the prudent-investor rule would be "$100 million, tops."

Anything more, he said, would place too much of the fund's assets into a single risk. Storer's opinion, however, is not binding on the trustees, who under HB 215 could adopt regulations defining different standards.

Draft Testimony from Mike Burns 5/5/05

The Prudent Investor Rule:

Background Placed in the Context of the Alaska Permanent Fund and Its Mission

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➢ **Why should the Prudent Investor Rule even be considered as the primary overarching policy governing the investment of the Alaska Permanent Fund?**

To answer that question, it is best to begin with the Permanent Fund's Mission:

> ***"To maximize the value of Alaska's Permanent Fund through prudent long-term investment and protection of principal to produce income to benefit all generations of Alaskans"***

Inherent in the mission are six distinct objectives that are, at least partially, in conflict and therefore difficult to mesh. Specifically:

1. ***"maximize the value"*** of the Fund: i.e., maximize the rate of return achieved by investing the Fund's assets.

2. ***"prudent"*** investment: i.e., conform the investment strategy for the Fund to the standard of "prudent" behavior as defined by applicable law.

3. ***"long-term"*** investment: i.e., target investment outcomes with a long-term horizon, in this case, "permanent" horizon.

4. ***"protection of principal"***: i.e., ensure to the extent possible that the corpus of the Permanent Fund not irrevocably decline in value

5. ***"produce income"***: i.e., ensure the Fund produces sufficient realized returns (income) to meet applicable requirements (in this case annual distributions)

6. ***"to benefit all generations of Alaskans"***: i.e., ensure the Fund's ability to produce income is sustained over time.

It is not difficult to see the many challenges inherent in the Permanent Fund's mission and equally easy to see that they often are in conflict. Maximizing returns in a manner that is prudent, doing so over the long-run (indeed perpetuity) and still protecting Fund principle while ***at the same time*** producing and distributing substantial levels of income annually in perpetuity (across future generations) is a major challenge for those charged with investing the Fund's assets.

For several hundred years, most trustees facing similar challenges have operated under a "prudent" policy implemented by a simple constraint: permit the investment of fund

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assets in only those instruments which, ***when viewed individually***, were likely to produce income and protect the ***nominal*** value of the fund. These instruments were few and primarily focused on fixed income. This particular foundation for a prudent investment policy succeeded in some respects, but has generally failed to meet the full spectrum of requirements such as those expressed in the Permanent Fund's Mission. In particular:

- The predominate, and in some cases, exclusive use of fixed income and related securities left the ***real*** corpus extremely vulnerable to inflation. Over time, this severely eroded the its ability to achieve its funding objective – its ultimate purpose – whether to produce desired levels of annual income or some other need.

- The predominate use of low risk, but low return, investments such as fixed income and related securities plus the more conservative classes of domestic equity securities yielded over time, lower returns as the price for whatever protection of the ***nominal*** value of the corpus and diminished annual volatility in fund value was achieved.

- The narrow list of allowable (and usually highly correlated) investments made the total fund's value and annual returns nearly as volatile as the narrow classes of underlying securities. The narrower the list of allowable investments (and the more correlated), the greater this ***full*** translation of investment level volatility to the total fund. This process only accentuated the incentive to seek out the least volatile investments – no matter of the potential returns that might have to be sacrificed.

Over the last three decades, trustees facing challenges highly similar, and in some cases identical, to those facing the Alaska Permanent Fund have been abandoning the "restrictive list" foundation for implementing a prudent investment policy and instead adopting the Prudent Investor Rule as the guiding policy for investment fund assets.

49/50 STATES

The Prudent Investor Rule's Underlying Premise

The Prudent Investor Rule's underlying premise is that the primary responsibility of fiduciaries is to ensure the estimated risk and return of the ***total portfolio*** is appropriate in light of risk tolerances and the particular objectives served by the assets. This focus on the best estimates of the total portfolio's long-term behavior along with the development of modern portfolio theory has fundamentally changed the foundation for "prudent" fiduciary behavior. The key outcome of these twin developments is that properly diversified mixes of various asset classes—some of which may exhibit high volatility when viewed ***individually*** – when combined in a total portfolio are more likely to achieve given return expectations with less risk or, conversely, yield higher expected returns for the same amount of risk as a portfolio built on a "restrictive list" basis using only low volatility instruments. In current law embodying this emphasis on the whole portfolio rather than individual investment categories, the fiduciary is said to have "a duty to evaluate investments ***in the context of the portfolio as a whole***" while the duty to select reasonable levels of risk are targeted to the fund and diversification itself becomes a fiduciary obligation.

In practical terms, this means that for a fund, such as the Alaska Permanent Fund confronted with an obligation to maximize the Fund's value and produce income for current and future generations of Alaskans, the optimal course of action may well be to employ a highly varied mix of investment classes, some of which exhibit high volatility (i.e., risk). The rationale proceeds as follows:

- Faced with the obligations related to return, principal protection and income, the Fund's fiduciaries will obviously want to seek to meet them while avoiding any unwarranted risk (particularly risk that does not bring with it the prospect of increased return).

- Broadly diversifying the Fund's investments among asset classes is the only mechanism that can simultaneously reduce total portfolio risk for a given level of expected return.

- Successful diversification is put into practice by finding the best mix of assets that together are likely to meet the Fund's return expectations but, also together, yield a pattern of returns over time that exhibit as little volatility as possible.

- A minimum risk, diversified portfolio is achieved by combining investment classes whose returns are at least partially uncorrelated with one another, that is their returns rise and fall over time in different patterns.

Yet, achieving that minimum risk, diversified portfolio may well ***require*** the use of individual investment classes that, individually, exhibit above average volatility, *if* the fluctuations in their returns follow a markedly different pattern

than the other investment classes used in the mix and thus, tend to smooth the overall returns achieved by the portfolio.

- Moreover, both the expected returns of all asset classes and their correlation with the other classes may change over time, albeit usually slowly. This requires that in executing their duties, fiduciaries such as those overseeing the Permanent Fund be able to gradually adjust the portfolio mix potentially using at various points in time all available asset classes.

The relevant point for Alaska Permanent Fund is that it is quite possible that either now or at some point in the future, the inability to access a broader range of asset classes may result in the creation of a Fund that contains either excess risk or unnecessarily lower long-term returns. Whether that point is likely now, as opposed to later, is the subject of the analysis in Tab IV.

To illustrate this point I would ask you to turn to the graph on p. 41.

