ALASKA LEGISLATURE COMMITTEE FILES 1997-1998 8672
9596 SENATE JUDICIARY

233

STATE OF ALASKA
1998 LEGISLATIVE SESSION
DEPARTMENT OF CORRECTIONS

LL NO. HB 272 (JUD)
PAGE 2 of 2
DATE 4/7/98

This fiscal analysis is based on the following:

*One pilot program will be established in Anchorage beginning in Jan. 1999. Program design will be developed June through December and the program will be implemented in January. Program costs are based on six months of operation for FY 99.
*The decision to designate an offender to the Electronic Monitoring program as an alternative to incarceration will be made by the Dept. of Corrections with guidance from the court through sentencing recommendations.
*No domestic violence or sex offenders will be put into the program.
*The program will have 60 slots available for a total of 21,900 person days of coverage annually.
*The Program will be administered through a contract with the private sector.

Personal Services:	**60.0**	
Probation Officer II in Anchorage at Sixth Avenue Correctional Center		60.0
Contractual Services:	**183.2**	
Communication: Local, long distance, postage, DHL, other related costs		1.5
Miscellaneous: Risk Management, other misc. costs		0.3
Rentals and Leases: Lease of Electronic Monitoring Equipment (estimated)		120.5
One drive by unit X $75.00 per month X 12 months		0.9
Electronic Monitoring equipment installer, maintenance contracts		60.0
Supply:	**12.4**	
Office Supplies: Consumable office supplies, duplicating supplies, etc.		1.0
Scientific Supplies: Alcohol/Drug test cups for immediate field testing		10.8
Data Processing Supplies: paper forms, diskettes, ribbons, etc.		0.2
Other Operating Supplies: law enforcement supplies, safety and electronic supplies		0.4
Equipment: (one time)	**2.5**	
Standard Personal Computer		
Total Annual Cost		**255.6**
FY 99		**130.3**

Electronic monitoring is used successfully in other jurisdictions as a cost-effective alternative to incarceration and has proven to be a good tool for enforcing curfews and monitoring offenders. The $11.70 per day cost of such a program in Alaska will avoid the much higher costs of the only other options currently available in our state - $100 per day in jail or $57 per day in a Community Residential Center.

There are various types of electronic equipment currently in use, including beepers, computerized-programmed contact devices using either voice or a worn device, transmitters, and continuously signaling devices. This fiscal note is based on known prices of one technology, "ankle or wrist bracelets", but is not intended to confine the use to any one technology. That is, the type of technology should be determined by an Implementation Planning Team, and could change as other technologies are developed or become available in the market place.

This fiscal note provides for a 6-month planning period for a pilot project in Anchorage and for 6 months of program implementation. The Implementation Planning Team will involve representatives from the courts, state and municipal prosecutors, Corrections, law enforcement, public defense and the private sector to assure program success.

FISCAL NOTE

No: 1

Bill Version: CSHB 272 (JUD)
(H) Publish Date: 3/4/98

STATE OF ALASKA
1998 LEGISLATIVE SESSION

Revision Date:
Title: "An Act to permit a court to order a defendant to serve A sentence by electronic monitoring..."
Sponsor: Representative Green
Requestor: H (JUD)

Department Affected: Administration
BRU: Legal and Advocacy Services
Component: Public Defender Agency

COMPONENT SERIAL NO. 1631

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04
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						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary.)

This bill authorizes judges to permit the service of a sentence for a misdemeanor crime by electronic monitoring rather than incarceration in a correctional facility. Because the costs of such monitoring are to be assessed to the defendant, it creates serious equal protection problems - reserving jail for the poor. It also makes tampering with the device or leaving the designated place of confinement a misdemeanor crime of unlawful evasion. Given the restriction on availability to those who can pay for it, and the current cost of such a program, it is unlikely that this will greatly increase the Agency caseload immediately. However, this technology is becoming more affordable and widespread. Future fiscal impact is uncertain.

Prepared by: Barbara K. Brink, Director
Division: Public Defender Agency
Phone: (907) 264-4414
Date:

Approved by Commissioner: Mark Boyer
Agency: Department of Administration
Date: 4/1/98

DISTRIBUTION COPIES TO GOVERNOR'S LEGISLATIVE OFFICE
For further distribution information, call the Governor's Legislative Office

COMMITTEE COPY

0:HB272

SENATE COMMITTEE REPORT

DATE: 4/18/98

FURTHER: Finance

DATE TURNED IN TO OFFICE: 5-7-98

Judiciary Committee considered CS FOR HOUSE BILL NO. 272(FIN)

"An Act relating to allowing the commissioner of corrections to allow a prisoner to serve a term of imprisonment or period of temporary commitment by electronic monitoring; and relating to the crime of escape."

and recommends:

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

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

[ ] attached amendment(s)

[ ] adopt Letter of Intent by _____ Committee

[ ] further referral to the _____ Committee

Senate Bill:
[ ] same title
[ ] new title

House Bill:
[ ] same title
[ ] technical title
[ ] new: SCR#_____

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	NR	DNP	AM
Mike Miller	X		X		
CHAIR: Robin L. Taylor	X	VICE CHAIR:			

NEW FISCAL NOTE(S):

Department	Date	Zero	Fiscal

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
CORRECTIONS/A & O	4-8-98		✓
ADMIN - PDA	2-17-98	✓	

[ ] APPROPRIATION -- no fiscal note

*include fiscal notes accompanying Governor's bill

HB 310

The Agency's generic certification for promulgation of new SNURs appears on June 2, 1997 (62 FR 29684) (FRL-5597-1), and was provided to the Chief Counsel for Advocacy of the Small Business Administration.

X. Submission to Congress and the General Accounting Office

Under 5 U.S.C. 801(a)(1)(A), as added by the Small Business Regulatory Enforcement Fairness Act of 1996, the Agency has submitted a report containing this rule and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the General Accounting Office prior to publication of this rule in today's Federal Register. This is not a major rule as defined by 5 U.S.C. 804(2).

List of Subjects in 40 CFR Part 721

Environmental protection, Chemicals, Hazardous materials, Recordkeeping and reporting requirements.

Dated: June 16, 1997

Ward Penberthy,

Acting Director, Chemical Control Division, Office of Pollution Prevention and Toxics.

Therefore, it is proposed that 40 CFR part 721 be amended as follows:

PART 721—[AMENDED]

1. The authority citation for part 721 would continue to read as follows:

Authority: 15 U.S.C. 2604, 2607, and 2625(c).

2. By adding new § 721.5867 to read as follows:

§ 721.5867 Substituted phenol.

(a) *Chemical substance and significant new uses subject to reporting.* (1) The chemical substance generically identified as substituted phenol (PMNs P-89-1125, P-91-87, P-92-41, P-92-511, P-94-1527, and P-94-1755) is subject to reporting under this section for the significant new uses described in paragraph (a)(2) of this section.

(2) The significant new uses are:

(i) *Release to water.* Requirements as specified in § 721.90 (a)(4), (b)(4), and (c)(4)(where n = 1).

(ii) [Reserved]

(b) *Specific requirements.* The provisions of subpart A of this part apply to this section except as modified by this paragraph.

(1) *Recordkeeping.* Recordkeeping requirements as specified in § 721.125 (a), (b), (c), and (k) are applicable to manufacturers, importers, and processors of this substance.

(2) *Limitations or revocation of certain notification requirements.* The provisions of § 721.185 apply to this section.

[FR Doc. 97-16760 Filed 6-25-97; 8:45 am]

BILLING CODE 6560-50-F

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

50 CFR Part 679

[Docket No. 970611133-7133-01; I.D. 052997B]

RIN: 0648-AJ36

Fisheries of the Exclusive Economic Zone Off Alaska; Improved Retention/Improved Utilization

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Proposed rule; request for comments.

SUMMARY: NMFS proposes regulations to implement Amendment 49 to the Fishery Management Plan for the Groundfish Fishery in the Bering Sea and Aleutian Islands Area (FMP). Amendment 49 would require all vessels fishing for groundfish in the Bering Sea and Aleutian Islands Management Area (BSAI) to retain all pollock and Pacific cod beginning January 1, 1998, and all rock sole and yellowfin sole beginning January 1, 2003. This proposed rule would establish a 15-percent minimum utilization standard for all at-sea processors for pollock and Pacific cod beginning January 1, 1998, and for rock sole and yellowfin sole beginning January 1, 2003. This action is necessary to respond to socioeconomic needs of the fishing industry that have been identified by the North Pacific Fishery Management Council (Council) and is intended to further the goals and objectives of the FMP.

DATES: Comments on the proposed rule must be received at the following address by August 11, 1997.

ADDRESSES: Comments must be sent to Ronald J. Berg, Chief, Fisheries Management Division, Alaska Region, NMFS, P.O. Box 21668, Juneau, AK 99802, Attn: Lori J. Gravel, or delivered to the Federal Building, 709 West 9th Street, Juneau, AK. Copies of the proposed FMP amendment and the Environmental Assessment/Regulatory Impact Review/Initial Regulatory Flexibility Analysis (EA/RIR/IRFA) prepared for Amendment 49 are available from NMFS at the above address, or by calling the Alaska Region, NMFS at 907-586-7228. Send comments regarding burden estimates or any other aspect of the data requirements, including suggestions for reducing the burdens, to NMFS and to the Office of Information and Regulatory Affairs, Office of Management and Budget (OMB), Washington, DC 20503, Attn: NOAA Desk Officer.

FOR FURTHER INFORMATION CONTACT: Kent Lind, 907-586-7228.

SUPPLEMENTARY INFORMATION: The domestic groundfish fisheries in the exclusive economic zone of the BSAI are managed by NMFS under the FMP. The FMP was prepared by the Council under the Magnuson-Stevens Fishery Conservation and Management Act (Magnuson-Stevens Act). Regulations governing the groundfish fisheries of the BSAI appear at 50 CFR parts 600 and 679.

The Council has submitted Amendment 49 for Secretarial review and a notice of availability of the FMP amendment was published on June 5, 1997 (62 FR 30835), with comments on the FMP amendment invited through August 4, 1997. Comments may address the FMP amendment, the proposed rule, or both, but must be received by August 4, 1997, to be considered in the approval/disapproval decision on the FMP amendment. All comments received by August 4, 1997, whether specifically directed to the FMP amendment or the proposed rule, will be considered in the approval/disapproval decision on the FMP amendment.

Management Background and Need for Action

In September 1996, the Council approved an Improved Retention/Improved Utilization (IR/IU) program as Amendment 49 to the FMP. Amendment 49 is the result of over 3 years of analysis and debate of alternative solutions to the problem of discards occurring in the groundfish fisheries off Alaska. Approximately 600 million lbs (273,000 mt) of groundfish were discarded annually in the groundfish fisheries of the BSAI, in each of the last several years, which represents an unacceptably high level of discard and waste in the opinion of the Council, the fishing industry, and the American public. The bulk of these groundfish discards are "economic" discards (i.e., catch that is discarded voluntarily for economic reasons). Economic discards include fish of the target species that are the wrong sex or of a size not suitable for the processing equipment being used, species of lower

value than the target species or for which viable markets do not exist, and damaged fish rendered unsuitable for processing.

Because such discards are counted against the overall total allowable catch (TAC) established for each species, they do not represent a direct biological concern. However, they represent foregone harvest opportunities for other fishing operations that might otherwise target and utilize those fish. Furthermore, the high levels of discards represent an important social policy issue, which the fishing industry and the Council choose to address.

One of the Council's Comprehensive Fishery Management Goals, adopted in 1984, is to "Minimize the catch, mortality, and waste of non-target species, and reduce the adverse impacts of one fishery on another." In adopting this goal, the Council recognized that fish caught as bycatch in one fishery represent an allocation away from any target fishery for the bycatch species. This is especially so when a bycatch species (e.g., pollock), is fully utilized by other sectors of the industry.

In addition, a priority objective of the FMP is to "provide for the rational and optimal use, in a biological and socioeconomic sense, of the region's fisheries resources as a whole." Consistent with these goals and objectives, many of the management programs passed by the Council and enacted by NMFS are aimed at reducing the bycatch of non-target species and thereby increasing the relative amounts of each species that are taken and utilized by target fisheries. In this context, bycatch is broadly understood to mean the unintended capture or mortality of fish regardless of whether the unwanted bycatch is subsequently discarded.

The issues of bycatch and discards of groundfish resources have been long-term subjects of Council concern. In 1993, the Council began discussion and scoping analyses of specific alternatives aimed at reducing bycatch and discards. A common thread among these alternative programs was to provide incentives to reduce the bycatch of unwanted species and to increase the utilization of those species that are caught. Alternative programs under analysis included: Individual fishing quotas for groundfish species; a "Harvest Priority" program, which would provide for quota set-asides for vessels exhibiting low bycatch rates of non-target species; and mandates for retention and utilization, with the built-in incentives for fishing operations to avoid catch of unwanted species. While other alternatives were discussed, primary focus was given to these three alternative programs.

After public testimony and debate, the Council decided to further narrow its focus on mandatory retention and utilization requirements as the most expeditious and direct method to address groundfish discards. In addition, the Council believed that a mandatory retention program would provide significant incentives for industry to avoid bycatch in the first place and develop more selective fishing gear and methods.

In 1994, the Council examined bycatch and discard statistics and concluded that two species, pollock and rock sole, were being discarded at unacceptably high rates. The Council initially proposed an IR/IU program that would be limited to discards of pollock and rock sole in the midwater pollock and rock sole fisheries, respectively. An "Implementation Issues Assessment" was completed in March 1995 and presented to the Council's Advisory Panel (AP) and Scientific and Statistical Committee. In September 1995, the Council appointed an industry committee as a sounding board for implementation issues related to the proposed IR/IU program. Subsequently, on advice of the industry committee and the AP, Pacific cod and yellowfin sole were added to the program because discard rates for those species were also determined to be unacceptably high. The Council also extended the program to all groundfish fisheries and gear types because applying IR/IU regulations to specific target fisheries was determined to be unworkable. In December 1995, at the request of the Council, NMFS began preparation of a formal analysis (Environmental Assessment/Regulatory Impact Review/Initial Regulatory Flexibility Analysis (EA/RIR/IRFA) of the proposed IR/IU program.

The analysis determined that pollock, Pacific cod, rock sole, and yellowfin sole represent approximately 76 percent of the total discards of allocated groundfish in the BSAI groundfish fisheries (over the period of the analysis). The Council concluded that by requiring 100 percent retention of these four species, initially pollock and Pacific cod, and subsequently yellowfin and rock sole, the Council's objective of "substantially reducing discards of unprocessed groundfish" in these fisheries could be achieved. The expressed intent of the Council was to implement a program that "would provide an incentive for fishermen to avoid unwanted catch, increase utilization of fish that are taken, and thus reduce discards of whole fish." The following Problem Statement accompanied the Council's December 1995 action:

> In managing the fisheries under its jurisdiction, the North Pacific Fishery Management Council is committed to: (1) Assuring the long-term health and productivity of fish stocks and other living marine resources of the North Pacific and Bering Sea ecosystem; and (2) reducing bycatch, minimizing waste, and improving utilization of fish resources in order to provide the maximum benefit to present generations of fishermen, associated fishing industry sectors, communities, consumers, and the nation as a whole. These commitments are also reflected in the Council's CRP [Comprehensive Rationalization Plan] problem statement.
>
> The Council's overriding concern is to maintain the health of the marine ecosystem to ensure the long-term conservation and abundance of the groundfish and crab resources. As a response to this concern, a program to promote improved utilization and effective control/reduction of bycatch and discards in the fisheries off Alaska should address the following problems:
>
> 1. Bycatch and discard loss of groundfish, crab, herring, salmon, and other non-target species.
>
> 2. Economic loss and waste associated with the discard mortality of target species harvested but not retained for economic reasons.
>
> 3. Inability to provide for a long-term, stable fisheries-based economy due to loss of fishery resources through wasteful fishing practices.
>
> 4. The need to promote improved retention and utilization of fish resources by reducing waste of target groundfish species to achieve long-term sustainable economic benefits to the nation.