HB 215

Alaska Permanent Fund Corporation

Reducing Risk, Increasing Return

Background

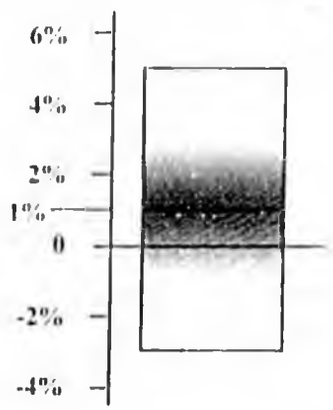
AS 37.13.120 contains a "legal list" of allowed investments for the Alaska Permanent Fund.

The Board of Trustees recently asked two consulting firms, Callan Associates and RV Kuhns, to determine the list's impact on the Fund's potential investment returns and risk. These firms found that the Fund may be taking on greater risk without the promise of commensurate returns under the restrictions in the legal list.

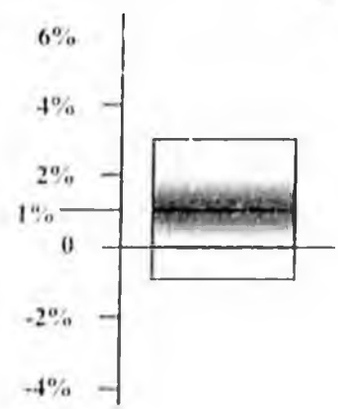
What is risk? Standard deviation? Volatility?

Risk is defined as the measurable possibility of losing value on an investment. It is expressed as the standard deviation above and below the return, the range of possible returns. In the example on the left, 4% is the standard deviation.

Expected return of 1% ± 4%



Expected return of 1% ± 2%

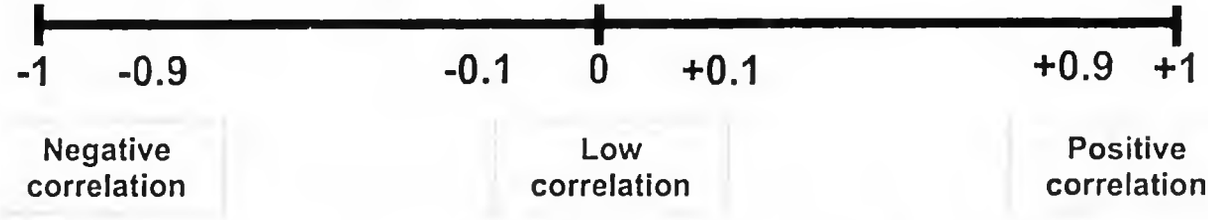


Volatility describes the level of risk for investments, from individual securities to investment strategies to a total portfolio. The returns on highly volatile investments can swing wildly, while the expected returns for less volatile investments will fall into a more narrow range. In the examples above, the figure on the left shows greater volatility and risk than the figure on the right.

What is correlation?

Correlation is a statistical measure of the relationship between two different assets, describing whether or not they move in tandem under various market conditions.

This relationship is expressed with a number between plus one (perfect positive correlation) and minus one (perfect negative correlation). Positively correlated investments usually rise and fall together, while negatively correlated investments move in opposite directions.



Investments with a low correlation (a correlation value close to zero) do not move in relationship to each other. The less correlated the assets, the less able we are to predict how these investments will perform in relation to each other.

Diversifying assets among negatively correlated investments can increase the likelihood of stable performance under various market conditions. Investing in assets with low correlation to each other can lower total portfolio risk even further.

Modern portfolio theory

In the past, institutional portfolios were managed by assessing the individual risk for each asset type. Investments that were considered too risky would not be included in the portfolio.

This is similar to how many individual investors approach their personal retirement portfolios. When the investor is young, they are open to more risk and can invest in more volatile assets. As they approach retirement age and the eventual payout of earnings, it becomes more important to protect the value of the portfolio and the investor shifts to less risky assets.

However, institutional funds have different characteristics than a retirement account. Institutional funds must be protected for the long term, while providing annual payouts. As markets have changed, this has created a modern portfolio theory that focuses more on spreading investments across non-correlated assets than focusing on the individual risk of each asset type. Managing investments in this manner can lower the overall risk of the portfolio, even while the fund is invested in assets that are considered risky.

How does this work?

The following hypothetical examples show how the correlation between assets can affect the overall risk for a portfolio.

Portfolio A is invested in race horses and race tracks.

	Race horses	Race tracks
Return	10.0%	7.0%
Std. deviation (risk)	12.0%	8.0%

Correlation between assets: .90

Portfolio B is invested in Beanie Babies and fine art.

	Beanie Babies	Fine art
Return	10.0%	7.0%
Std. deviation (risk)	13.2%	8.8%

Correlation between assets: .10

While the assets in each portfolio have corresponding returns, they have different risk levels and different correlations. When they are weighted the same, which portfolio has the greater total risk?

Portfolio A

Race horses = 56% of portfolio

Race tracks = 44% of portfolio

Expected return is 8.68%

Standard deviation (risk) 10.00%

Portfolio B

Beanie Babies = 56% of portfolio

Fine art = 44% of portfolio

Expected return is 8.68%

Standard deviation (risk) 8.70%

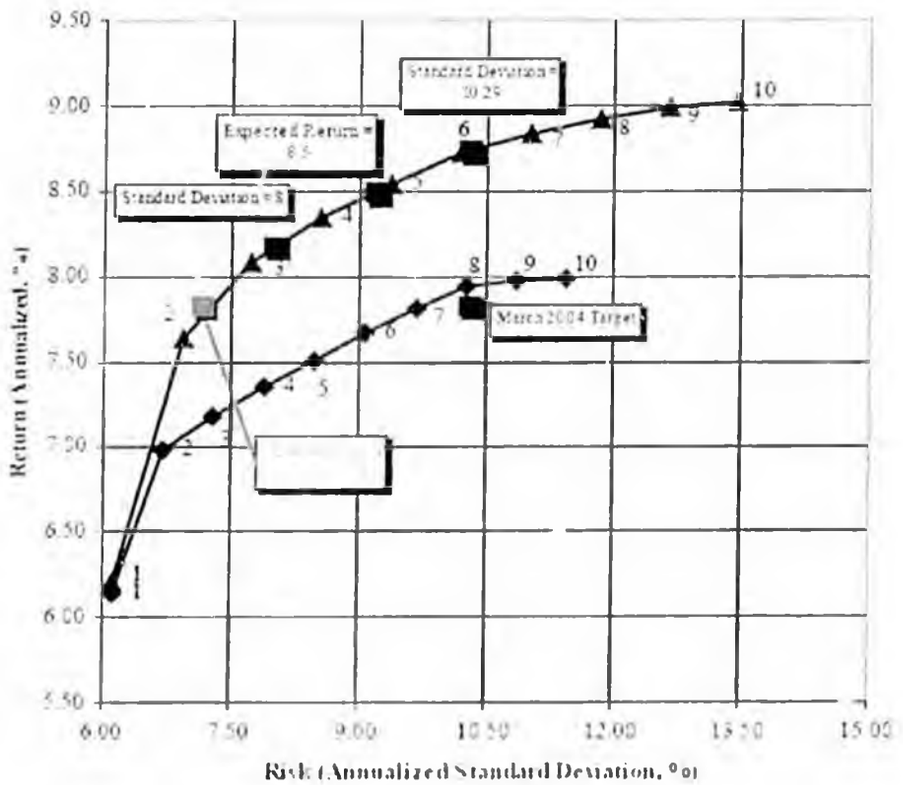
The portfolio using higher risk investments was able to achieve a lower overall risk for equal returns because it used investments that are less correlated.

Where is the Permanent Fund?

The following chart shows potential risk and return for various portfolios under the Fund's current investment restrictions (blue line), and under the Prudent Investor Rule alone (red line). The underlying asset allocations for the main points of this chart are shown on the next page.

The chart demonstrates that under the Prudent Investor Rule, the Fund could potentially earn the same return as the current portfolio (March 2004 target) with more than 3% less risk (Expected Return = 7.83). Or, for the same risk the Fund could earn almost 1% more return (Standard Deviation = 10.29).

Efficient Frontier



The Trustees understand the Legislature's need to balance risk and return for the Fund. While an aggressive rate of growth may be desired by some, others may find it more important to lower the Fund's risk while maintaining a reasonable rate of return.

Increasing the Fund's investment options would allow the Trustees greater flexibility in managing the Fund for the benefit of all Alaskans, whether it is for greater return, lower risk or both This is especially important as the Legislature begins to contemplate the use of Fund earnings for more than just the dividend program.

How would the Trustees use that flexibility?

The statutory list prevents investments in newer high risk assets such as broad emerging market debt, high yield bonds and certain forms of real estate investments. These assets, while considered risky on their own, can lower the overall risk of a portfolio through low correlation with other asset types.

These asset types are fairly easy to describe, and with time could be added to the statutory list with Legislative approval. However, by the time they are added, the investment opportunity may have closed, leaving the Permanent Fund out in the cold.

Asset Classes	March 2004 Target	Expected Return 7.83	Standard Deviation = 10.29	Standard Deviation = 8	Expected Return = 8.5
Large Cap US Equity	30	20	20	20	20
Small/Mid Cap US Equity	7	5	5	5	5
International Equity	16	10	10	10	10
Emerging Markets	2	0	6	0	4
Fixed Income	28	20	20	20	20
Non-US Fixed Income	4	5	0	5	1
Real Estate	6	15	14	15	15
REITs	4	0	0	0	0
Private Equity	2	0	10	4	6
Absolute Return	1	10	5	10	9
Cash Equivalents	0	0	0	0	0
Commodities	0	5	5	5	5
Convertibles	0	0	0	0	0
High Yield	0	0	0	0	0
Real Return	0	1	0	1	0
Timber	0	5	5	5	5
TIPS	0	1	0	0	0
Total	100	100	100	100	100

As the investment world seeks new ways to improve returns in increasingly efficient markets, investors are creating new strategies that mix multiple investment options or asset types within a single investment mandate. Absolute return strategies, an alternative asset type that the Fund currently invests in under the 10% basket clause, are portfolios that invest for an absolute target return using the most promising investment opportunities available. These portfolios are defined by their return targets, not by the assets they hold.

This new wave of investment practice does not fit well within the rigid structure of a legal list. If the Fund's legal list were moved to regulation as suggested by a recent Attorney General's opinion, it would still require that these strategies have some form of definition. However, the less cumbersome regulatory process would allow Trustees to craft and modify regulatory definitions of alternative investment strategies.

The Prudent Investor Rule

STATE/TERRITORY ADOPTIONS*
of the PRUDENT INVESTOR ACT

Alaska (ASPIB)	Maryland **	Pennsylvania
Arizona	Michigan	Rhode Island
Arkansas	Minnesota	South Carolina
California	Missouri	South Dakota
Colorado	Montana	Tennessee
Connecticut	Nebraska	Texas
District of Columbia	Nevada	Utah
Hawaii	New Hampshire	U.S. Virgin Islands
Idaho	New Jersey	Vermont
Illinois	New Mexico	Virginia
Indiana	North Carolina	Washington
Iowa	North Dakota	West Virginia
Kansas	Ohio	Wisconsin
Maine	Oklahoma	Wyoming
Massachusetts	Oregon	

** Source is National Conference of Commissioners on Uniform State Laws*

*** Substantially Similar*

The Prudent Investor Rule is a legal standard that requires the APFC Board of Trustees to act as a prudent institutional investor would when making investment decisions. Alaska statutes require that the Board follow the Prudent Investor Rule in addition to the other statutory investment restrictions.

The Permanent Fund's peers—state pension funds and large institutional endowment funds—have been moving away from legal investment lists. Instead, they are simply required to conform to the Prudent Investor Rule.

New York and New Mexico are both seeking legislative approval to expand the investment flexibility for their state pension funds.

What can we do?

The Constitution says that the Alaska Permanent Fund will be invested in assets "specifically designated by law." This prevents the Legislature from removing the legal list and simply requiring that all Fund investments conform to the Prudent Investor Rule. However, a recent Attorney General's opinion says the Legislature may delegate authority to the Board of Trustees to create a list of allowed investments in regulation. A regulatory list may be amended more quickly than statutes, allowing the Trustees the flexibility to respond to changes in the investment world.

Legislation drafted at the request of the Trustees would allow the list to be moved to regulation, while maintaining key restrictions in statute. The most important of these restrictions is the requirement that all Fund investments conform to the Prudent Investor Rule.

The Alaska Permanent Fund Corporation thanks Michael O'Leary of Callan Associates, and Russ Kuhns, Rebecca Gratsinger, and Jim Voytko of RV Kuhns, for their assistance in producing this handout.