At the April 1996 Council meeting, the IR/IU Industry Working Group and NMFS staff made their respective reports to the AP and Council. In response, again at the urging of the AP, and supported by public testimony, the Council further modified the IR/IU options under consideration. The Council identified two retention options, the no-action or "Status Quo" alternative and a "species-based" approach. The Council also identified three utilization options (in addition to the "Status Quo" alternative), each dictating, to a greater or lesser degree, the form and extent of processing of the retained catch.

The revised proposal would apply only to BSAI groundfish fisheries, extend to all gear types, and require 100 percent retention of pollock, Pacific cod, rock sole, and yellowfin sole. In the case of the two flatfish species, the revised proposal also examined two additional sub-options: (1) Incrementally phasing in 100 percent retention over a period of time, or (2) delaying implementation of the 100 percent retention requirement until a specified date in the future. In

either case, however, the Council indicated its intent to require 100 percent retention of pollock and Pacific cod for all operations beginning January 1, 1998.

In September 1996, after extensive debate and public testimony, the Council took final action on the IR/IU program and adopted it as Amendment 49 to the FMP. The retention option adopted by the Council would require full retention of pollock and Pacific cod beginning January 1, 1998, and full retention of rock sole and yellowfin sole beginning January 1, 2003.

The utilization option adopted by the Council, the least restrictive of the three options under consideration, would allow retained catch of the four groundfish species to be processed into any product form, regardless of whether the resulting product is suitable for direct human consumption. Of present products, only meal, bait, and offal are regarded as not suitable for direct human consumption, with offal considered to be processing waste rather than a product form.

The Council also established a 15-percent minimum utilization rate as aggregate product recovery rate (PRR) by species. NMFS has calculated average PRRs for each species, product combination produced in the groundfish fisheries off Alaska. These standard PRRs are established in regulation at Table 3 of 50 CFR part 679. Because the lowest NMFS PRR for a non-roe, primary product produced from an IR/IU species is 15 percent for deep skin pollock fillets, the IR/IU Industry Working group concluded that a 15-percent minimum utilization rate was achievable for all sectors of the industry and would allow for variations in actual PRRs by size of fish and season. If, under certain circumstances, a processor fails below 15 percent for a particular primary product, the vessel operator would be able to meet the minimum utilization requirement by retaining sufficient ancillary products to bring the aggregate utilization rate above 15 percent.

On October 11, 1996, the President signed into law the Sustainable Fisheries Act of 1996 (Public Law 104-297) which reauthorized and amended the Magnuson-Stevens Act. Several provisions of the Magnuson-Stevens Act now provide statutory authority for regulatory programs to improve retention and utilization in the groundfish fisheries off Alaska. Section 303(a)(11) of the Magnuson-Stevens Act requires the Council to "establish a standardized reporting methodology to assess the amount and type of bycatch occurring in the fishery, and include conservation and management measures that, to the extent practicable and in the following priority--(A) minimize bycatch; and (B) minimize the mortality of bycatch which cannot be avoided." In implementing this provision of the Act, the Council is further required under section 313(f) to "submit conservation and management measures to lower, on an annual basis for a period of not less than 4 years, the total amount of economic discards occurring in the fisheries under its jurisdiction." The proposed IR/IU program, submitted by the Council, is intended to meet these statutory requirements.

Elements of the Proposed IR/IU Program

Affected Vessels and Processors

The proposed IR/IU program would apply to all vessels fishing for groundfish in the BSAI and all at-sea processors processing groundfish harvested in the BSAI, regardless of vessel size, gear type, or target fishery. Because the Magnuson-Stevens Act does not authorize NMFS to regulate on-shore processing of fish, the requirements of this proposed rule would not be extended to shore-based processors.

The Council has assumed that the State of Alaska (State) will implement a parallel IR/IU program for shore-based processors. In testimony at the September 1996 and April 1997 Council meetings, the State indicated its intent to implement parallel IR/IU regulations for the shore-based processing sector. Parallel State regulations are especially necessary to address the relationship between the processing plant and the delivering vessel. A shore-based IR/IU program must require a processor to accept all IR/IU species offered for delivery by a vessel fishing for groundfish in the BSAI. Otherwise, rejection of deliveries by a processor would be the equivalent of discarding of IR/IU species by that processor.

IR/IU Species

The proposed IR/IU program would define four groundfish species as IR/IU species: pollock, Pacific cod, rock sole, and yellowfin sole. Retention and utilization requirements would apply to pollock and Pacific cod beginning January 1, 1998. Rock sole and yellowfin sole would be added to the program beginning January 1, 2003. The purpose of the 5-year delay for rock sole and yellowfin sole is to provide industry with sufficient time to develop more selective fishing techniques and/or markets for these fish.

Minimum Retention Requirements

The proposed rule would establish minimum retention requirements by vessel type (catcher vessel, catcher/processor, and mothership), and by the directed fishing status of the IR/IU species (open to directed fishing, closed to directed fishing, and retention prohibited). In general, vessel operators would be required to retain 100 percent of their catch of an IR/IU species unless a closure to directed fishing limits retention of that species. When a closure to directed fishing limits retention of an IR/IU species, the vessel operator would be required to retain all catch of that species up to the maximum retainable bycatch (MRB) amount in effect for that species, and catch in excess of the MRB amount must be discarded. The specific retention requirements by vessel type and directed fishing status are set out in table format at § 679.27(c) of the proposed regulations and are summarized below.

Catcher Vessels

Operators of catcher vessels would be required to retain all IR/IU species brought on board the vessel until the catch is lawfully transferred to an authorized party (e.g., a federally licensed processor or buying station). This requirement applies to all IR/IU species brought on board a vessel, whether harvested by the vessel itself, or transferred from another vessel. When an IR/IU species is closed to directed fishing, vessel operators would be required to retain all fish of that species brought on board the vessel up to the MRB amount in effect for that species, and discard all catch in excess of the MRB amount in effect for that species. When regulations require an IR/IU species to be treated as a prohibited species, retention of that species would be prohibited, and all catch of that species would have to be discarded.

Catcher/Processors and Motherships

Operators of catcher/processors and motherships would be required to retain a primary product from all IR/IU species brought on board the vessel until the product is lawfully transferred or offloaded to an authorized party. Because catcher/processors and motherships process groundfish at sea, discarding of processing waste from IR/IU species would be allowed provided that a primary product is retained from each fish that is brought on board the vessel. No restrictions would exist on the type of primary product produced from each IR/IU species provided that all primary and ancillary products are logged in the vessel's daily cumulative

production logbook (DCPL). Whole fish could be considered a product for the purpose of this program provided that they are logged as whole fish in the vessel's DCPL.

When an IR/IU species is closed to directed fishing, operators of catcher/processors and motherships would have to retain a primary product from all fish of that species brought on board the vessel up to the point that the round-weight equivalent of primary products equals the MRB amount in effect for that species. Catch or production in excess of the MRB amount would have to be discarded. If a closure requires an IR/IU species to be treated as a prohibited species, retention would be prohibited and all catch of that species would have to be discarded.

Retention Requirements Under Directed Fishing Closures

NMFS assesses each groundfish TAC annually to determine how much of a species' TAC is needed as bycatch in other groundfish fisheries. The remainder is made available as a directed fishing allowance. NMFS closes a species or species group to directed fishing when the directed fishing allowance for that species has been reached in order to leave sufficient portions of the TAC to provide for bycatch in other fisheries. However, if TAC is reached, retention of that species becomes prohibited and all catch of the species must be discarded. Under existing regulations, a species or species group may be open to directed fishing, closed to directed fishing, or retention may be prohibited.

Directed fishing is defined in regulations as "any fishing activity that results in the retention of an amount of a species or species group on board a vessel that is greater than the MRB amount for that species or species group." The MRB amount for a species is calculated as a percentage (by weight) of the species closed to directed fishing relative to the weight of other species that are open for directed fishing and retained on board the vessel. On catcher/processors, which retain product rather than whole fish, the MRB amount is determined using round-weight equivalents, which are calculated using NMFS PRRs established by regulation at Table 3 of 50 CFR part 679. The MRB percentage for each species is established in regulation at Table 11 of 50 CFR part 679. When a species is closed to directed fishing, bycatch amounts of the species may still be retained on board a vessel, up to the MRB amount in effect for that species and catch in excess of the MRB amount must be discarded.

The MRB percentages serve as a management tool to slow down the rate of harvest of a species closed to directed fishing, and to reduce the incentive for fishing vessels to target on that species. In most cases, an MRB of 20 percent is established to slow the harvest rate of a species, yet avoid significant discard amounts of these species to the extent they are taken as bycatch in other open groundfish fisheries. Directed fishing closures are also made when a fishery has reached a prohibited species bycatch allowance, or to prevent overfishing of another groundfish species taken as bycatch.

Under the proposed IR/IU program, if a vessel's bycatch of an IR/IU species exceeds an MRB amount in effect for that species, all catch in excess of the MRB amount would have to be discarded. Under such a circumstance, monitoring, enforcement, and compliance with the IR/IU program will be complicated. This situation is most likely to occur in trawl fisheries where bycatch of pollock is prevalent. Directed fishing for pollock (by inshore and offshore sectors) typically is closed from late February or early March until release of the second seasonal allowance of pollock on September 1. During this time, pollock may be a prevalent bycatch species in Pacific cod and flatfish fisheries and could comprise more than 20 percent (the MRB percentage for pollock) of total catch by some vessels. If this occurs, a vessel may be required to simultaneously retain and discard portions of the catch of an IR/IU species. The relationship between the proposed IR/IU program and directed fishing closures is illustrated in the two following examples.

Example 1: Simultaneous Compliance With IR/IU and a Directed Fishing Closure on a Catcher Vessel

Table 1 provides an example of a catcher vessel on a hypothetical fishing trip for Pacific cod while pollock is closed to directed fishing. In this example, IR/IU requirements apply only to pollock and Pacific cod as would be the case prior to 2003. The example shows the vessel operator retaining all Pacific cod and retaining pollock up to the 20 percent MRB in effect for pollock. Catch of other groundfish species not governed by the IR/IU program may be retained or discarded subject to other regulations and the discretion of the vessel operator. To simplify the example, all catch of other groundfish species is shown as discarded.

TABLE 1.—HYPOTHETICAL FISHING TRIP FOR A CATCHER VESSEL FISHING FOR PACIFIC COD WHILE DIRECTED FISHING FOR POLLOCK IS CLOSED (CATCH AND DISCARDS SHOWN IN MT)

Haul No.	Haul weight	Pacific cod			Pollock			Other species		
		Total	Ret.	Disc.	Total	Ret.	Disc.	Total	Ret.	Disc.
1	50.0	25.0	25.0	0.0	25.0	5.0	20.0	10.0	0.0	10.0
Subtotal	60.0	25.0	25.0	0.0	25.0	5.0	20.0	10.0	0.0	10.0
2	50.0	40.0	40.0	0.0	5.0	5.0	0.0	5.0	0.0	5.0
Subtotal	110.0	65.0	65.0	0.0	30.0	10.0	20.0	15.0	0.0	15.0
3	55.0	35.0	35.0	0.0	10.0	10.0	0.0	10.0	0.0	10.0
Subtotal	165.0	100.0	100.0	0.0	40.0	20.0	20.0	25.0	0.0	25.0
4	50.0	45.0	45.0	0.0	3.0	3.0	0.0	2.0	0.0	2.0
Total	215.0	145.0	145.0	0.0	43.0	23.0	20.0	27.0	0.0	27.0

Table 1 shows the vessel operator retaining and discarding pollock during the course of the fishing trip to remain in compliance with the proposed IR/IU program and the MRB amount in effect for pollock. The disposition of pollock in each haul is as follows:

Haul 1. This haul of 60 mt contains 25 mt of Pacific cod, 25 mt of pollock, and 10 mt of other groundfish. The vessel operator retains all 25 mt of Pacific cod in compliance with IR/IU, at his discretion discards the other groundfish and retains an amount of pollock equal to 20 percent of the

retained catch of species open to directed fishing, or 5 mt (25 mt of retained Pacific cod × 0.2 = 5 mt).

Haul 2. This haul of 50 mt contains 40 mt of Pacific cod, 5 mt of pollock and 5 mt of other groundfish. The vessel operator retains all 40 mt of Pacific cod in compliance with IR/IU, at his discretion discards the 5 mt of other groundfish, and retains all 5 mt of pollock. At this point, the vessel's MRB amount for pollock equals 13 mt (65 mt retained Pacific cod × 0.2 = 13 mt) and the cumulative retained catch of pollock equals 10 mt, therefore all pollock from this haul must be retained.

Haul 3. This haul of 55 mt contains 35 mt of Pacific cod, 10 mt of pollock and 10 mt of other groundfish. The vessel operator retains all 35 mt of Pacific cod in compliance with IR/IU, at his discretion discards the 10 mt of other groundfish, and retains all 10 mt of pollock. At this point, the vessel's MRB amount for pollock equals 20 mt (100 mt retained Pacific cod × 0.2 = 20 mt) and the cumulative retained catch of pollock equals 20 mt.

Haul 4. This haul of 50 mt contains 45 mt of Pacific cod, 3 mt of pollock and 2 mt of other groundfish. The vessel operator retains all 45 mt of Pacific cod in compliance with IR/IU, at his discretion discards the 2 mt of other groundfish and retains all 3 mt of pollock. At this point, the vessel's MRB amount for pollock equals 29 mt (145 mt retained Pacific cod × 0.2 = 29 mt) and the cumulative retained catch of pollock equals 23 mt.

At the time of delivery, the vessel's fish ticket should show landed weights of 145 mt for Pacific cod and 23 mt for pollock and the processor will report 20 mt of pollock discards and 27 mt of other groundfish discards in the NMFS daily cumulative production logbook. In this example, the delivery weight of pollock as a percentage of the delivery weight of Pacific cod is equal to 15.9 percent, which is less than the 20 percent MRB percentage for pollock. In addition, the vessel's logbook will show 20 mt of pollock discards. Nevertheless, the vessel would be in compliance with the proposed IR/IU regulations because retention of the extra 20 mt of pollock from haul 1 would have exceeded the MRB amount for pollock at the time that haul 1 was brought on board.

Example 2: Simultaneous Compliance With IR/IU and a Directed Fishing Closure on a Catcher/Processor

Tables 2 and 3 provide an example of a catcher/processor beginning a hypothetical rock sole fishing trip during which some species are open to directed fishing and other species are closed to directed fishing. In this example, IR/IU requirements would apply to all four IR/IU species as would be the case after 2003. A hypothetical distribution of catch, retention and discard of 100 mt of groundfish under the existing status quo is displayed on Table 2, and under the proposed IR/IU program with all four IR/IU species on Table 3. Fishery status for all species in the catch is indicated as either open, closed, or retention prohibited.