SENATE COMMITTEE REPORT

DATE: 4/21/05

FURTHER: (Finance)

DATE TURNED IN TO OFFICE: 5/3/05

State Affairs Committee considered CS FOR HOUSE BILL NO. 215(FIN)

HB 215 PERM FUND CORP. INVESTMENTS/REGULATIONS

"An Act relating to the investment responsibilities of the Alaska Permanent Fund Corporation; relating to regulations proposed and adopted by the Board of Trustees of the Alaska Permanent Fund Corporation and providing procedures for the adoption of regulations by the board; and providing for an effective date."

and recommends:

[ ] be **replaced** with _____ **CS** _____ (_____)

[ ] adopt **previous** _____ **CS** _____ (_____)

[ ] attached amendment(s)

[ ] adopt Letter of Intent by _____ Committee

[ ] further referral to _____ Committee

CS Senate Bill:
[ ] Same Title
[ ] New Title

SCS House Bill:
[ ] Same Title
[ ] Technical Title Change
[ ] New Title w/ SCR #____

NEW FISCAL NOTE(S):

Department	Date	Fiscal	Indet.	Zero	FN#

PREVIOUS FISCAL NOTE(S):

Department	Date	Fiscal	Indet.	Zero	FN#
REV - MPIC	4/13/05			✓	1

[ ] **APPROPRIATION - no fiscal note**

SIGNATURES AND RECOMMENDATIONS:	DO PASS	DO NOT PASS	NO REC	AMEND
			✓	
			✓	
			✓	
CHAIR: Lesil Kerrigan			✓	

HB 216

HOUSE COMMITTEE REPORT

(11)
Date Referred to Committee: April 4, 2005 **FURTHER REFERRALS:**

Date of Committee Action: 4/19/05

The FINANCE Committee considered: **HB 216**

HOUSE BILL NO. 216 **PROPERTY/CASUALTY INSURANCE REGULATION**

"An Act relating to insurance rate-making and form filing."

Recommends it be replaced with [ ] HCS *or* [✓] CS *for* HB 216 (L+C)
For Senate Bills with new title: [ ] Technical Title [ ] New Title: HCR___ ___ **[✓] Same Title [ ] New Title**

[ ] attach amendments
[ ] add new referral to _____Committee
[ ] Letter of Intent_____Committee

List of Abbrev for Depts.:
ADM
CED
COR
CRT
EED
DEC
DFG
GOV
HSS
LEG
LAW
LWF
MVA
DNR
DPS
REV
DOT
UA

NEW FISCAL NOTES *Assigned by Chief Clerk's Office				
List by Dept(s):	*FN#	Fiscal	Indet.	Zero

PREVIOUS FISCAL NOTES				
List by Dept(s):	FN#	Fiscal	Indet.	Zero
DED	#1			✓

Signing with recommendations	Printed Last Name	DP	DNP	NR	AM
Mike Hawker	Hawker	☆			
Bill Croft	Croft	✓			
Steve Moses	Moses	✓			
	STATE			✓	
Chair: Ken Meyer	Meyer	✓			
Chair: Mike Chenault	Chenault			X	

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FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: 1
Bill Version: CSHB 216(L&C)
(H) Publish Date: 4/4/05

Revision Date/Time (Note if correction):
Dept Affected: Commerce
Title: Property/Casualty Insurance Regulation
RDU: Insurance (116)
Component: Insurance
Sponsor: Labor & Commerce
Requester: House Labor & Commerce
Component No.: 354

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES						
CHANGE IN REVENUES ( )						

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2005) cost: 0.0
Mark this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: *(Attach a separate page if necessary)*

This legislation relates to insurance rate-making and form filing, and does not financially impact the operations of the division

Prepared by: Linda S. Hall, Director — Phone: 907-269-7920
Division: Insurance — Date/Time: 3/16/05 5:53 PM
Approved By: Edgar Blatchford, Commissioner — Date: 3/16/2005
Agency: Commerce, Community & Economic Development

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Rep.Tom_Anderson@legis.state.ak.us

Representative Tom Anderson
District 19 - Anchorage

Sponsor Statement for HB 216

Title: "An Act relating to insurance rate-making and form filing."

Under existing law property/casualty insurance rates and forms are subject to the insurance commissioner's prior approval before they may be put in place. While maintaining the insurance commissioner's authority to oversee rate changes, a key component of the bill is its creation of a percentage "flex band." HB 216 allows an insurer to make rate increases and decreases within the flex band without having to first obtain the insurance commissioner's prior approval. Rate changes outside of the flex band must be filed with the insurance commissioner for her review before the rates are put into effect. For forms, HB 216 gives the insurance company a choice. The insurer may seek the commissioner's prior approval, or the insurer may file the form with the commissioner for a period of time before the form is used.

HB 216 has three basic purposes. First, the bill will create an environment where insurers compete more vigorously on rates and products offered to consumers. Second, HB 216 will encourage insurers who are in the Alaska market to stay here and will attract new insurers to Alaska. This will result in more competition, which will give consumers more choices and more competitive prices. Third, HB 216 is in line with the national movement away from strict government price controls toward a more flexible, more competitively oriented system for the regulation of insurance rates and forms.

HB 216 is the result of discussions among insurance companies, agents and the Director of Insurance and her staff. The discussions started last July and have been ongoing over the past nine months. The participants in this effort used the flex-rating model law adopted by the National Conference of Insurance Legislators (NCOIL) as a starting point. Some elements of the NCOIL model were adopted – others were discarded. However, HB 216 is consistent with the NCOIL model's goal of modernizing state insurance regulation. We believe that HB 216 will create a more dynamic, more competitively oriented insurance market in Alaska. The competition on rates and forms that HB 216 will encourage will benefit Alaska insurance consumers.

I urge your support of HB 216.

Sectional Analysis
CSHB216

Prepared by Rita Nowak
Property Casualty Insurance Association of America

Alaska House Bill 216
Sectional Analysis

Summary of Alaska House Bill 216

House Bill 216 proposes the following changes to the current property and casualty rate and form review process:

Flex-Rating

- Insurers would have the option of submitting rate filings excluding medical malpractice, workers' compensation, and assigned risk rates under a flex-rating procedure (a 10% band) without prior approval. Rate changes outside of the flex band would still be subject to prior approval.
- Advisory organizations would not have the option of submitting filings under the flex-rating approach.
- Impaired or insolvent insurers operating under a rehabilitation plan, an order of supervision, or an impaired financial condition would be precluded from submitting filings under the flex-rating procedure.
- Insurers submitting a rate filing for a new product or coverage will be precluded from submitting filings under the flex-rating procedure.

Form Filings

- Insurers would have the option of submitting form filings under a file and use approach with a thirty-day waiting period. When an insurer chooses this option, a signed self-certification form from an authorized company officer or a state filings manager stating that the filing complies with Alaska statutes must be included with the form filing. However, the Director would still have the authority to disapprove any form violating Alaska statutes. Insurers will be able to continue to submit form filings under the current prior approval provisions.
- The bill includes specific monetary penalties for insurers submitting materially false or misleading compliance certificates.