TABLE 2.—HYPOTHETICAL DISTRIBUTION OF A 100 MT HAUL OF GROUNDFISH FOR A CATCHER/PROCESSOR PARTICIPATING IN THE BSAI ROCK SOLE FISHERY, UNDER THE STATUS QUO

Round weight catch and discard				Retained products and round-weight equivalents			
Species	Status of fishery	Round wt. catch	Round wt. discard	Product	NMFS PRR[1]	Product wt.	Round-wt. equivalent
Rock sole	Open	52.0	31.0	H&G w/roe	0.8	16.8	21.0
Yellowfin sole	Open	6.0	4.0	H&G eastern cut	0.65	1.3	2.0
Other flatfish	Open	7.0	4.0	H&G eastern cut	0.65	1.95	3.0
Pacific cod	Open	8.0	5.0	H&G eastern cut	0.47	1.41	3.0
Sablefish	Open	0.1	0.0	H&G western cut	0.68	0.07	0.1
Other groundfish	Open	3.1	3.1	None		0.0	0.0
Subtotal		75.2	47.1				[2]29.1
Pollock	Closed	20.0	1.5	H&G eastern cut	0.56	1.12	2.0
Greenland turbot	Closed	0.2	0.1	H&G eastern cut	0.65	0.07	0.1
Atka mackerel	Closed	0.1	0.0	H&G eastern cut	0.61	0.11	0.5
Arrowtooth	Closed	2.3	2.3	H&G eastern cut		0.0	0.0
Rockfish	Prohibited	0.5	0.5	None		0.0	0.0
Subtotal		23.8	21.2				2.6
Total		100.0	68.3				31.7

[1] The actual PRR realized by a particular vessel may vary from the NMFS standard PRR due to the size of fish, time of year, and adjustment of processing equipment. However, NMFS standard PRRs are always used when calculating round-weight equivalents for the purpose of determining MRB amounts. As a result, the round-weight equivalent amount for a particular product may not equal the actual round weight of fish used to produce that product.

[2] Round-weight equivalent of retained groundfish used to calculate MRB amounts for species closed to directed fishing.

TABLE 3.—HYPOTHETICAL DISTRIBUTION OF A 100 MT HAUL OF GROUNDFISH FOR A CATCHER/PROCESSOR PARTICIPATING IN THE BSAI ROCK SOLE FISHERY, WITH IR/IU REQUIREMENTS FOR POLLOCK, PACIFIC COD, ROCK SOLE AND YELLOWFIN SOLE

Round weight catch and discard				Retained products and round-weight equivalents			
Species	Status of fishery	Round wt. catch	Round wt. discard	Product	NMFS PRR	Product wt.	Round-wt. equivalent[1]
Rock sole	Open	52.0	0.0	H&G w/roe	0.8	41.6	52.0
Yellowfin sole	Open	6.0	0.0	H&G eastern cut	0.65	3.9	6.0
Other flatfish	Open	7.0	4.0	H&G eastern cut	0.65	1.95	3.0
Pacific cod	Open	8.0	0.0	H&G eastern cut	0.47	3.76	8.0
Sablefish	Open	0.1	0.0	H&G western cut	0.68	0.07	0.1
Other groundfish	Open	3.1	3.1	None		0.0	0.0

TABLE 3.—HYPOTHETICAL DISTRIBUTION OF A 100 MT HAUL OF GROUNDFISH FOR A CATCHER/PROCESSOR PARTICIPATING IN THE BSAI ROCK SOLE FISHERY, WITH IR/IU REQUIREMENTS FOR POLLOCK, PACIFIC COD, ROCK SOLE AND YELLOWFIN SOLE—Continued

Round weight catch and discard				Retained products and round-weight equivalents			
Species	Status of fishery	Round wt. catch	Round wt. discard	Product	NMFS PRR	Product wt.	Round-wt. equivalent [1]
Subtotal		75.2	7.1				69.1 [1]
Pollock	Closed	20.0	6.2 [2]	H&G eastern cut	0.56	7.73	13.8
Greenland turbot	Closed	0.2	0.1	H&G eastern cut	0.65	0.07	0.1
Atka mackerel	Closed	0.7	0.2	H&G eastern cut	0.61	0.31	0.5
Arrowtooth	Closed	2.3	2.3	H&G eastern cut		0.0	0.0
Rockfish	Prohibited	0.6	0.6	None		0.0	0.0
Subtotal		23.8	9.4				14.4
Total		100.0	16.5				83.5

[1] Round-weight equivalent of retained groundfish used to calculate MRB amounts for species closed to directed fishing.
[2] Pollock catch in excess of the MRB amount that must be discarded.

In Table 3, the vessel's hypothetical retained and discarded catch is redistributed from Table 2 to show that:

1. All catch of Pacific cod, yellowfin sole, and rock sole must be retained because the directed fisheries for these species are open.

2. Catch of groundfish open to directed fishing, other than Pacific cod, yellowfin sole, and rock sole, may be retained or discarded subject to other regulations.

3. With the exception of pollock, catch of groundfish closed to directed fishing may be retained up to the MRB amount.

4. Catch of pollock, for which the directed fishery is closed, must be retained up to the MRB. At that point, all additional bycatch of pollock must be discarded. Because the vessel is a catcher processor, MRB calculations are made using round-weight equivalents of the vessel's retained products. The MRB percentage for pollock is 20 percent. In Table 3, the round-weight equivalent of retained catch of species open to directed fishing is 69.1 mt. Therefore, a round-weight equivalent of primary pollock products equal to 13.8 mt (69.1 mt × 0.2 = 13.8 mt) must be retained and the remainder of the catch (20 mt − 13.8 mt = 6.2 mt) must be discarded.

5. Catch of Greenland turbot and Atka mackerel do not exceed MRB percentages, so all of this catch may be retained or discarded at the discretion of the operator. Retention of rockfish is prohibited and all catch of rockfish must be discarded.

Note that in Example 2, the vessel is beginning a fishing trip and no other catch or products are retained on board. If the vessel continues the fishing trip, MRB calculations would be made based on all retained catch during the fishing trip as shown in Example 1, rather than the retained catch from each individual haul.

Examples 1 and 2 illustrate simple cases of one species for which the vessel operator must retain a portion of the catch to meet the proposed retention standards but must simultaneously discard the remainder to comply with a pollock directed fishing closure. As more species are closed to directed fishing, or placed on prohibited status, monitoring the exact quantities of each bycatch species that must be retained and discarded will become more complicated for industry, observers, and enforcement officers.

Additional Retention Requirements

Bleeding Codends and Shaking Longline Gear

The minimum retention requirements outlined above apply to all fish of each IR/IU species that are brought on board a vessel. Any activity intended to cause the discarding of IR/IU species prior to their being brought on board a vessel, such as bleeding codends or shaking fish off longlines, would be prohibited. NMFS recognizes that some escapement of fish from fishing gear does occur in the course of fishing operations. Therefore, incidental escapement of IR/IU species, such as fish squeezing through mesh or dropping off longlines, would not be considered a violation unless the escapement is intentionally caused by action of the vessel operator or crew.

At-Sea Discard of Products

In addition to the retention requirements outlined above, the proposed rule would prohibit the at-sea discard of products from any IR/IU species. This would include any IR/IU product that has been frozen, canned, or reduced to meal.

Discard of Fish or Product Transferred From Other Vessels

The retention requirements of this proposed rule would apply to all IR/IU species brought on board a vessel, whether caught by that vessel or transferred from another vessel. Discard of IR/IU species or products that were transferred from another vessel would be prohibited.

R/IU Species Used as Bait

IR/IU species could be used as bait provided the bait is physically attached to authorized fishing gear when deployed. Dumping IR/IU species as loose bait (e.g., chumming) would be prohibited. Minimum Utilization Requirements

Beginning January 1, 1998, all catcher processors and motherships would be required to maintain a 15 percent utilization rate for each IR/IU species. Calculation of a vessel's utilization rate would depend on the type of vessel (catcher/processor or mothership) and directed fishing status of the IR/IU species in question. The minimum utilization requirements by vessel type and directed fishing status are set out in tables at § 679.27(h) of the proposed regulations and are summarized below.

Catcher/Processors

On a catcher/processor, when directed fishing for an IR/IU species is open, the total weight of retained or lawfully transferred products from IR/IU species harvested during a fishing trip would have to equal or exceed 15 percent of the round weight catch of that species during the fishing trip. When directed fishing for an IR/IU species is closed, the weight of retained products would have to equal or exceed either 15 percent of the MRB amount in

effect for that species or 15 percent of the round weight catch of that species, whichever is lower. When retention of an IR/IU species is prohibited, there would be no minimum utilization rate and any retention of fish or products would be prohibited.

Motherships

On a mothership, when directed fishing for an IR/IU species is open, the total weight of retained or lawfully transferred products from an IR/IU species received during a reporting week must equal or exceed 15 percent of the round weight of that species received during the same reporting week. When directed fishing for an IR/IU species is closed, the weight of retained products would have to equal or exceed 15 percent of the MRB amount in effect for that species or 15 percent of the round weight catch of that species, whichever is lower. When retention of an IR/IU species is prohibited, there would be no minimum utilization rate and any retention of fish or products would be prohibited.

Simultaneous Compliance With Retention and Utilization

A vessel operator must simultaneously meet both the minimum retention standard and the minimum utilization standard to be in compliance with the proposed IR/IU program. Compliance with either standard in the absence of the other would be considered a violation.

Recordkeeping Requirements

This proposed rule includes changes to existing recordkeeping requirements to aid the monitoring and enforcement of the IR/IU program. Beginning January 1, 1998, all catcher vessels and catcher/processors that are currently required to maintain NMFS logbooks would be required to log the round weight catch of pollock and Pacific cod in the NMFS catcher vessel daily fishing logbook (DFL) or catcher/processor DCPL on a haul-by-haul or set-by-set basis. Motherships would be required to log the receipt round weight of pollock and Pacific cod in the mothership DCPL on a delivery-by-delivery basis. Beginning January 1, 2003, this requirement would extend to rock sole and yellowfin sole. These changes are necessary to provide vessel operators and enforcement agents with round weight information for each IR/IU species in order to monitor compliance with the IR/IU program.

Technical Changes to Existing Regulations

The definition of "round weight or round-weight equivalent" at § 679.2 would be changed by restricting the definition to "round-weight equivalent". The term "round weight" is already defined by NMFS in regulations appearing at 50 CFR part 600. In addition, regulations at § 679.50(c)(i), which specify observer coverage requirements for motherships based on "round weight or round-weight equivalent" of groundfish processed, would be revised by removing the term "round weight." Observer coverage requirements for motherships during a calendar month would therefore be based only on the round-weight equivalent of groundfish processed. This change is necessary because the terms "round weight" and "round-weight equivalent" would no longer be synonymous under the proposed rule.

Classification

At this time, NMFS has not determined that Amendment 49 is consistent with the national standards, other provisions of the Magnuson-Stevens Act, and other applicable laws. NMFS, in making that determination, will take into account the data, views, and comments received during the comment period, which ends August 4, 1997.

This proposed rule contains a revised collection-of-information requirement subject to the Paperwork Reduction Act (PRA). This collection-of-information requirement has been submitted to OMB for approval. The catcher vessel DFL, catcher/processor DCPL and mothership DCPL would be revised to require that vessel operators log the round weight of each IR/IU species on a haul-by-haul basis for catcher vessels and catcher/processors and a delivery-by-delivery basis for motherships. The estimated current and new public reporting burdens for these collections of information are as follows: For catcher vessels using fixed gear, the estimated burden would increase from 20 minutes to 23 minutes; for catcher vessels using trawl gear, the estimated burden would increase from 17 minutes to 22 minutes; for catcher/processors using fixed gear, the estimated burden would increase from 32 minutes to 35 minutes; for catcher/processors using trawl gear, the estimated burden would increase from 29 minutes to 34 minutes; for motherships, the estimated burden would increase from 28 to 33 minutes. Send comments regarding reporting burden estimates or any other aspect of the data requirements, including suggestions for reducing the burdens to NMFS and OMB (see ADDRESSES).

Public comment is sought regarding: Whether this proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information has practical utility; the accuracy of the burden estimate; ways to enhance the quality, utility, and clarity of the information to be collected; and ways to minimize the burden of the collection of information, including through the use of automated collection techniques or other forms of information technology.

Notwithstanding any other provision of the law, no person is required to respond to, nor shall any person be subject to a penalty for failure to comply with, a collection-of-information subject to the requirements of the PRA, unless that collection-of-information displays a currently valid OMB control number.

An RIR was prepared for this proposed rule that describes the management background, the purpose and need for action, the management action alternatives, and the social impacts of the alternatives. The RIR also estimates the total number of small entities affected by this action and analyzes the economic impact on those small entities.

An IRFA was prepared as part of the RIR, which describes the impact this proposed rule would have on small entities, if adopted. The analysis examines the economic effects of this proposed rule by fishery and gear type and makes the following conclusions: (1) The economic effects of the proposed rule on vessels using longline, jig, and pot gear would not be significant; (2) the economic effects of the proposed rule on trawl catcher vessels and shore-based processors would not be significant; and (3) the economic effects of the proposed rule on trawl catcher/processor operations may or may not be significant depending upon the fishery as well as the size and processing capacity of the vessel in question.

Under the category of trawl catcher/processors, the economic effects on vessels participating in the pollock, sablefish, Greenland turbot, rockfish, and Atka mackerel fisheries would not be significant. However, the economic effects on vessels participating in the Pacific cod, rock sole, yellowfin sole, flathead sole and "other" flatfish fishery would be significant. This is because the bycatch of IR/IU species in these fisheries is substantial. The quantity of additional retained catch that operators in these fisheries would be required to handle under the proposed rule would impose significant operational costs on these fisheries, taken as a whole. This is especially true for products for which markets are limited or undeveloped (e.g., small Pacific cod, male rock sole,

and head-and-gut (H&G) pollock). Current prices for these products may be insufficient to cover the costs of their production.

In general, the impacts on any individual factory trawler operation would vary inversely with the size and configuration of the vessel, hold capacity, processing capability, markets and market access, as well as the specific composition and share of the total catch of the four IR/IU species. The burden would tend to fall most heavily upon the smallest, least diversified operations among the current fleet. In addition, the groundfish vessel moratorium, proposed license limitation program, and U.S. Coast Guard load-line requirements severely limit reconstruction to increase vessel size and/or processing capacity. These restrictions are expected to further limit the ability of smaller catcher/processors to adapt to the proposed IR/IU program.

NMFS data indicate that in 1995, 44 at-sea processors participated in the BSAI Pacific cod trawl fishery (4 motherships and 40 catcher/processors); 38 at-sea processors participated in the BSAI rock sole fishery (2 motherships and 36 catcher/processors); 48 at-sea processors participated in the BSAI yellowfin sole fishery (4 motherships and 44 catcher processors); 19 catcher/processors participated in the flathead sole fishery; and 23 at-sea processors participated in the "other" flatfish fishery (1 mothership and 22 catcher/processors).

The IRFA further concludes that catcher/processors participating in the Pacific cod fishery with the capability to fillet product would face no significant burden in complying with the proposed IR/IU program. Catcher/processors in the Pacific cod fishery that are limited to H&G product would be significantly disadvantaged because viable markets for H&G pollock do not exist. For this reason, catcher/processors limited to H&G product would be significantly disadvantaged in every fishery where substantial quantities of pollock bycatch occurs.

The physical limitations of the current fleet of catcher/processors that operate in the rock sole, yellowfin sole, flathead sole, and "other" flatfish fisheries could make adaptation to, and compliance with, the proposed IR/IU program effectively impossible. The result may be that adoption of the proposed rule would create such an operational barrier that the rock sole fishery would be discontinued, or alternatively the small-vessel fleet, which currently comprises this fishing fleet, might be displaced by larger and more operationally diversified fleets of vessels, (e.g., larger catcher/processors and motherships).

The no action alternative was rejected because, under a continuation of the current regulations, underutilized groundfish catches would result in an unacceptably high level of discards.

The option of requiring retention of rock sole and yellowfish sole to be phased-in beginning with the first year of the program was rejected in favor of postponing retention requirements for these species for 5 years to provide the opportunity for these fisheries to adapt and attempt to come into compliance with the proposed program.

The utilization options requiring all retained catches of the four species to be processed for direct human consumption and limiting the production of fish meal from the four species were rejected as too restrictive.

The RFA requires that the IRFA describe significant alternatives to the proposed rule that accomplish the stated objectives of the applicable statutes and that minimize any significant impact on small entities. Consistent with the stated statutory objectives, the IRFA must discuss significant alternatives to the proposed rule such as (1) establishing different reporting requirements for small entities that take into account the resources available to small entities; (2) consolidation or simplification of reporting requirements; (3) the use of performance rather than design standards; and (4) allowing exemptions from coverage for small entities. The economic impacts imposed by this rule would not be alleviated by modifying reporting requirements for small entities. Where relevant, this proposed rule employs performance standards rather than design standards and allows maximum flexibility in meeting its requirements. The Council also considered and rejected the following alternatives that might have mitigated impacts on small businesses. (1) An alternative that would have allowed exemptions or modified phase-in periods based on vessel size, was rejected because it would have diluted the reductions in bycatch and discards and would have provided an unfair competitive advantage to a certain sector of the industry. (2) A "harvest priority program" that would have rewarded vessels demonstrating low bycatch rates was rejected because it would not reduce discard rates expeditiously enough. (3) A voluntary bycatch and discard reduction program was rejected because it would not have met statutory requirements of the Magnuson-Stevens Act.

This proposed rule has been determined to be not significant for the purposes of E.O. 12866.

The Administrator, Alaska Region, NMFS determined that fishing activities conducted under this rule would not affect endangered and threatened species listed or critical habitat designated pursuant to the Endangered Species Act in any manner not considered in prior consultations on the groundfish fisheries of the BSAI.

List of Subjects in 50 CFR Part 679

Fisheries, Reporting and recordkeeping requirements.

Dated: June 19, 1997.

Rolland A. Schmitten,

Assistant Administrator for Fisheries, National Marine Fisheries Service.

For the reasons set out in the preamble, 50 CFR part 679 is proposed to be amended as follows:

PART 679—FISHERIES OF THE EXCLUSIVE ECONOMIC ZONE OFF ALASKA

1. The authority citation for 50 CFR part 679 continues to read as follows:

Authority: 16 U.S.C. 773 *et seq.*, 1801 *et seq.*, and 3631 *et seq.*

2. In § 679.2, the definitions of "IR/IU" and "IR/IU species" are added in alphabetical order and the heading and the definition of "round weight or round-weight equivalent" are revised to read as follows:

§ 679.2 Definitions.

* * * * *

IR/IU means the improved retention/improved utilization program set out at § 679.27.

IR/IU species means any groundfish species that is regulated by a retention or utilization requirement set out at § 679.27.

* * * * *

Round-weight equivalent means the weight of groundfish calculated by dividing the weight of the primary product made from that groundfish by the PRR for that primary product as listed in Table 3 of this part, or, if not listed, the weight of groundfish calculated by dividing the weight of a primary product by the standard PRR as determined using the best available evidence on a case-by-case basis.

* * * * *

3. In § 679.5, paragraphs (c)(3)(ii)(G) and (e)(2)(ii)(F) are added to read as follows:

§ 679.5 Recordkeeping and reporting.

* * * * *

(c) * * *

(3) * * *
(ii) * * *
(G) The round weight catch of pollock and Pacific cod.
* * * * *
(e) * * *
(2) * * *
(ii) * * *
(F) The receipt round weight of pollock and Pacific cod.
* * * * *

4. Section 679.27 is added to read as follows:

§ 679.27 Improved Retention/Improved Utilization Program.

(a) *Applicability.* The retention and utilization requirements of this section apply to any vessel fishing for groundfish in the BSAI or processing groundfish harvested in the BSAI.

(b) *IR/IU species.* The following species are defined as "IR/IU species" for the purposes of this section:
(1) Pollock
(2) Pacific cod
(3) (beginning January 1, 2003) rock sole
(4) (beginning January 1, 2003) yellowfin sole

(c) *Minimum retention requirements*—(1) *Definition of retain on board.* Notwithstanding definitions at 50 CFR part 600, for this purpose of this section, to retain on board means to be in possession of on board a vessel.

(2) The following table displays minimum retention requirements by vessel category and directed fishing status:

If you own or operate a	And	You must retain on board until lawful transfer
(i) Catcher vessel	(A) Directed fishing for an IR/IU species is open	All fish of that species brought on board the vessel.
	(B) Directed fishing for an IR/IU species is prohibited.	All fish of that species brought on board the vessel up to the MRB amount for that species.
	(C) Retention of an IR/IU species is prohibited	No fish of that species.
(i) Catcher/processor	(A) Directed fishing for an IR/IU species is open	A primary product from all fish of that species brought on board the vessel.
	(B) Directed fishing for an IR/IU species is prohibited.	A primary product from all fish of that species brought on board the vessel up to the point that the round-weight equivalent of primary products on board equals the MRB amount for that species.
	(C) Retention of an IR/IU species is prohibited	No fish or product of that species.
(i) Mothership	(A) Directed fishing for an IR/IU species is open	A primary product from all fish of that species brought on board the vessel.
	(B) Directed fishing for an IR/IU species is prohibited.	A primary product from all fish of that species brought on board the vessel up to the point that the round-weight equivalent of primary products on board equals the MRB amount for that species.
	(C) Retention of an IR/IU species is prohibited	No fish or product of that species.

(d) *Bleeding codends and shaking longline gear.* Any action intended to discard or release an IR/IU species prior to being brought on board the vessel is prohibited. This includes, but is not limited to bleeding codends and shaking or knocking fish off longline gear.

(e) *At-sea discard of product.* Any product from an IR/IU species that has been frozen, canned, or reduced to meal may not be discarded at sea.

(f) *Discard of fish or product transferred from other vessels.* The retention requirements of this section apply to all IR/IU species brought on board a vessel, whether harvested by that vessel or transferred from another vessel. At-sea discard of IR/IU species or products that were transferred from another vessel is prohibited.

(g) *IR/IU species as bait.* IR/IU species may be used as bait provided that the deployed bait is physically secured to authorized fishing gear. Dumping of unsecured IR/IU species as bait (chumming) is prohibited.

(h) *Minimum utilization requirements.*

(1) *Catcher/processors.* If you own or operate a catcher/processor, the minimum utilization requirement for an IR/IU species harvested in the BSAI is determined by the directed fishing status for that species according to the following table:

If . . .	Your total weight of retained or lawfully transferred products produced from the catch of that IR/IU species during a fishing trip must . . .
(i) Directed fishing for an IR/IU species is open.	Equal or exceed 15 percent of the round weight catch of that species during the fishing trip.
(ii) Directed fishing for an IR/IU species is prohibited.	Equal or exceed 15 percent of the round weight catch of that species during the fishing trip or 15 percent of the MRB amount for that species, whichever is lower.
(iii) Retention of an IR/IU species is prohibited.	Equal zero.

(2) *Motherships.* If you own or operate a mothership, the minimum utilization requirement for an IR/IU species harvested in the BSAI is determined by the directed fishing status for that species according to the following table:

If . . .	Your weight of retained or lawfully transferred products produced from deliveries of that IR/IU species received during a reporting week must . . .
(i) Directed fishing for an IR/IU species is open.	Equal or exceed 15 percent of the round weight of that species received during the reporting week.

If . . .	Your weight of retained or lawfully transferred products produced from deliveries of that IR/IU species received during a reporting week must . . .
(ii) Directed fishing for an IR/IU species is prohibited.	Equal or exceed either 15 percent of the round weight of that species received during the reporting week or 15 percent of the MRB amount for that species, whichever is lower.
(iii) Retention of an IR/IU species is prohibited.	Equal zero.

5. In § 679.50, paragraphs (c)(1)(i) and (c)(1)(ii) are revised to read as follows:

§ 679.50 Groundfish Observer Program applicable through December 31, 1997.

* * * * * * *

(c) * * *

(1) * * *

(i) A mothership of any length that processes 1,000 mt or more in round-weight equivalent of groundfish during a calendar month is required to have an observer aboard the vessel each day it receives or processes groundfish during that month.

(ii) A mothership of any length that processes from 500 mt to 1,000 mt in round-weight equivalent of groundfish during a calendar month is required to have an observer aboard the vessel at least 30 percent of the days it receives or processes groundfish during that month.

* * * * * * *

[FR Doc. 97-16697 Filed 6-25-97; 8:45 am]

BILLING CODE 3510-22-P

REPRESENTATIVE ALAN AUSTERMAN Alaska State Legislature

P.O. Box 2368, Kodiak, Alaska 99615 (907) 486-5930 • Session: State Capitol, Juneau, Alaska 99801 465-2487

Sponsor Statement
CSHB 310 (RLS)

CSHB 310 extends, to other groundfish species, the current ban in state law regarding the waste of pollock. It enables the Alaska Board of Fisheries to require processors to meet minimal standards for the utilization of other groundfish in addition to pollock, similar to regulations adopted by the Secretary of Commerce for offshore processors. The legislation is necessary because current state law only prohibits the waste of pollock and not other groundfish species, such as Pacific cod, rock sole, and yellowfin sole.

The State of Alaska and the North Pacific Fisheries Management Council are moving in concert to reduce waste in the groundfish fisheries of the Gulf of Alaska and Bering Sea. For several years the North Pacific Fisheries Management Council has been studying ways to reduce the discard of fish caught in the groundfish fisheries of the Bering Sea and Gulf of Alaska. The Council has determined that a large proportion of the fish discarded are discarded for economic reasons; in particular, pollock, Pacific cod, rock sole and yellowfin sole are being discarded at unacceptably high rates.

The council selected pollock and Pacific cod as targets for immediate inclusion in its plan to increase retention and utilization (IR/IU). Yellowfin sole and rock sole are scheduled to be included in the IR/IU program beginning January 1, 2003. The Council plan requires: 1) catcher vessels to retain all fish harvested of the species designated for IR/IU when directed fishing for these species is open, or the Maximum Retainable Bycatch (MRB) when directed fisheries for these species is closed; 2) a product be retained from every fish harvested; 3) processors to produce primary products that utilize at least fifteen percent of the total weight of the harvested species subject to IR/IU rules

During the Council deliberations on IR/IU, the State of Alaska agreed to adopt a corresponding program for shorebased processors and vessels fishing for groundfish in state waters. The National Marine Fisheries Service has recently implemented a program for improved retention of pollock and Pacific cod for vessels operating in the Gulf of Alaska and Bering Sea exclusive economic zones. The state Board of Fisheries has acted to adopt mirroring regulations for the retention of pollock and Pacific cod by fishing vessels and for the utilization of pollock by processors. However, without this legislation, the board cannot regulate the utilization of Pacific cod by processors.

No: 2

FISCAL NOTE

Bill Version: HB 310
(H) Publish Date: 1/30/98

STATE OF ALASKA
1998 LEGISLATIVE SESSION

Revision Date (Note if correction) 1/14/98 Dept. Affected Public Safety
Title An Act relating to the utilization of groundfish taken in a commercial fishery; providing for an effective date
BRU Fish and Wildlife Protection
Component Detachments
Sponsor Rep. Austerman
Requester House Spec. Committee on Fisheries
Component Serial No. 490

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04
Personal Services	0.0	0.0	0.0	0.0	0.0	0.0
Travel	0.0	0.0	0.0	0.0	0.0	0.0
Contractual	0.0	0.0	0.0	0.0	0.0	0.0
Supplies	0.0	0.0	0.0	0.0	0.0	0.0
Equipment	0.0	0.0	0.0	0.0	0.0	0.0
Land & Structures	0.0	0.0	0.0	0.0	0.0	0.0
Grants & Claims	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES ( )	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts	0.0	0.0	0.0	0.0	0.0	0.0
1003 GF Match	0.0	0.0	0.0	0.0	0.0	0.0
1004 GF	0.0	0.0	0.0	0.0	0.0	0.0
1005 GF/Program Receipts	0.0	0.0	0.0	0.0	0.0	0.0
1037 GF/Mental Health	0.0	0.0	0.0	0.0	0.0	0.0
Other (Specify Type)	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY98) cost: 0.0

POSITIONS

Full-time	0	0	0	0	0	0
Part-time	0	0	0	0	0	0
Temporary	0	0	0	0	0	0

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

This bill would require all commercial fishers to retain and process for lawful utilization designated groundfish species caught as bycatch during any commercial fishery. This bill is consistent with Department program objectives and will not adversely impact the Division's budget.