Consent to Rate (Section 4)

- Language was added to further explain the reasons(s) for the need to use a rate in excess of a filed rate for a specific risk.

Technical and Conforming Changes

- Technical and conforming changes were made to Title 21 to take into account the new provisions.

Following is a detailed sectional analysis of House Bill 216:

Section 1 AS 21.09.110(b)

This law specifies filing requirements for policy forms and rates requiring approval under Alaska Statues § 21.39 (rates and rating organizations) and § 21.42 (insurance contracts).

Section 2 AS 21.39.040(a)

Rate filings are to be submitted under the specified filing procedures, AS § 21.39.040(prior approval), or AS §21.39.210(flex-rating), AS 21.39.220(file and use, filing of rates, supplementary rate information, and supporting information).

Alaska House Bill 216
Sectional Analysis

Section 3 AS 21.39.040(d)
This section pertains to the situation where an insurer does not provide sufficient information in its rate filing. The Director shall require the insurer to furnish specific information upon which the insurer supports the filing.

Section 4 AS 21.39.040(g)
Upon written application of an insured that states the reasons for unusual or extrahazardous characteristics not otherwise contemplated in a filed rating plan, an insurer may file a rate for use on a specific risk that exceeds a rate provided by an otherwise applicable filing.

Section 5 AS 21.39 (New Section: 21.39.041)
Except for workers compensation prospective loss cost filings and assigned risk pool rates by certain rating organizations, insurers and ratir organizations must file medical malpractice, workers compensation, and assigned risk rating ystems specified under Alaska law. Such filings must be made with the director for the purpose of review and approval prior to use.

Filings made pursuant to this requirement are subject to a 15-day waiting period before they become effective, but the director may extend the waiting period for up to an additional 15 days. If the waiting period is extended, the director must so notify the insurer or rating organization within the initial waiting period that additional time is required for consideration of the filing. If the director determines the filing meets the requirements of these provisions, it must be approved.

This law specifies such filings must include the effective date, or in the absence of a specific effective date, the insurer or rating organization may specify a reasonable period after approval for the filing to be effective.

Upon written application of the insurer or rating organization, the director may permit a filing to become effective before the expiration of the 15-day waiting period specified by this law. Filings are deemed to meet the requirements of Alaska law regarding rates and rating organizations unless the director disapproves the filing within the specified waiting period.

If a filing is not accompanied by the information supporting the filing, and the director does not have sufficient information to determine whether the filing is in compliance with applicable provisions of Alaska law, the insurer must be required to furnish the information supporting the filing. Under such circumstances, the waiting period will commence as of the date the required information is furnished. Such information may include the insurer or rating organization's experience or judgment, or the experience of other insurers or rating organizations, any interpretation of statistical data relied upon for the filing, and any other factors relevant to the filing.

When an insurer or rating organization fails to provide such information within 30 days of receiving the director's request, and upon receiving a written application for an extension of the waiting period submitted within the initial 30 day response period, the director may extend the waiting period for an additional 15 days. The director may deem an insurer or rating organization's failure to provide requested information as a request to withdraw the filing from further consideration.

If within the initial review period established by this law, the director determines a filing fails to meet the requirements of these provisions, the director must send the insurer or rating organization making the filing a written notice of disapproval. Such notice must indicate the

manner in which the filing fails to meet the requirements of this law and must specify the filing will not become effective.

Section 6 AS 21.39.050(c)
Additionally, if at any time subsequent to the review period provided established by these provisions, and after notice and hearing in accordance with this law, the director determines a filing does not meet the requirements of Alaska law, he or she must give each insurer or rating organization making the filing an order specifying the manner in which the filing fails to meet the requirements set forth by these provisions.

Section 7 AS 21.39.070(b)
Deviations permitted to be filed will remain effective for a period of at least one-year from the effective date unless, with the director's approval, the insurer withdraws the deviation or the deviation is otherwise terminated under specified provisions of Alaska law.

Section 8 AS 21.39.110(a)
This law specifies that groups, associations, or other organizations of insurers which engage in joint underwriting or joint reinsurance, are subject to Alaska law regarding rates and rating organizations, except those provisions regarding flex rating. Moreover, joint reinsurance is subject to provisions regarding examinations, penalties, and hearing procedures and judicial review under Alaska law regarding rates and rating organizations.

Section 9 AS 21.39 (New Sections: 21.39.210 and 21.39.220)

Section 21.39.210 (Flex-rating)
Unless a rate level change pertains to workers compensation, medical malpractice, or assigned risk plans, this law permits increases or decreases in an insurer's rate level to take effect without prior approval. However, such rate level changes must reflect a cumulative rate level increase or decrease for all coverages, calculated from the effective date to 12 months before the effective date, of not greater than 10 percent.

This law permits insurers to make multiple rate filings during any 12-month period if the cumulative rate level change, as calculated from the effective date to 12 months before the effective date, is not greater than 10 percent.

For policies governed under these provisions, filings producing rate level changes within the limitations specified by this law are effective without prior approval and may take effect on the date specified in the filing. However, such filings will not be effective earlier than the date the filing is received by the division. Rate level changes may not be applied to a policy until the beginning of the policy period.

Furthermore, filings submitted pursuant to these provisions must include exhibits showing the calculation of the overall rate level change and the insurer's expense provisions. Loss cost adjustment filings must include supporting information showing how the loss cost adjustment is calculated and the director may request additional information if he or she does not have adequate information upon which to determine whether the filing is in compliance with Alaska law regarding rates and rating organizations.

Filings made pursuant to these provisions are considered to be in compliance with Alaska's insurance laws. But, if the director determines the filing fails to meet the requirements of Alaska's insurance laws, he or she must issue an order specifying the specific provisions of

Alaska law the insurer has violated and identifying the reasons the filing is not in compliance. Moreover, the order must state a reasonable date on when the filing is no longer effective. Orders issued pursuant to these provisions do not affect any contract issued or made prior to the effective date of the order.

These provisions do not apply to rating organizations or impaired or insolvent insurers operating under a rehabilitation plan, order of supervision, or an impaired financial condition as determined by the director.

Section 21.39.220(New) (File and use, filing of rates, supplementary rate information, and supporting information)
Insurer rate level increases or decreases falling outside the limitations provided under AS 21.39.210(a) (flex rating), are subject to file and use provisions under this law, unless otherwise exempt under another provision of Alaska law regarding rates and rating organizations. Such rate filings must be submitted to the director under these file and use provisions. Where an insurer is operating under a rehabilitation plan, order of supervision or an impaired financial condition as determined by the director, rate filings must be submitted to the division under the prior approval provisions of Alaska law. Filings must also be submitted for new products or coverage introductions that do not have a rate on file under the file and use provisions.

Additionally, insurers must file all rates, supplementary rate information, and supporting information with the director at least 30 days prior to the proposed effective date of a filing. Such filings must be reviewed within 15 days, but that period may be extended for an additional 15 days if the director gives the insurer or rating organization notice within the initial 15 day period stating additional time for consideration of the filing is necessary. For purposes of this law, the waiting period is the 30-day period following the date the director receives the filing.

Filings made pursuant to these provisions must include an effective date, which may not be before the end of the waiting period. If the insurer or rating organization applies in writing, the director may permit the filing to become effective before expiration of the waiting period. Filings are deemed to meet the requirements of this law and to become effective unless disapproved within the waiting period. Additionally, the director must disapprove a rate if he or she determines it does not meet the requirement of Alaska's insurance laws.

If a filing is not accompanied by the information supporting the filing, and the director does not have sufficient information to determine whether the filing is in compliance with applicable provisions of Alaska law, the insurer will be required to furnish the information supporting the filing. Under such circumstances, the waiting period will commence as of the date the required information is furnished. Such information may include the insurer or rating organization's experience or judgment, or the experience of other insurers or rating organizations, any interpretation of statistical data relied upon for the filing, and any other factors relevant to the filing. When an insurer or rating organization fails to provide such information within 30 days of receiving the director's request, and upon receiving a written application for an extension of the waiting period, the director may extend the waiting period for an additional 15 days, if such application is made within the initial 30 day response period. Filings may be disapproved for failure to provide requested information during the response period. Notices of disapproval must indicate a reasonable future date on which the filing is to be considered no longer effective.

If, within the specified waiting period, the director finds a filing does not meet the requirements of Alaska law regarding rates and rating organizations, the director must send the insurer or rating organization which made the filing, written notice of disapproval. Such notice must specify the

manner in which the filing fails to comply with this law and must state a reasonable future date on which the filing is to be considered no longer effective.

Filings and supporting information will be open to public inspection after the director completes the review of the filing.

Section 10 AS 21.42.120(b)
Insurers and rating organizations must submit filings for prior approval under AS 21.42.123 (form filing subject to prior approval) or AS 21.42.125 (form filing subject to file and use).

Section 11 AS 21.42.120
This law permits the director to order an insurer or rating organization to submit a specific insurance document or form, or a type of insurance document or form for prior approval if the director believes such approval is necessary for the protection of the public.

Section 12 AS 21.42 (New Sections 21.42.123 and 21.42.125)

Section 21.42.123 (Form filing subject to prior approval)
Prior approval filings must be made at least 30 days before the effective date of such filing. At the conclusion of the 30-day period, the filed form is considered approved unless it has been affirmatively disapproved by order of the director before the end of the 30-day period. If the director approves the form before the end of the required 30-day period, such approval constitutes a waiver of the unexpired portion of the waiting period.

Additionally, the waiting period for approval or disapproval may be extended for up to an additional 30 days if the director gives the insurer or rating organization notice within the initial 30 day period. In the absence of a prior approval or disapproval, forms subject to an extended waiting period are deemed approved at the end of the extended period. However, the director may, at any time after the notice, and for cause shown, withdraw the approval.

Insurers or rating organizations may be required to revise a filing in order to meet the prior approval filing requirements under Alaska's insurance laws. If an insurer or rating organization fails to provide requested information within 30 days after such request by the director, or within an additional 15 day period granted upon the insurer or rating organization's written request, such failure will be deemed a request by the insurer or rating organization to withdraw the filing from further consideration.

Filings made pursuant to these provisions must state and effective date or otherwise specify a reasonable time period after approval for the filing to be effective. Furthermore, prior approval filings will be open to public inspection after such filings become effective.

Section 21.42.125(Form filing subject to file and use; penalties)
File and use filings must be filed with the director for a waiting period of at least 30 days, but that period may be extended by the director or the insurer or rating organization for up to an additional 30 days if notice is given as required by this law. Such notice must be give within the initial 30 day period and the filing may become effective at the end of the waiting period unless disapproved by the director within the time of the waiting period.

Filings must state an effective date that must be after the waiting period but, upon the insurer or rating organization's written request, the director may permit a reviewed filing to become effective before the expiration of the waiting period.

File and use forms must include a signed compliance certificate certifying the filing complies with Alaska's insurance laws. Compliance certificates must be signed by an authorized officer of the filing organization or the organization's state filings manager and state that, to the best knowledge of the signor, the filing complies with applicable laws.

In addition to other penalties provided by law, if an insurer or rating organization submits a materially false or misleading compliance certificate, the director may require the organization to submit future form filings for prior approval. Moreover, a person violating these requirements regarding compliance certificates may also be subject to civil penalties of up to $25,000 for each violation. Filings that do not include a signed compliance certificate will be reviewed under the prior approval procedure pursuant to Alaska law.

This law also permits the director to require insurers and rating organizations to provide additional information demonstrating that a file and use filing meets the requirements of Alaska's insurance laws, or the director may require such organizations to revise a filing to meet those requirements. The director must consider an insurer or rating organization's failure to provide information required pursuant to this provision as a request to withdraw the filing from further consideration. File and use filings will be open to public inspection after the filing becomes effective.

Section 13 AS 21.39.050(a)
This law also repeals AS 21.39.050(a) pertaining to the disapproval of filings.

Alaska State Legislature

House of Representatives

Official Business

State Capitol
Juneau, AK 99801-1182

SECTIONAL ANALYSIS FOR HB 216
BY: Representative Tom Anderson

This law modifies the following sections of Alaska Statutes: 21.09.110(joint underwriting or joint reinsurance); 21.39.040, 21.39.040(d) and 21.39.040(rate filings); 21.39.050(c)(disapproval of filings); 21.39.070(b)(deviations); 21.39.110(a)(joint underwriting or joint reinsurance); and 21.42.120(filing, approval of forms). It also adds the following sections to Alaska Statutes: 21.39.041(prior approval); 21.39.210(flex-rating); 21.39.220(file and use, filing of rates, supplementary rate information, and supporting information); 21.42.123(form filing subject to prior approval); and 21.42.125(form filing subject to file and use; penalties). Additionally, this law repeals 21.39.050(a) (disapproval of filings).

Section 1 AS 21.09.110(b)

This law specifies filing requirements for policy forms and rates requiring approval under Alaska Statues § 21.39 (rates and rating organizations) and § 21.42 (insurance contracts).