Prepared by Captain Joel L. Hard Phone 746-9139
Division Fish and Wildlife Protection Date 1/14/98
Approved by Commissioner Ronald L. Otte Date 1/14/98
Agency Department of Public Safety

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR'S LEGISLATIVE OFFICE

COMMITTEE COPY For further distribution information, call the Governor's Legislative Office

No: 1

FISCAL NOTE

Bill Version: HB 310

(H) Publish Date: 1/30/98

STATE OF ALASKA
1998 LEGISLATIVE SESSION

Revision Date (Note if correction) _____ Dept. Affected Fish and Game

Title Utilization of groundfish BRU CFMD

Component Fisheries management

Sponsor Rep. Austerman

Requester House Fisheries Component Serial No 1941

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04
Personal Services	0.0	0.0	0.0	0.0	0.0	0.0
Travel	0.0	0.0	0.0	0.0	0.0	0.0
Contractual	0.0	0.0	0.0	0.0	0.0	0.0
Supplies	0.0	0.0	0.0	0.0	0.0	0.0
Equipment	0.0	0.0	0.0	0.0	0.0	0.0
Land & Structures	0.0	0.0	0.0	0.0	0.0	0.0
Grants & Claims	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES						
CHANGE IN REVENUES ( )	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY98) cost: _____

POSITIONS

Full-time	0	0	0	0	0	0
Part-time	0	0	0	0	0	0
Temporary	0	0	0	0	0	0

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

Prepared by Bob Clasby Phone 465-6100

Division Commercial Fisheries Management and Development Date 1/21/98

Approved by Commissioner: Frank Rue Frank Rue Date 1/21/98

Agency Fish and Game

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR'S LEGISLATIVE OFFICE

For further distribution information, call the Governor's Legislative Office

(Rev 3/97) 98fnform.xls/CMB

COMMITTEE COPY

SENATE COMMITTEE REPORT

DATE: 3/26/98

FURTHER:

DATE TURNED IN TO OFFICE: 04-03-98

Judiciary Committee considered CS FOR HOUSE BILL NO. 310(RLS)

"An Act relating to the utilization of groundfish; 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 the _____ Committee

Senate Bill:
[ ] same title
[ ] new title

House Bill:
[ ] same title
[ ] technical title
[ ] new: SCR"_____

SIGNING: DO PASS	DP	OTHER RECOMMENDATIONS	NR	DNP	AM
Pearce	✓	Sean Parnell	X		
CHAIR: Robin L. Taylor	✓	CHAIR:			

NEW FISCAL NOTE(S):

Department	Date	Zero	Fiscal

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
P.S. FISH & WILDLIFE	1-14-98	✓	
F&G CFMD FISH. MGT	1-21-98	✓	

[ ] **APPROPRIATION -- no fiscal note**

***include fiscal notes accompanying Governor's bill**

HB 321

Alaska State Legislature
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE
MILITARY & VETERANS AFFAIRS
COMMUNITY & REGIONAL AFFAIRS
OIL & GAS

Representative Joe Ryan
1 800-922-3875 http://www.akrepublicans.org

INTERIM:
716 W. 4TH AVE.
ANCHORAGE, AK 99501
PHONE (907) 258-8161

SESSION:
STATE CAPITOL
ROOM 420
JUNEAU, AK 99801-1182
PHONE (907) 465-3875

SPONSOR STATEMENT for House Bill 321

The Uniform Prudent Investor Act reverses common law rules that restrict the investment powers of trustees. The new act requires a trustee to invest as a prudent investor would, using reasonable care, skill and caution in light of the objectives and risk tolerance of the individual trust. Diversification of assets is an obligation. Trustees can delegate investment responsibilities to experts. Within the scope of these powers and duties, trustees can choose to invest in any kind of asset that meets the objective of the specific trust.

What are the specific advantages of the Uniform Prudent Investor Act?

1. Trusts are likely to achieve a better return for beneficiaries than is the case under the common law rules.
2. Trustees can protect the trust corpus better through diversification of assets than is the case under the common law rules
3. Trustees can invest to counter the effects of inflation, something that the common rules do not allow.
4. A trustee no longer is forced to relay upon his or her own knowledge and expertise, but can acquire investment services to enhance his or her own knowledge and skill.
5. Trustees can take into account the changing character and kinds of assets available for investment, free from archaic restrictions.

6. Trustees are judged on overall performance of the assets in a trust, rather than on the performance of specific assets.
7. The specific needs of each trust can be taken into account in devising investment strategy, rather than be subordinate to generic investment rules treating all trusts as the same.
8. The Act will provide uniformity of law, necessary in an interstate investment enviroment.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

130 Seward Street, Suite 409
Juneau, Alaska 99801-2105

MEMORANDUM

February 9, 1998

SUBJECT: Sectional Summary (HB 321)

TO: Representative Joe Ryan

FROM: Tamara Brandt Cook
Director TBC

Here is the sectional summary you requested for a bill dealing with trusts based on the Uniform Prudent Investor Act of the National Conference of Commissions on Uniform State Laws.

Secs. 1 and 2. Correct a cross-reference to a statute repealed in this bill.

Sec. 3. Adds a new article -- the Uniform Prudent Investor Act.

Sec. 13.36.200. Requires a trustee to comply with the prudent investor rule and permits the rule to be expanded, restricted, eliminated, or altered by the provisions of a trust.

Sec. 13.36.205. Requires a trustee to manage assets by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Lists specific circumstances that a trustee must consider. Requires a trustee to make a reasonable effort to verify facts relevant to management of trust assets. A trustee with special skills has a duty to use those skills.

Sec. 13.36.210. Requires diversification of investments, unless the purposes of the trust are better served without diversifying.

Sec. 13.36.215. Requires a trustee to review a trust and make decisions regarding assets within a reasonable time after accepting a trusteeship or receiving the assets.

Sec. 13.36.220. Requires a trustee to manage assets solely in the interest of the beneficiaries.

Sec. 13.36.225. Requires a trustee to act impartially if a trust has two or more beneficiaries.

Sec. 13.36.230. A trustee may only incur costs that are reasonable in managing a trust.

Sec. 13.36.235. Compliance with the prudent investor rule is determined in light of the facts existing at the time of the trustee's decision or action.

Sec. 13.36.240. A trustee may delegate investment and management functions, but the trustee must exercise care, skill and caution in selecting an agent, establishing the terms of the delegation, and reviewing the agent's actions.

Sec. 13.36.260. Certain general phrases that may appear in a trust invoke the standards of this article.

Sec. 13.36.265. The new article applies to trusts existing on and created after the effective date of those sections, but, as applied to existing trusts, the article governs only decisions or actions that occur after the effective date.

Sec. 13.36.270. The new article is to construed to make uniform the law among the states that adopt a Uniform Prudent Investor Act.

Sec. 13.36.275. The short title is the Uniform Prudent Investor Act.

Sec. 4. The existing statute dealing with a trustee's standard of care is repealed.

Sec. 5. Immediate effective date.

TBC:glc
98-070.glc

Alaska State Legislature
House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE
MILITARY & VETERANS AFFAIRS
COMMUNITY & REGIONAL AFFAIRS
OIL & GAS

Representative Joe Ryan
1 800-922-3875 http://www.akrepublicans.org

INTERIM:
716 W. 4TH AVE.
ANCHORAGE, AK 99501
PHONE (907) 258-8161

SESSION:
STATE CAPITOL
ROOM 420
JUNEAU, AK 99801-1182
PHONE (907) 465-3875

SPONSOR STATEMENT for House Bill 321

The Uniform Prudent Investor Act reverses common law rules that restrict the investment powers of trustees. The new act requires a trustee to invest as a prudent investor would, using reasonable care, skill and caution in light of the objectives and risk tolerance of the individual trust. Diversification of assets is an obligation. Trustees can delegate investment responsibilities to experts. Within the scope of these powers and duties, trustees can choose to invest in any kind of asset that meets the objective of the specific trust.

What are the specific advantages of the Uniform Prudent Investor Act?

1. Trusts are likely to achieve a better return for beneficiaries than is the case under the common law rules.
2. Trustees can protect the trust corpus better through diversification of assets than is the case under the common law rules
3. Trustees can invest to counter the effects of inflation, something that the common rules do not allow.
4. A trustee no longer is forced to relay upon his or her own knowledge and expertise, but can acquire investment services to enhance his or her own knowledge and skill.
5. Trustees can take into account the changing character and kinds of assets available for investment, free from archaic restrictions.

6. Trustees are judged on overall performance of the assets in a trust, rather than on the performance of specific assets.
7. The specific needs of each trust can be taken into account in devising investment strategy, rather than be subordinate to generic investment rules treating all trusts as the same.
8. The Act will provide uniformity of law, necessary in an interstate investment enviroment.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

130 Seward Street, Suite 409
Juneau, Alaska 99801-2105

MEMORANDUM February 9, 1998

SUBJECT: Sectional Summary (HB 321)

TO: Representative Joe Ryan

FROM: Tamara Brandt Cook
Director TBC

Here is the sectional summary you requested for a bill dealing with trusts based on the Uniform Prudent Investor Act of the National Conference of Commissions on Uniform State Laws.

Secs. 1 and 2. Correct a cross-reference to a statute repealed in this bill.

Sec. 3. Adds a new article -- the Uniform Prudent Investor Act.

Sec. 13.36.200. Requires a trustee to comply with the prudent investor rule and permits the rule to be expanded, restricted, eliminated, or altered by the provisions of a trust.

Sec. 13.36.205. Requires a trustee to manage assets by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Lists specific circumstances that a trustee must consider. Requires a trustee to make a reasonable effort to verify facts relevant to management of trust assets. A trustee with special skills has a duty to use those skills.

Sec. 13.36.210. Requires diversification of investments, unless the purposes of the trust are better served without diversifying.

Sec. 13.36.215. Requires a trustee to review a trust and make decisions regarding assets within a reasonable time after accepting a trusteeship or receiving the assets.

Sec. 13.36.220. Requires a trustee to manage assets solely in the interest of the beneficiaries.

Sec. 13.36.225. Requires a trustee to act impartially if a trust has two or more beneficiaries.

Sec. 13.36.230. A trustee may only incur costs that are reasonable in managing a trust.

Sec. 13.36.235. Compliance with the prudent investor rule is determined in light of the facts existing at the time of the trustee's decision or action.

Sec. 13.36.240. A trustee may delegate investment and management functions, but the trustee must exercise care, skill and caution in selecting an agent, establishing the terms of the delegation, and reviewing the agent's actions.

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

130 Seward Street, Suite 409
Juneau, Alaska 99801-2105

MEMORANDUM February 9, 1998

SUBJECT: Sectional Summary (HB 321)

TO: Representative Joe Ryan

FROM: Tamara Brandt Cook
Director TBC

Here is the sectional summary you requested for a bill dealing with trusts based on the Uniform Prudent Investor Act of the National Conference of Commissions on Uniform State Laws.

Secs. 1 and 2. Correct a cross-reference to a statute repealed in this bill.

Sec. 3. Adds a new article -- the Uniform Prudent Investor Act.

Sec. 13.36.200. Requires a trustee to comply with the prudent investor rule and permits the rule to be expanded, restricted, eliminated, or altered by the provisions of a trust.

Sec. 13.36.205. Requires a trustee to manage assets by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Lists specific circumstances that a trustee must consider. Requires a trustee to make a reasonable effort to verify facts relevant to management of trust assets. A trustee with special skills has a duty to use those skills.

Sec. 13.36.210. Requires diversification of investments, unless the purposes of the trust are better served without diversifying.

Sec. 13.36.215. Requires a trustee to review a trust and make decisions regarding assets within a reasonable time after accepting a trusteeship or receiving the assets.

Sec. 13.36.220. Requires a trustee to manage assets solely in the interest of the beneficiaries.

Sec. 13.36.225. Requires a trustee to act impartially if a trust has two or more beneficiaries.

Sec. 13.36.230. A trustee may only incur costs that are reasonable in managing a trust.

Sec. 13.36.235. Compliance with the prudent investor rule is determined in light of the facts existing at the time of the trustee's decision or action.

Sec. 13.36.240. A trustee may delegate investment and management functions, but the trustee must exercise care, skill and caution in selecting an agent, establishing the terms of the delegation, and reviewing the agent's actions.

Sec. 13.36.260. Certain general phrases that may appear in a trust invoke the standards of this article.

Sec. 13.36.265. The new article applies to trusts existing on and created after the effective date of those sections, but, as applied to existing trusts, the article governs only decisions or actions that occur after the effective date.

Sec. 13.36.270. The new article is to construed to make uniform the law among the states that adopt a Uniform Prudent Investor Act.

Sec. 13.36.275. The short title is the Uniform Prudent Investor Act.

Sec. 4. The existing statute dealing with a trustee's standard of care is repealed.

Sec. 5. Immediate effective date.

TBC:glc
98-070.glc

STATE OF ALASKA

TONY KNOWLES, GOVERNOR

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

P.O. BOX 110300
JUNEAU, ALASKA 99811-0300
PHONE: (907)465-3600
FAX: (907)465-2075

February 12, 1998

The Honorable Joe Ryan
House of Representatives
Alaska State Legislature
State Capitol, Room 420
Juneau, Alaska 99811

Re: HB 321: Uniform Prudent Investor Act

Dear Rep. Ryan:

The Department of Law has reviewed HB 321, which proposes enactment of the Uniform Prudent Investor Act. We find no legal problems. The bill is an important vehicle to keep our law current on modern portfolio theory and trust management principles.

Sincerely,

BRUCE M. BOTELHO
ATTORNEY GENERAL

By: Deborah E. Behr
Assistant Attorney General

DEB:ng
H:\LEGIS98\BILL\321_HB.LTR

cc: Pat Pourchot, Legislative Director
Office of the Governor

Chrystal Smith, Legal Administrator
Dept. of Law

Mary Ellen Beardsley
Assistant Attorney General
Anchorage

Vince Usera
Assistant Attorney General
Juneau

03-C32LH

AG OPINION

LAW OFFICES
DILLON & FINDLEY
A PROFESSIONAL CORPORATION

JUNEAU
Dennis C. Bailey
Caroline Cremata
Paul L. Dillon
Thomas W. Findley
Devon P. Grover
Richard D. Monkman
Arthur H. Peterson
Peter K. Putzier
Paralegal
Teri Heuscher
Firm Administrator
Melanie E. Mickelson

The Ebner Building
350 North Franklin Street
Juneau, Alaska 99801
Telephone (907) 586-4000
Facsimile (907) 586-3777

ANCHORAGE
Ray R. Brown
Mairi Long
Kristen D. Pettersen
Paralegal
M. Benita Raymond

510 L Street, Suite 601
Anchorage, Alaska 99501
Telephone (907) 277-5400
Facsimile (907) 277-8896

January 30, 1998

The Honorable Joe Ryan
House of Representatives
Alaska State Legislature
State Capitol, Room 420
Juneau, Alaska 99811

HAND DELIVERED

Re: House Bill 321, Uniform Prudent Investor Act

Dear Representative Ryan:

You have asked for my comments on HB 321, which proposes enactment of the Uniform Prudent Investor Act. It very closely tracks the "official" version promulgated by the National Conference of Commissioners on Uniform State Laws. I strongly support it, and urge its passage.

The only significant modifications from the official version are the following:

1. sec.1's amendment of AS 13.16.350(a) merely picks up, with regard to the standards applicable to the personal representative of an estate, the standards in the new statutes, for consistency;

2. sec. 2's amendment of AS 13.26.245 does the same thing for the duties of a conservator;

3. proposed AS 13.36.265(b) (on page 5 of the bill) merely makes the "application" section specifically applicable to the decisions and actions of personal representatives and conservators, as dealt with in secs. 1 and 2 of the bill;

4. sec. 4 of the bill repeals AS 13.36.075, the current section that sets out a trustee's standard of care and performance, again to be consistent with the amendments made in secs. 1 and 2; the substance of existing AS 13.36.075 is set out and expanded upon in proposed AS 13.36.205 (at pages 2 and 3 of the bill).

This bill was promulgated by the National Conference in 1994, has already been enacted in 19 states, and is pending in at least seven others. (The latest figures that I have are dated July 1, 1997. I will try to get you an update.)

I will slightly paraphrase a purpose statement from the National Conference: This Act removes much of the common-law restriction upon the investment authority of trustees and similar fiduciaries. It allows them to use modern portfolio theory to guide investment decisions. A fiduciary's performance is measured on the performance of the whole portfolio, not upon the performance of each single investment. This Act allows the fiduciary to delegate investment decisions to qualified and supervised agents. It requires sophisticated risk-return analysis to guide investment decisions. Thus, this Act expedites trust management, while assuring both the person creating the trust and the beneficiary of a trust of a sound set of standards for that management.

I hope that these comments are helpful to you in getting this bill enacted this year. You might also want to consider the Uniform Principal and Income Act as a companion bill, or as part of this one. Let me know if you have any questions; however, this is another subject on which Commissioner Jerry Kurtz is more well-versed than I.