Section 2 AS 21.39.040(a)

These provisions require each insurer to file every manual, minimum, class rate, rating schedule or rating plan, rating rule, and any modification thereto which an insurer proposes to use. However, such information is not required for marine risks which are not written according to manual rates or rating plans and commercial insurance for which the director of insurance authorizes an informational filing pursuant to this law. Filings submitted pursuant to these provisions must be in accordance with Alaska Statutes §§ 21.39.041(prior approval), 21.39.210(flex-rating), and 21.39.220(file and use, filing of rates, supplementary rate information, and supporting information). They must also state the proposed filing effective date and the character and extent of the coverage contemplated.

Section 3 AS 21.39.040(d)

Pursuant to AS 21.39.040(d), if the director has insufficient information to determine if a filing meets the requirements of this law, the director must require the insurer to furnish information supporting the filing.

Section 4 AS 21.39.040(g)

Upon written application of an insured that states the reasons for unusual or extra hazardous characteristics not otherwise contemplated in a filed rating plan, an insurer may file a rate for use on a specific risk that exceeds a rate provided by an otherwise applicable filing.

Section 5 AS 21.39 (New Section: 21.39.041)

Except for workers compensation prospective loss cost filings and assigned risk pool rates by certain rating organizations, insurers and rating organizations must file medical malpractice, workers compensation, and assigned risk rating systems specified under Alaska law. Such filings must be made with the director for the purpose of review and approval prior to use.

Filings made pursuant to this requirement are subject to a 15-day waiting period before they become effective, but the director may extend the waiting period for up to an additional 15 days. If the waiting period is extended, the director must so notify the insurer or rating organization within the initial waiting period that additional time is required for consideration of the filing. If the director determines the filing meets the requirements of these provisions, it must be approved.

This law specifies such filings must include the effective date, or in the absence of a specific effective date, the insurer or rating organization may specify a reasonable period after approval for the filing to be effective.

Upon written application of the insurer or rating organization, the director may permit a filing to become effective before the expiration of the 15-day waiting period specified by this law. Filings are deemed to meet the requirements of Alaska law regarding rates and rating organizations unless the director disapproves the filing within the specified waiting period.

If a filing is not accompanied by the information supporting the filing, and the director does not have sufficient information to determine whether the filing is in compliance with applicable provisions of Alaska law, the insurer must be required to furnish the information supporting the filing. Under such circumstances, the waiting period will commence as of the date the required information is furnished. Such information may include the insurer or rating organization's experience or judgment, or the experience of other insurers or rating organizations, any interpretation of statistical data relied upon for the filing, and any other factors relevant to the filing.

When an insurer or rating organization fails to provide such information within 30 days of receiving the director's request, and upon receiving a written application for an extension of the waiting period submitted within the initial 30 day response period, the director may extend the waiting period for an additional 15 days. The director may deem an insurer or rating organization's failure to provide requested information as a request to withdraw the filing from further consideration.

If within the initial review period established by this law, the director determines a filing fails to meet the requirements of these provisions, the director must send the insurer or rating organization making the filing a written notice of disapproval. Such notice must indicate the manner in which the filing fails to meet the requirements of this law and must specify the filing will not become effective.

Section 6 AS 21.39.050(c)

Additionally, if at any time subsequent to the review period provided established by these provisions, and after notice and hearing in accordance with this law, the director determines a filing does not meet the requirements of Alaska law, he or she must give each insurer or rating organization making the filing an order specifying the manner in which the filing fails to meet the requirements set forth by these provisions.

Section 7 AS 21.39.070(b)

Deviations permitted to be filed will remain effective for a period of at least one-year from the effective date unless, with the director's approval, the insurer withdraws the deviation or the deviation is otherwise terminated under specified provisions of Alaska law.

Section 8 AS 21.39.110(a)

This law specifies that groups, associations, or other organizations of insurers which engage in joint underwriting or joint reinsurance, are subject to Alaska law regarding rates and rating organizations, except those provisions regarding flex rating. Moreover, joint reinsurance is subject to provisions regarding examinations, penalties, and hearing procedures and judicial review under Alaska law regarding rates and rating organizations.

Section 9 AS 21.39 (New Sections: 21.39.210 and 21.39.220)

Section 21.39.210 (Flex-rating)

Unless a rate level change pertains to workers compensation, medical malpractice, or assigned risk plans, this law permits increases or decreases in an insurer's rate level to take effect without prior approval. However, such rate level changes must reflect a cumulative rate level increase or decrease for all coverages, calculated from the effective date to 12 months before the effective date, of not greater than 10 percent.

This law permits insurers to make multiple rate filings during any 12-month period if the cumulative rate level change, as calculated from the effective date to 12 months before the effective date, is not greater than 10 percent.

For policies governed under these provisions, filings producing rate level changes within the limitations specified by this law are effective without prior approval and may take effect on the date specified in the filing. However, such filings will not be effective earlier than the division receives the date the filing. Rate level changes may not be applied to a policy until the beginning of the policy period.

Furthermore, filings submitted pursuant to these provisions must include exhibits showing the calculation of the overall rate level change and the insurer's expense provisions. Loss cost adjustment filings must include supporting information showing how the loss cost adjustment is calculated and the director may request additional information if he or she does not have adequate information upon which to determine whether the filing is in compliance with Alaska law regarding rates and rating organizations.

Filings made pursuant to these provisions are considered to be in compliance with Alaska's insurance laws. But, if the director determines the filing fails to meet the requirements of Alaska's insurance laws, he or she must issue an order specifying the specific provisions of Alaska law the insurer has violated and identifying the reasons the filing is not in compliance. Moreover, the order must state a reasonable date on when the filing is no longer effective. Orders issued pursuant to these provisions do not affect any contract issued or made prior to the effective date of the order.

These provisions do not apply to rating organizations or impaired or insolvent insurers operating under a rehabilitation plan, order of supervision, or an impaired financial condition as determined by the director.

Section 21.39.220(New) (File and use, filing of rates, supplementary rate information, and supporting information)

Insurer rate level increases or decreases falling outside the limitations provided under AS 21.39.210(a) (flex rating), are subject to file and use provisions under this law, unless otherwise exempt under another provision of Alaska law regarding rates and rating organizations. Such rate filings must be submitted to the director under these file and use provisions. Where an insurer is operating under a rehabilitation plan, order of supervision or an impaired financial condition as determined by the director, rate filings must be submitted to the division under the prior approval provisions of Alaska law. Filings must also be submitted for new products or coverage introductions that do not have a rate on file under these file and use provisions.