Yours truly,

Arthur H. Peterson
Uniform Law Commissioner
for Alaska

cc: Rest of Alaska's ULC Delegation:
Deborah E. Behr
W. Grant Callow
Tamara Brandt Cook
L.S. (Jerry) Kurtz, Jr.
Jay A. Rabinowitz

AHP/ph

ALASKA TRUST COMPANY
Wealth Management Specialists

February 9, 1998

Representative, Joe Ryan
2011 Farmer Place, #4
Anchorage, Alaska 99508

Re: The Prudent Investor Act

Dear Joe:

I have been advised that you would like a brief summary of what the new Prudent Investor act accomplishes. The Prudent Investor Act is designed to replace the antiquated "Prudent Person Rule".

The Prudent Investor Act requires that the trustee, or other fiduciaries, incorporate a modern portfolio theory in to its investment approach. This requires the trustee, or other fiduciary, to consider all appropriate factors in implementing a portfolio of investments.

The major points of the new legislation are to clarify, or allow for, the following:

(1) The standard of prudence applies to the trust as a whole instead of individual investments.

(2) The overall investment strategy should be based upon the risk and reward objectives suitable for the trust.

(3) The duty to diversify must be part of the investment strategy, unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify, taking in to account the purposes, terms, and provisions of the governing document.

(4) No particular investment is inherently prudent or imprudent.

(5) No special status is given to original investments and the trustee must review them within a reasonable time.

840 K Street, Suite 204
Anchorage, Alaska 99501
Phone: 907-278-6775 Fax: 907-258-1649
aktrust@pobox.alaska.net

(6) A corporate trustee, or paid professional advisor acting as trustee, is accountable under a special investment skills standard.

(7) Delegation of investment authority is permitted but the trustee retains liability for the investment performance of the delegee.

This new statute is designed to raise the level of the trustees responsibility and duties to the beneficiaries. The overall investment strategy needs to be designed to enable the trustee to make appropriate present, and future, distributions to the beneficiaries.

When structuring a portfolio the trustee needs to consider the following:

- The size of the portfolio.
- The expected duration of the trust.
- Liquidity and distribution requirements.
- General economic conditions.
- The effect of inflation-or deflation.
- The tax consequences of investment decisions or strategies, and of distributions of principal or income to the beneficiaries.
- The role that each investment plays within the overall portfolio.
- The expected total return of the portfolio from both income, and appreciation from capitol.
- The distribution needs of the beneficiaries.

A version of the Prudent Investor Rule has been approved by over (20) states and it is anticipated that over the next few years, all states will incorporate the Prudent Investor Rule standards and requirements.

Please let me know if the above explanation is sufficient. I would be happy to discuss any further clarification that you may need on this matter.

Sincerely,

Douglas J. Blattmachr
President & CEO

DJB/ss

UNIFORM PRUDENT INVESTOR ACT

– A SUMMARY –

Trustees of trusts and like fiduciaries have been subject to rules severely restricting the types of investment modalities in which they can invest the assets of the trusts that they administer and manage. Interest-bearing instruments – safe income – of limited kinds (no junk bonds) are the limit of risk permitted or thought to be permitted under the traditional rules. Protect the paper value of the principal at all costs is the mandate for trustees. In addition, a trustee's performance is rated by the performance of each and every investment, singly, and not on the performance of the whole of the portfolio. And trustees have been precluded from obtaining professional investment help.

The result for trusts is modest income production at best without regard for the erosion of a trust's assets by inflation. Can it be that these rules miscalculate the real risk and actually jeopardize the assets of a trust rather than provide for their protection?

The answer is yes. And a remedy is now at hand in the Uniform Prudent Investor Act (UPIA), promulgated by the Uniform Law Commissioners in 1994. The adoption of this act by the state legislatures will correct the rules, based on false and damaging premises, that now govern the actions of trustees.

By no means does UPIA turn trustees into unrestrained speculators. It provides rules governing investment that, in fact, result in greater protection for the trust's assets while providing a prospect of better income. UPIA does not encourage irresponsible, speculative behavior, but requires careful assessment of investment goals, careful analysis of risk versus return, and diversification of assets to protect them. It gives the trustee the tools to accomplish these ends. UPIA requires trustees to become devotees of "modern portfolio theory" and to invest as a prudent investor would invest "considering the purposes, terms, distribution requirements, and other circumstances of the trust" using "reasonable care, skill, and caution."

The trustee has a list of factors which must be considered in making investment decisions, including "general economic conditions," "possible effect of inflation or deflation," "the expected total return from income and the appreciation of capital," and "other resources of the beneficiaries." The trustee must take tax consequences of investment decisions into account. There is a positive obligation to diversify assets "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The trustee's obligations are significant, requiring sophisticated approaches to investment that really take into account the right risk-to-return ratio for the particular trust.

In addition, a trustee's performance in UPIA is measured by the performance of all the assets together. A loss with respect to a single asset does not mean that the trustee has violated his or her fiduciary responsibilities. The act takes the truly holistic approach to investment practices.

In return for these obligations, UPIA removes any restrictions upon the types of investment modalities which may be chosen in a trust's portfolio. It is quite possible, for example, to hold positions in high-interest bonds (junk bonds) or mutual funds investing in such bonds, in a diversified portfolio, if such an investment meets the needs of the particular trust in light of the risk/return analysis specific to that trust.

One of the boons to trustees of smaller trusts is the ability to invest in mutual funds. Mutual funds reduce investment risk by diversifying their portfolios. By using mutual funds, a trustee of a trust that does not have a large enough corpus to effectively diversify its assets can enhance diversification of the trust's portfolio to limit the trust's risk of loss.

UPIA also permits the trustee to delegate investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." Careful selection of the agent and careful, periodic review of the agent's actions are part of the trustee's responsibility when delegating authority. An agent has a responsibility of reasonable care in conducting the delegated business of the trust.

Why is it that the prudent man rule of prior law may, in fact, jeopardize the assets in a trust? Some of the instruments in which trustees have been able to invest have become more volatile in price. Treasury bonds, for example, long thought to be safe investments, now fluctuate considerably in value with the fluctuation of interest rates. The former so-called safe investment may not be so safe anymore. In contrast, common stocks have shown consistently better returns over the years than bonds – yet trustees have been prevented from investing in common stocks. Stocks have been historically safer investments, therefore, in diversified portfolios than bonds have been. Trusts have been deprived of return at some greater risk by the antiquated rules that govern investment of their assets.

By far the most insidious damage to trust assets comes from inflation. If trustees cannot invest in modalities that exceed the rate of inflation in return, the inevitable result is diminution of the corpus of the trusts they manage. The beneficiaries of trusts so restricted lose in all ways, both with respect to income and principal.

The UPIA provides rules that can be modified or waived in the trust agreement. Any person who wishes to put property in trust and who wants to provide different standards of conduct for the trustee is permitted to do so under UPIA.

UPIA provides a reasonable approach to the investment of trust assets that better meets the needs of beneficiaries while preserving trust assets. It should become the law in every state as soon as possible.

Founded in 1892, the National Conference of Commissioners on Uniform State Laws is a confederation of state commissioners on uniform laws. Its membership is comprised of 300 practicing lawyers, judges, and law professors who are appointed by each of the 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands to draft uniform and model state laws and work toward their enactment.

A Few Facts About
THE UNIFORM PRUDENT INVESTOR ACT

PURPOSE: This act removes much of the common law restriction upon the investment authority of trustees of trusts and like fiduciaries. It allows such fiduciaries to utilize modern portfolio theory to guide investment decisions. A fiduciary's performance is measured on the performance of the whole portfolio, not upon the performance of each investment singly. The act allows the fiduciary to delegate investment decisions to qualified and supervised agents. It requires sophisticated risk-return analysis to guide investment decisions.

ORIGIN: Completed by the Uniform Law Commissioners in 1994.

ENDORSED BY: American Bar Association
American Bankers Association

STATE ADOPTIONS:

Arizona
Arkansas *
California
Colorado
Connecticut *
Idaho *
Maine
Minnesota
Missouri
Nebraska
New Jersey *
New Mexico
North Dakota *
Oklahoma
Oregon
Rhode Island
Utah
Washington
West Virginia

1997 INTRODUCTIONS:

District of Columbia
Hawaii
Indiana
Iowa
Massachusetts
Mississippi
Vermont

For any further information regarding the Uniform Prudent Investor Act, please contact John McCabe or Katie Robinson at 312-915-0195.

ORGANIZATION

The National Conference of Commissioners on Uniform State Laws has worked for the uniformity of state laws since 1892. It is a non-profit unincorporated association, comprised of state commissions on uniform laws from each state, the District of Columbia, the Commonwealth of Puerto Rico and the U.S. Virgin Islands. Each jurisdiction determines the method of appointment and the number of commissioners actually appointed. Most jurisdictions provide for their commission by statute.

There is only one fundamental requirement for the more than 300 uniform law commissioners: that they be members of the bar in the jurisdiction they represent. While some commissioners serve as state legislators, most are practitioners, judges and law professors. They serve for specific terms, and receive no salaries or fees for their work with the Conference.

The state uniform law commissions come together as the National Conference for one purpose — to study and review the law of the states to determine which areas of law should be uniform. The commissioners promote the principle of uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable. It must be emphasized that the Conference can only propose — no uniform law is effective until a state legislature adopts it.

The Conference is a working organization. The uniform law commissioners participate in drafting specific acts; they discuss, consider and amend drafts of other commissioners; they decide whether to recommend an act as a uniform or a model act; and they work toward enactment of Conference acts in their home jurisdictions.

HISTORY

The uniform law movement began in the latter half of the 19th century. The Alabama State Bar Association recognized as early as 1881 the legal tangles created by wide variations in state laws. But it was not until 1889 that the American Bar Association decided, at its 12th Annual Meeting, to work for "uniformity of the laws" in the then 44 states.

Within a year, the New York Legislature authorized the governor to appoint three commissioners to explore the best way to effect uniformity of law between increasingly interdependent states. The ABA endorsed New York's action. The result was the first meeting of the *Conference of State Boards of Commissioners on Promoting Uniformity of Law in the U.S.*

Seven states sent commissioners to that first meeting of the Conference in Saratoga Springs, New York in 1892. By 1912, every state had appointed uniform law commissioners. The U.S. Virgin Islands is the last jurisdiction to join, appointing its first commission in 1988.

Since its organization, the Conference has drafted more than 200 uniform laws on numerous subjects and in various fields of law, setting patterns for uniformity across the nation. Uniform acts include the Uniform Probate Code, the Uniform Child Custody Jurisdiction Act, the Uniform Partnership Act, the Uniform Anatomical Gift Act and the Uniform Limited Partnership Act.

Most significant was the 1940 Conference decision to attack major commercial problems with comprehensive legal solutions — a decision that set in motion the project to produce the Uniform Commercial Code. The Code took ten years to complete and another 14 years before it was enacted across the country. It remains the signature product of the Conference.

Today the Conference is recognized primarily for its work in commercial law, family law, probate and estates, law of business organizations, health law, and conflicts of law. It rarely drafts law that is regulatory in character.

FINANCIAL SUPPORT

The major portion of financial support for the Conference comes from state appropriations. Expenses are apportioned among the states by means of an assessment based on population.

The Conference gets maximum results from minimum budgets because its major asset, drafting expertise, is donated. The only compensation for commissioners is the satisfaction derived from solving important legal problems. Commissioners devote hundreds and even thousands of

hours – amounting in some cases to millions of dollars worth of time – to the development of uniform and model acts. No state could afford the bills for the legal expertise that is donated to the drafting of uniform state laws.

PROCEDURES

Each uniform law is years in the making. The process starts with the Scope and Program Committee, which initiates the agenda of the Conference. It investigates each proposed act, and then reports to the Executive Committee whether a subject is one in which it is desirable and feasible to draft a uniform law. If the Executive Committee approves a recommendation, a drafting committee of commissioners is appointed. Drafting committees meet throughout the year. Tentative drafts are not submitted to the entire Conference until they have received extensive committee consideration.

Draft acts are then submitted for initial debate of the entire Conference at an annual meeting. Each act must be considered section by section, at no less than two annual meetings by all commissioners sitting as a Committee of the Whole. With hundreds of trained eyes probing every concept and word, it is a rare draft that leaves an annual meeting in the same form it was initially presented.

Once the Committee of the Whole approves an act, its final test is a vote by states – one vote per state. A majority of the states present, and no less than 20 states, must approve an act before it can be officially adopted as a Uniform or Model Act.

At that point, a Uniform or Model Act is officially promulgated for consideration by the states. Legislatures are urged to adopt Uniform Acts exactly as written, to "promote uniformity in law among the several states." Model Acts are designed to serve as guideline legislation, which states can borrow from or adapt to suit their individual needs and conditions.

When drafting is completed on an act, a commissioner's work has only begun. They advocate the adoption of uniform and model acts in their home states. Normal resistance to anything "new" makes this the hardest part of a commissioner's job. But the result can be workable modern state law that helps keep the federal system alive.

The work of the Conference simplifies the legal life of businesses and individuals by providing rules and procedures that are consistent from state to state. Representing both state government and the legal profession, it is a genuine confederation of state interests. It has sought to bring uniformity to the divergent legal traditions of more than 50 sovereign jurisdictions, and has done so with significant success.

THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

676 N. St. Clair
Suite 1700
Chicago, IL 60611
(312) 915-0195

FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB321 (H) L&C

Revision Date:
Title: Uniform Prudent Investor Act
Sponsor: Rep Ryan
Requestor: House Labor and Commerce

Department: Commerce and Economic Development
BRU: Banking, Securities and Corporations
Component: Banking, Securities and Corporations

COMPONENT SERIAL NO.

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY02	FY 03	FY 04
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	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 General Fund						
1005 GF Program Receipts						
1006 GF Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $ 0.0

POSITIONS

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director — Phone: 465-2521
Division: Banking, Securities and Corporations — Date: 2-5-98
Approved by Commissioner: Deborah B. Sedwick — Date: 2-9-98
Agency: Commerce and Economic Development

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR S LEGISLATIVE OFFICE
For further distribution information, call the Governor's Legislative Office

FISCAL NOTE(S)

FISCAL NOTE

STATE OF ALASKA
1998 LEGISLATIVE SESSION

BILL NO. HB321 (H) L&C

Revision Date:
Title: Uniform Prudent Investor Act
Sponsor: Rep Ryan
Requestor: House Labor and Commerce

Department: Commerce and Economic Development
BRU: Banking, Securities and Corporations
Component: Banking, Securities and Corporations

COMPONENT SERIAL NO.

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 99	FY 00	FY 01	FY02	FY 03	FY 04
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	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 General Fund						
1005 GF Program Receipts						
1006 GF Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY 98) cost: $ 0.0

POSITIONS

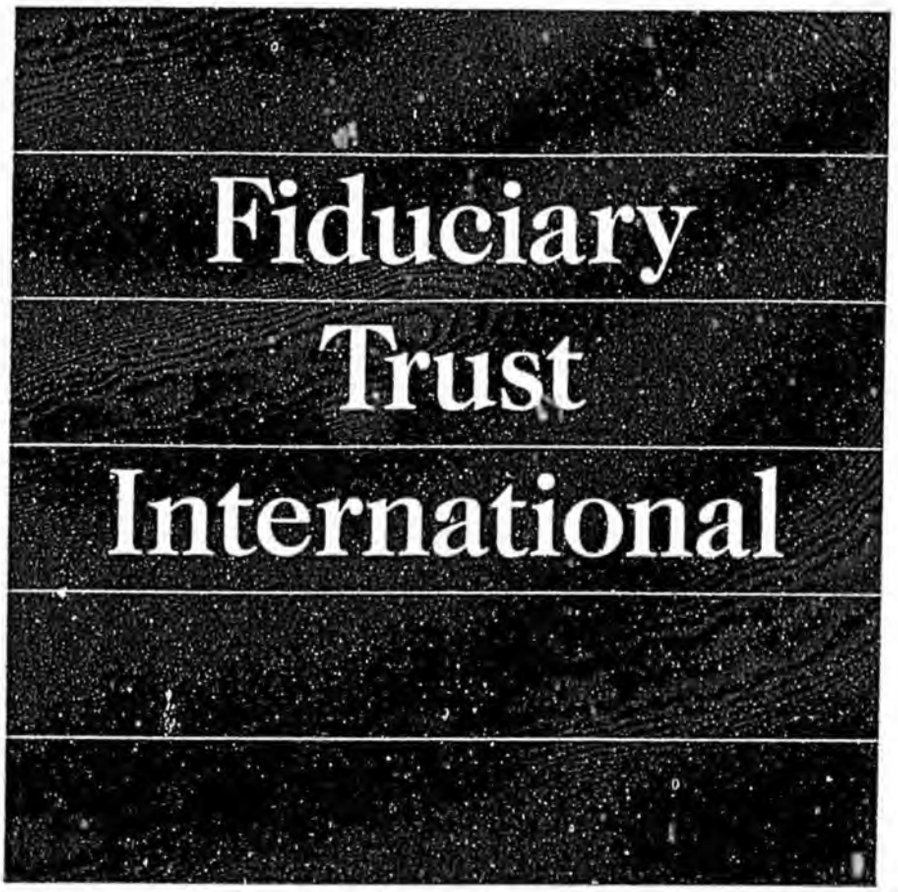
FULL-TIME	
PART-TIME	
TEMPORARY	

ANALYSIS: (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director — Phone: 465-2521
Division: Banking, Securities and Corporations — Date: 2-5-98
Approved by Commissioner: Deborah B. Sedwick — Date: 2-9-98
Agency: Commerce and Economic Development

PREPARER TO PROVIDE ALL DISTRIBUTION COPIES TO GOVERNOR S LEGISLATIVE OFFICE
For further distribution information, call the Governors Legislative Office

FISCAL NOTE(S)



Uniform Prudent Investor Act

Investment Legislation Governing Trusts and Foundations

As of November, 1997

Fiduciary Trust Company International

BACKGROUND
INFORMATION

Investment Legislation Governing Trusts and Foundations (by State)

As of November, 1997

A model Uniform Prudent Investor Act ("UPIA") was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994 and recommended for enactment by the states. The UPIA allows trustees and similar fiduciaries to employ modern portfolio theory to guide investment decisions, and evaluates a fiduciary's conduct based on a strategy for the total portfolio, rather than on the selection of individual assets. In addition, the UPIA makes the following alterations in the former criteria for fiduciary investment: (A) the tradeoff between risk and return is identified as the fiduciary's central investment consideration; (B) categoric restrictions on types of investments have been abrogated; (C) the concept that fiduciaries should diversify portfolio investments has been integrated into the definition of prudence; (D) the much criticized rule of trust law forbidding the trustee to delegate investment and management functions has been reversed (some jurisdictions impose notice requirements not mandated by the UPIA); and (E) the trustee may be relieved from liability for acts of the agent, if certain requirements are met.

It should be noted that charitable foundations and private trusts are subject to similar investment rules. The UPIA is applicable to foundations organized in trust form. Charitable corporations, on the other hand, are governed in many jurisdictions by the Uniform Management of Institutional Funds Act ("UMIFA"). The far right column of the chart indicates whether a state has adopted UMIFA.

The chart at the right shows the states that have adopted the UPIA, or substantial portions thereof, as of this publication. Additionally, many other states are identified that now require a total portfolio approach to investment management, but which do not otherwise have provisions resembling the UPIA. If a state has no total portfolio statute, the chart makes no representation regarding whether that state's laws contain any other provision resembling the UPIA.

State	Uniform Prudent Inv. Act (or most UPIA provisions) Effective Date	Total Portfolio Statutes (minimal UPIA provisions) Effective Date	Authority
Alabama		5/16/89	Ala. Code §§
Alaska			
Arizona	7/20/96		Ariz. Rev. Stat
Arkansas	3/31/97		Act 940 of 19
California	1/1/96		Cal. Prob. Cod
Colorado	7/1/95		Colo. Rev. Sta
Connecticut	6/2/97		Public Act No
Delaware		7/3/86	Del. Code An
Dist. of Columbia		2/1/95	D.C. Super. C
Florida	10/1/93		Fla. Stat. Ann
Georgia		1/1/98	Ga. Code Ann
Hawaii	4/14/97		30 Hawaii Re
Idaho	7/1/97		Idaho Code §
Illinois	1/1/92		760 Ill. Comp
Indiana			
Iowa		4/22/01	Iowa Code An
Kansas	7/1/93		Kan. Stat. Ann
Kentucky		7/15/96	Kent. Rev. Sta
Louisiana			
Maine	1/1/97		Me. Rev. Stat
Maryland	10/1/94		Md. Est. & T
Massachusetts			
Michigan			
Minnesota	1/1/97		Minn. Stat. A
Mississippi			
Missouri	8/28/96		Mo. Ann. Sta
Montana		10/1/89	Mont. Code
Nebraska	4/2/97		Legislative B
Nevada		4/17/89	Nev. Rev. Sta
New Hampshire			
New Jersey	3/7/97		N.J. Stat. An
New Mexico	7/1/95		N.M. Stat. A
New York	1/1/95		N.Y. Est., P
North Carolina			
North Dakota	8/1/97		N.D. Cent. C
Ohio			
Oklahoma	11/1/95		Okla. Stat. t
Oregon	9/9/95		Or. Rev. Stat
Pennsylvania			
Rhode Island	8/6/96		R.I. Stat. §§
South Carolina		6/5/90	S.C. Code A
South Dakota	7/1/95		S.D. Codifie
Tennessee		7/1/89	Tenn. Code
Texas		6/16/91	Tex. Prop. C
Utah	7/1/95		Utah Code
Vermont			
Virginia	4/6/92		Va. Code A
Washington	7/23/95		Wash. Rev. C
West Virginia	7/1/96		W. Va. Cod
Wisconsin			
Wyoming			

	(A) Risk/Return Objectives Emphasized	(B) Unrestricted Investment Types Authorized	(C) Diversification of Portfolio as Prudent	(D) Delegation of Investment Management Authorized	(E) Trustee/Agent Liability Severed	(F) Notice of Delegation Required	Uniform Management of Institutional Funds Act (UMIFA)
20.2 and 19-3-322	No	No	No	Yes	No	No	Yes
							No
§§ 14-7601 to 14-7611	Yes	Yes	Yes	Yes	Yes	No	No
	Yes	Yes	Yes	Yes	Yes	No	Yes
16045 to 16054	Yes	Yes	Yes	Yes	Yes	No	Yes
§§ 15-1.1-101 to 15-1.1-115	Yes	Yes	Yes	Yes	Yes	No	Yes
140	Yes	Yes	Yes	Yes	Yes	No	Yes
12, § 3302	No	Yes	No	No	No	No	Yes
R. 5(a)	Yes	Yes	No	No	No	No	Yes
18.11 and 518.112	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3-8-2	No	Yes	No	No	No	No	Yes
statutes 554C	Yes	Yes	Yes	Yes	Yes	No	Yes
10	Yes	Yes	Yes	Yes	Yes	No	Yes
Ann. §§ 5/5 and 5/5.1	Yes	Yes	Yes	Yes	Yes	Yes	Yes
							Yes
33.123	No	No	No	No	No	No	Yes
8-1202 and 17-5004	Yes	Yes	Yes	Yes	Yes	Yes	Yes
277—applies only to corporate fiduciaries	Yes	No	Yes	Yes	No	No	Yes
							Yes
tit. 18-A, § 7-302	Yes	Yes	Yes	Yes	Yes	No	Yes
ode Ann. § 15-114	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
							Yes
501B.151 and 501B.152	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
56 900 to 456.913	Yes	Yes	Yes	Yes	Yes	No	Yes
72-34-114	No	Yes	No	No	Yes	No	Yes
	Yes	Yes	Yes	Yes	Yes	No	Yes
050	No	Yes	No	No	No	No	No
							Yes
20-11.1 to 3B:20-11.12	Yes	Yes	Yes	Yes	Yes	Yes	Yes
5-7-601 to 45-7-612	Yes	Yes	Yes	Yes	Yes	No	No
Trusts Law § 11-2.3	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
9-02-08.1 to 59-02-08.11	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
175.60 to 175.72	Yes	Yes	Yes	Yes	Yes	No	Yes
194 to 128.218	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
18-15-13	Yes	Yes	Yes	Yes	Yes	No	Yes
7-302	No	Yes	No	No	No	No	Yes
Ann. §§ 55-5-6 to 55-5-16	Yes	Yes	Yes	Yes	No	No	No
3-117	No	Yes	No	No	No	No	Yes
§ 113.056	No	Yes	No	No	No	No	Yes
7-302	Yes	Yes	Yes	Yes	Yes	No	No
							Yes
45.1	No	Yes	Yes	No	No	No	Yes
§ 11.100.010 et seq.	No	Yes	Yes	No	No	No	Yes
1 to 44-6C-15	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
							Yes

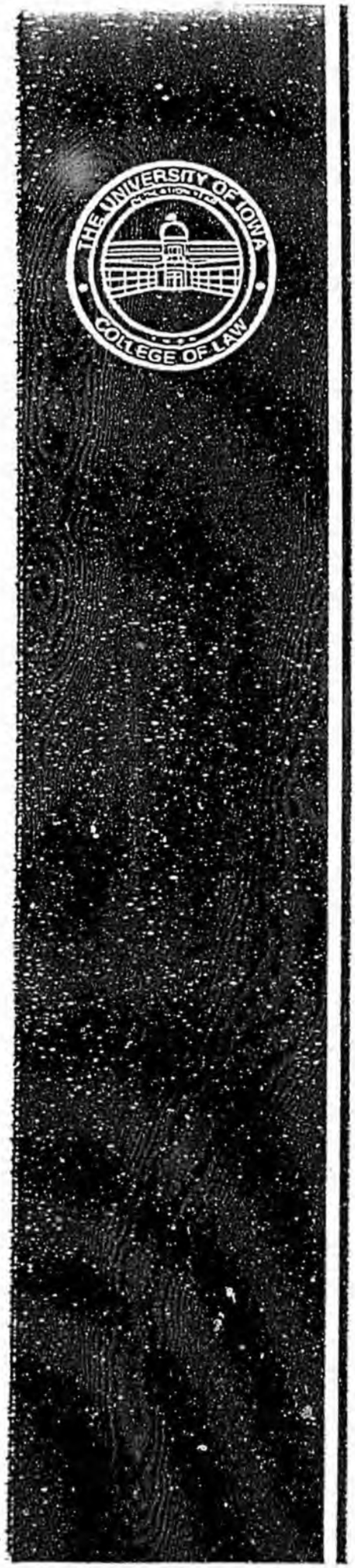
Fiduciary Trust Company International
Two World Trade Center
New York, New York 10048-0772
Telephone: 212-466-4100
Fax: 212-524-5011

Fiduciary Trust International of California
444 South Flower Street
Suite 3010
Los Angeles, California 90071-2961
Telephone: 213-489-7400
Fax: 213-489-2078

Fiduciary International, Inc.
1717 Pennsylvania Avenue, NW
Suite 630
Washington, DC 20006
Telephone: 202-393-7900
Fax: 202-393-7906

Fiduciary Trust International of the South
International Place
100 S.E. Second Street
Suite 2300
Miami, Florida 33131
Telephone: 305-372-1260
Fax: 305-372-0654

11/97



IOWA LAW REVIEW

March 1996 Volume 81/No. 3

The Uniform Prudent Investor Act and the Future of Trust Investing

John H. Langbein

REPRINTED FROM THE

March 1996 Vol. 81/No. 3

The Uniform Prudent Investor Act and the Future of Trust Investing

*John H. Langbein**

In recent years, American law has undergone a fundamental revision of the rules that govern how trustees invest. In 1987 the American Law Institute (ALI) began working on a partial revision of the Restatement of Trusts devoted exclusively to modifying trust-investment law. The ALI approved the new Restatement at its annual meeting in 1990 and released the final text in 1992.[1] Working from a preliminary text of the new Restatement, Illinois enacted legislation in 1991 embodying the key Restatement principles.[2]

In 1991 the Uniform Law Commission[3] began a three-year drafting project to codify the revised Restatement principles as a uniform law, which became the Uniform Prudent Investor Act. The Uniform Law Commission promulgated the final text of the Act in 1994.[4] The American Bar Association approved the Act at its February 1995 midyear meeting.[5] Already in 1995 seven states enacted the Uniform Prudent Investor Act

---

* Chancellor Kent Professor of Law and Legal History, Yale University. This article expands upon the Tamisiea Lecture presented at the University of Iowa, November 2, 1995. Some themes of this article were sketched earlier in presentations to the 1995 annual meeting of the American College of Trust and Estate Counsel, Scottsdale, Arizona, March 9-10, 1995. Although I served as the reporter for the Uniform Prudent Investor Act, I must emphasize that the views advanced in this article are mine and do not necessarily represent the views of the Uniform Law Commission. Suggestions from Edward C. Halbach, Jr., and Roger Ibbotson are gratefully acknowledged.

1. Restatement (Third) of Trusts: Prudent Investor Rule (1992). Professor Edward C. Halbach, Jr., of the University of California at Berkeley served as the reporter and principal drafter. He has discussed the project in Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 77 Iowa L. Rev. 1151 (1992), substantially republished as Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Prop., Prob. & Tr. J. 407 (1992); and Edward C. Halbach, Jr., Redefining the "Prudent Investor Rule" for Trustees, 129 Tr. & Est. 4 (Dec. 1990).

2. 760 ILCS §§ 5/5 (prudent investing), 5/5.1 (delegation) (1992). The principal drafter has described the Illinois act in Lyman W. Welch, How the Prudent Investor Rule May Affect Trustees, 130 Tr. & Est. 15 (Dec. 1991), substantially republished as Lyman W. Welch, Action is Needed in Response to Changes in Fiduciary Investment Duty, 18 ACTEC Notes 81 (1992).

3. The Commission's proper name is National Conference of Commissioners on Uniform State Laws (NCCUSL).

4. Unif. Prudent Investor Act (1994), 7B U.L.A. 16 (Supp. 1995) [hereinafter UPIA].

5. Uniform acts are routinely submitted to the American Bar Association (ABA) for approval. The relevant ABA sections customarily appoint advisors to the Uniform Law Commission's drafting committees. The ABA advisor for the Uniform Prudent Investor Act was Joseph Kartiganer.