Additionally, insurers must file all rates, supplementary rate information, and supporting information with the director at least 30 days prior to the proposed effective date of a filing. Such filings must be reviewed within 15 days, but that period may be extended for an additional 15 days if the director gives the insurer or rating organization notice within the initial 15 day period stating additional time for consideration of the filing is necessary. For purposes of this law, the waiting period is the 30-day period following the date the director receives the filing.

Filings made pursuant to these provisions must include an effective date, which may not be before the end of the waiting period. If the insurer or rating organization applies in writing, the director may permit the filing to become effective before expiration of the waiting period. Filings are deemed to meet the requirements of this law and to become effective unless disapproved within the waiting period. Additionally, the director must disapprove a rate if he or she determines it does not meet the requirement of Alaska's insurance laws.

If a filing is not accompanied by the information supporting the filing, and the director does not have sufficient information to determine whether the filing is in compliance with applicable provisions of Alaska law, the insurer will be required to furnish the information supporting the filing. Under such circumstances, the waiting period will commence as of the date the required information is furnished. Such information may include the insurer or rating organization's experience or judgment, or the experience of other insurers or rating organizations, any interpretation of statistical data relied upon for the filing, and any other factors relevant to the filing. When an insurer or rating organization fails to provide such information within 30 days of receiving the director's request, and upon receiving a written application for an extension of the waiting period, the director may extend the waiting period for an additional 15 days, if such application is made within the initial 30-day response period. Filings may be disapproved for failure to provide requested information during the response period. Notices of disapproval must indicate a reasonable future date on which the filing is to be considered no longer effective.

If, within the specified waiting period, the director finds a filing does not meet the requirements of Alaska law regarding rates and rating organizations, the director must send the insurer or rating organization, which made the filing, written notice of disapproval. Such notice must specify the manner in which the filing fails to comply with this law and must state a reasonable future date on which the filing is to be considered no longer effective.

Filings and supporting information will be open to public inspection after the director completes the review of the filing.

Section 10 AS 21.42.120(b)

Insurers and rating organizations must submit filings for prior approval under AS 21.42.123 (form filing subject to prior approval) or AS 21.42.125 (form filing subject to file and use).

Section 11 AS 21.42.120

This law permits the director to order an insurer or rating organization to submit a specific insurance document or form, or a type of insurance document or form for prior approval if the director believes such approval is necessary for the protection of the public.

Section 12 AS 21.42 (New Sections 21.42.123 and 21.42.125)

Section 21.42.123 (Form filing subject to prior approval)

Prior approval filings must be made at least 30 days before the effective date of such filing. At the conclusion of the 30-day period, the filed form is considered approved unless it has been affirmatively disapproved by order of the director before the end of the 30-day period. If the director approves the form before the end of the required 30-day period, such approval constitutes a waiver of the unexpired portion of the waiting period.

Additionally, the waiting period for approval or disapproval may be extended for up to an additional 30 days if the director gives the insurer or rating organization notice within the initial 30 day period. In the absence of a prior approval or disapproval, forms subject to an extended waiting period are deemed approved at the end of the extended period. However, the director may, at any time after the notice, and for cause shown, withdraw the approval.

Insurers or rating organizations may be required to revise a filing in order to meet the prior approval filing requirements under Alaska's insurance laws. If an insurer or rating organization fails to provide requested information within 30 days after such request by the director, or within an additional 15 day period granted upon the insurer or rating organization's written request, such failure will be deemed a request by the insurer or rating organization to withdraw the filing from further consideration.

Filings made pursuant to these provisions must state and effective date or otherwise specify a reasonable time period after approval for the filing to be effective. Furthermore, prior approval filings will be open to public inspection after such filings become effective.

Section 21.42.125(Form filing subject to file and use; penalties)

File and use filings must be filed with the director for a waiting period of at least 30 days, but that period may be extended by the director or the insurer or rating organization for up to an additional 30 days if notice is given as required by this law. Such notice must be give within the initial 30 day period and the filing may become effective at the end of the waiting period unless disapproved by the director within the time of the waiting period.

Filings must state an effective date that must be after the waiting period but, upon the insurer or rating organization's written request, the director may permit a reviewed filing to become effective before the expiration of the waiting period.

File and use forms must include a signed compliance certificate certifying the filing complies with Alaska's insurance laws. Compliance certificates must be signed by an authorized officer of the filing organization or the organization's state filings manager and state that, to the best knowledge of the signor, the filing complies with applicable laws.

In addition to other penalties provided by law, if an insurer or rating organization submits a materially false or misleading compliance certificate, the director may require the organization to submit future form filings for prior approval. Moreover, a person violating these requirements regarding compliance certificates may also be subject to civil penalties of up to $25,000 for each violation. Filings that do not include a signed compliance certificate will be reviewed under the prior approval procedure pursuant to Alaska law.

This law also permits the director to require insurers and rating organizations to provide additional information demonstrating that a file and use filing meets the requirements of Alaska's insurance laws, or the director may require such organizations to revise a filing to meet those requirements. The director must consider an insurer or rating organization's failure to provide information required pursuant to this provision as a request to withdraw the filing from further consideration. File and use filings will be open to public inspection after the filing becomes effective.

Section 13 AS 21.39.050(a)
This law also repeals AS 21.39.050(a) pertaining to the disapproval of filings.

STATE OF ALASKA
DEPARTMENT OF
COMMERCE
COMMUNITY AND
ECONOMIC DEVELOPMENT

DIVISION OF INSURANCE

Frank H. Murkowski, Governor

March 31, 2005

The Honorable Tom Anderson
Alaska House of Representatives
House Labor & Commerce Committee
State Capitol, Room 408
Juneau, AK 99801-1182

RE: HB 216 – An Act relating to insurance rate-making and form filing

Dear Representative Anderson:

During the hearing on HB 216 on March 21, 2005, Representative Rokeberg asked for information on what other states use for flex-rate bands, how much time it takes to get rates approved and what are typical rate changes. This letter and its attachment provides the requested information.

Please see the attached chart that summarizes the flex-rate laws of other states.

To provide information on typical rate changes, we have looked at rate filings that have been submitted to the division since January 1, 2000 for several different lines of business. For personal lines, personal auto and homeowners lines rate history from 3 different companies for each line are shown below.

Personal Auto Rate Change History

Company A

Rate Change	Effective Date	Flex-rating
7.0%	8/8/2000	
4.8%	4/22/2002	Yes
8.2%	8/30/2002	No
5.7%	9/8/2003	Yes

Had the flex-rating method proposed in HB 216 been available when these filings were made, the April 2002 filing would have qualified to be filed under the flex-rating provisions. The August 2002 would not qualify since the total rate change in the 12 months prior to August 30, 2002 is 13.4%, which is greater than the 10% flex band. The September 8, 2003 filing would

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