CORRECTION

THE FOLLOWING DOCUMENT(S)
HAVE BEEN REFILMED TO
ASSURE LEGIBILITY OR PAGINATION

Fiduciary Trust Company International
Two World Trade Center
New York, New York 10048-0772
Telephone: 212-466-4100
Fax: 212-524-5011

Fiduciary Trust International of California
444 South Flower Street
Suite 3010
Los Angeles, California 90071-2961
Telephone: 213-489-7400
Fax: 213-489-2078

Fiduciary International, Inc.
1717 Pennsylvania Avenue, NW
Suite 630
Washington, DC 20006
Telephone: 202-393-7900
Fax: 202-393-7906

Fiduciary Trust International of the South
International Place
100 S.E. Second Street
Suite 2300
Miami, Florida 33131
Telephone: 305-372-1260
Fax: 305-372-0654

11-97

IOWA LAW REVIEW

March 1996 Volume 81/No. 3

The Uniform Prudent Investor Act and the Future of Trust Investing

John H. Langbein

REPRINTED FROM THE

March 1996 Vol. 81/No. 3

The Uniform Prudent Investor Act and the Future of Trust Investing

John H. Langbein[*]

In recent years, American law has undergone a fundamental revision of the rules that govern how trustees invest. In 1987 the American Law Institute (ALI) began working on a partial revision of the Restatement of Trusts devoted exclusively to modifying trust-investment law. The ALI approved the new Restatement at its annual meeting in 1990 and released the final text in 1992.[1] Working from a preliminary text of the new Restatement, Illinois enacted legislation in 1991 embodying the key Restatement principles.[2]

In 1991 the Uniform Law Commission[3] began a three-year drafting project to codify the revised Restatement principles as a uniform law, which became the Uniform Prudent Investor Act. The Uniform Law Commission promulgated the final text of the Act in 1994.[4] The American Bar Association approved the Act at its February 1995 midyear meeting.[5] Already in 1995 seven states enacted the Uniform Prudent Investor Act

---

* Chancellor Kent Professor of Law and Legal History, Yale University. This article expands upon the Tamiment Lecture presented at the University of Iowa, November 2, 1995. Some themes of this article were sketched earlier in presentations to the 1995 annual meeting of the American College of Trust and Estate Counsel, Scottsdale, Arizona, March 9-10, 1995. Although I served as the reporter for the Uniform Prudent Investor Act, I must emphasize that the views advanced in this article are mine and do not necessarily represent the views of the Uniform Law Commission. Suggestions from Edward C. Halbach, Jr., and Roger Ibbotson are gratefully acknowledged.

1. Restatement (Third) of Trusts: Prudent Investor Rule (1992). Professor Edward C. Halbach, Jr., of the University of California at Berkeley served as the reporter and principal drafter. He has discussed the project in Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 77 Iowa L. Rev. 1151 (1992), substantially republished as Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Prop., Prob. & Tr. J. 407 (1992); and Edward C. Halbach, Jr., Redefining the "Prudent Investor Rule" for Trustees, 129 Tr. & Est. 4 (Dec. 1990).

2. 760 ILCS §§ 5/5 (prudent investing), 5/5.1 (delegation) (1992). The principal drafter has described the Illinois act in Lyman W. Welch, How the Prudent Investor Rule May Affect Trustees, 130 Tr. & Est. 15 (Dec. 1991), substantially republished as Lyman W. Welch, Action is Needed in Response to Changes in Fiduciary Investment Duty, 18 ACTEC Notes 81 (1992).

3. The Commission's proper name is National Conference of Commissioners on Uniform State Laws (NCCUSL).

4. Unif. Prudent Investor Act (1994), 7B U.L.A. 16 (Supp. 1995) [hereinafter UPIA].

5. Uniform acts are routinely submitted to the American Bar Association (ABA) for approval. The relevant ABA sections customarily appoint advisors to the Uniform Law Commission's drafting committees. The ABA advisor for the Uniform Prudent Investor Act was Joseph Karliganer.

California,[6] Colorado,[7] New Mexico,[8] Oklahoma,[9] Oregon,[10] Utah,[11] and Washington.[12] The Uniform Act is expected to be widely enacted in the years to come. In advance of the Uniform Act, several states enacted legislation patterned on the 1992 Restatement or on the Illinois act, including Kansas,[13] Florida,[14] Maryland,[15] New York,[16] South Dakota,[17] and Virginia.[18] We thus have a substantial core of states, including some of the most populous, that have already enacted the Uniform Act or something like it. I should also emphasize that the Restatement and the Uniform Act did not invent the reforms that they embody, and that several states, for example, Iowa[19] and Georgia,[20] revised their statutes in advance of the two national law reform projects to incorporate some of the principles that now appear in the Restatement and in the Uniform Act.

The Uniform Prudent Investor Act implements a tightly interconnected set of reforms. These adjustments to the legal regime were driven by profound changes that have occurred across the past generation in our understanding of the investment function. This new learning about the investment process is called the theory of efficient markets, or more broadly, Modern Portfolio Theory (MPT).[21] Four Nobel prizes in economics have thus far been awarded for the academic work that identified and verified the theory of efficient markets,[22] and more will come. As I cover the main features of the Uniform Prudent Investor Act, I have the occasion to point out places in which the influence of MPT is much in evidence. I have tried, however, to avoid the forbidding jargon of the efficient market literature. Lawyers and courts can understand the essential findings of MPT without mastering betas, capital asset pricing models, correlation coefficients, and the like.

6. Cal. Prob. Code §§ 16045-54 (Deering 1995).
7. Colo. Rev. Stat. §§ 15-1.1-101 to 115 (Supp. 1995) (effective July 1, 1995).
8. N.M. Stat. Ann. §§ 45-7-601 to 612 (Michie 1995) (effective July 1, 1995).
9. Okla. Stat. tit. 60 §§ 175.60-72 (Supp. 1995) (effective Nov. 1, 1995).
10. 1995 Or. Laws 157 (effective Sept. 9, 1995).
11. Utah Code Ann. § 75-7-302 (1995) (effective July 1, 1995).
12. 1995 Wash. Laws 307 (effective July 1, 1995).
13. Kan. Stat. Ann. § 17-5004 (Supp. 1994).
14. Fla. Stat. chs. 518.11 (prudent investing) & 518.12 (1995) (delegation).
15. Md. Code Ann., Est. & Trusts §§ 15-106, 15-114 (1994 & Supp. 1995).
16. N.Y. Est. Powers & Trusts Law § 11-2.3 (McKinney Supp. 1996) (Prudent Investor Act). The New York legislation is based in part upon an early draft of the Uniform Act.
17. S.D. Codified Laws Ann. §§ 55-5-6 to 14 (Supp. 1995).
18. Va. Code Ann. § 26-45.1 (Michie 1992) (prudent investing).
19. Iowa Code Ann. § 633.123 (West 1992) (amended 1991).
20. Ga. Code Ann. § 53-8-2(c) (1995) (amended 1992).
21. A succinct and elegant introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983). A convenient expedition for lawyers is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation).
22. Franco Modigliani of MIT (1985), Harry Markowitz of CUNY (1990), Merton Miller of Chicago (1990), and William Sharpe of Stanford (1990).

This Article is meant to serve as a guide to the Uniform Prudent Investor Act. I point to the main reforms and explain what motivated them. I also attempt a look into the future, offering some predictions about how trust-investment practice is likely to change as the principles embodied in the Restatement and the Uniform Act take effect. Among the changes foreseen are greater use of equities; of pooled investment vehicles, such as mutual funds; and of relatively unconventional investments, such as foreign securities and derivatives. I also speak of the tendency to break up trusteeship and allocate its functions among specialized service providers. I suggest that, even though the Uniform Prudent Investor Act is default law that the settlor of the trust can alter or oust, the Act is likely to limit the settlor's power to impose manifestly uneconomic investment restrictions. I also explain why the new trust-investment law is likely to have unsettling effects upon the seemingly quite distinct subject of principal-and-income law, that is, upon the rules that govern the allocations that trustees are commonly obliged to make between current and future beneficiaries of the trust.

I. OLDER STANDARDS OF PRUDENT INVESTING

Before canvassing the Uniform Act, I want to cast a brief backward glance at the trust-investment law that descended into the 1980s—the law that the ALI and the Uniform Law Commission determined to reform. Bear in mind that the rules of trust investment law that we are discussing are default rules, rules that the settlor can alter by apt language in the trust instrument.

English law got off to a bad start on trust investing. In 1719 Parliament authorized trustees to invest in shares of the South Sea Company. A number of them did, and when the South Sea "Bubble" burst the next year, share prices declined by 90 percent. The Chancellors took fright and developed a restricted list of presumptively proper trust investments, initially government bonds, later well-secured first mortgages. Lord St. Leonard's Act in 1859 added East India stock, and across the decades, some dribbles of legislation approved various other issues. Only in 1961 was the English statute amended to allow trustees to invest in equities more generally, and even then the investment was subject to a ceiling of half the trust fund.[23] That legislation remains in force, although an official revision commission has begun to deliberate on reforming it.

Some American jurisdictions had a similar history in the nineteenth and early twentieth centuries, developing so-called legal lists[24] of court-

23. A useful account of the history of trust investment law in England appears in A.H. Oosterhoff, Trustees' Powers of Investment: A Study Prepared at the Direction of the Ontario Law Review Commission 8-21, 38-46, 49-59 (1970).

24. The New York case of King v. Talbot, 40 N.Y. 76 (1869), came to exemplify legal list jurisprudence. The court restricted trustees to investments in government bonds or well secured mortgages and forbade corporate issues. The court reasoned that since a trustee

approved or legislatively-approved investments, which were initially restricted to government bonds and first mortgages, but grudgingly expanded in some states to include selected corporate issues.

The path of the future in American law led away from legal lists, however, and was forged in Massachusetts. In 1830, in the celebrated case of *Harvard College v. Amory*,[25] the Supreme Judicial Court adopted what came to be known as the prudent man rule.

Trustees, said the Massachusetts court, should "observe how men of prudence . . . manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[26] The Massachusetts rule represented a great advance[27] by abandoning the attempt to specify approved types of investment. Prudence is another word for reasonableness, and the prudent man rule echoed the contemporaneously developed reasonable man rule in the law of negligence. The standard of prudent investing was the standard of industry practice—what other trustees similarly situated were doing. Investment practice under the prudent man rule led rapidly to judicial approval of the use of corporate securities, both equities and bonds, in trust accounts. By the 1940s many American states had adopted by statute a version of the Massachusetts rule that the American Bankers Association promoted on behalf of corporate fiduciaries.[28] The Uniform Prudent Investor Act is designed to replace that act.

The prudent man rule as applied by the courts came to be encrusted with a strong emphasis on avoiding so-called "speculation," whatever that meant.[29] (Recall the language from *Harvard College v. Amory*, cautioning the trustee to invest "not in regard to speculation" and to treat "the probable safety of the capital" as central.)[30] As late as the 1959 Restatement we find the assertion that "the purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on maturity" is speculative and

cannot use the trust fund to operate a business, neither can the trustee invest in corporate securities "in which [the trust fund] is necessarily exposed to the hazard of loss or gain, according to the success or failure of the enterprise." Id. at 85-86.

25. 26 Mass. (9 Pick.) 446 (1830).

26. Id. at 461.

27. On the history of trust investment law in the United States, see Lawrence M. Friedman, The Dynastic Trust, 73 Yale L.J. 547, 551-72 (1964). *See generally* George G. Bogert & George T. Bogert, The Law of Trusts and Trustees §§ 612-14 (rev. ed. 1983).

28. *See* Mayo A. Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 Ohio St. L.J. 491, 501-03 (1951). For the text of the bankers' model act, the so-called Model Prudent Man Investment Act, see id. at 508-09.

29. Devis Longstreth, Modern Investment Management and the Prudent Man Rule 5-6 (1986).

30. Quoted *supra* text accompanying note 26.

imprudent.[31] In some jurisdictions investing in junior mortgages, no matter how well secured, was per se imprudent.[32] The view crystallized that an investment in a "new and untried enterprise"[33] was inherently speculative and imprudent. Ludicrous judicial applications of the notion of speculation continued in some jurisdictions into recent times.[34]

Trustees in the first half of the twentieth century, preoccupied with avoiding speculation and preserving capital, were inclined to emphasize long-term government and corporate bonds as the characteristic trust investment. Experience with inflation after World War II taught that bonds placed significant inflation risk on the bondholder. Investments in debt could therefore experience declines in real value as severe as in equities. We now know that, in inflation-adjusted terms, the long-term real rate of return on equities has greatly exceeded bonds. The Shiquefield/Ibbotson studies estimate the inflation-adjusted rate of return on stocks since the 1920s at about 9 percent per year, as compared to about 3 percent for bonds.[35] Fiduciaries have adapted to this knowledge, and through the second half of the century, have tended to increase the proportion of equity in trust accounts, at least in those trust accounts that can bear the greater volatility of equities.

II. The Uniform Prudent Investor Act

I turn now to the Uniform Prudent Investor Act, with a view to identifying and explaining its main reforms. As the title of the Act makes clear, the legislation retains the prudence standard.[36] As did the 1992 Restatement, the Act takes the opportunity to unisex the prudent man, who has now become the prudent investor. The Act directs the trustee to invest "as a prudent investor would . . . ."[37]

In giving content to the prudence label, the Act makes three great changes in the law. All three were presaged in the 1992 Restatement. First, the Act articulates a greatly augmented duty to diversify trust investments.[38] Next, in place of the old preoccupation with avoiding speculation, the Act substitutes a requirement of sensitivity to the risk

31. Restatement (Second) of Trusts § 227 cmt. f (1959).

32. 3 Austin W. Scott & William F. Fratcher, The Law of Trusts § 227.6, at 445-49 (4th ed. 1988).

33. Restatement (Second) of Trusts § 227 cmt. f (1959).

34. For example, in First Alabama Bank of Montgomery v. Martin, 425 So. 2d 415, 427 (Ala. 1982), *cert. denied*, 461 U.S. 938 (1983), the Supreme Court of Alabama surcharged a bank trustee for 17 disappointing stocks held in the bank's common trust fund. The court reasoned that the 17 were speculative because the bank purchased them in part with a view to obtaining capital appreciation when sold, and thus the issues had not been suitable long-term trust investments.

35. Roger G. Ibbotson & Rex A. Shiquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1978) 20-30 (2d ed. 1979).

36. UPIA §§ 1, 2(a).

37. Id. § 2(a).

38. Id. § 3.

tolerance of the particular trust, directing the trustee to invest for "risk and return objectives reasonably suited to the trust."[39] Finally, the Act reverses the much criticized nondelegation rule of former law and actually encourages trustees to delegate investment responsibilities to professionals.[40]

A. Diversification

A duty to diversify trust investments has been recognized in American trust law for about a century.[41] In recent decades the importance of diversification has been increasingly emphasized among investment professionals, and accordingly, the trustee's duty to diversify has become more acute—for example, in ERISA, the 1974 federal pension legislation, a fiduciary must diversify the investments of participants and beneficiaries to minimize risk of loss unless doing so is clearly imprudent.[42] The 1992 revision of the Restatement of Trusts integrated the duty to diversify into the very definition of prudent investing.[43]

The Uniform Prudent Investor Act demands that the "trustee *shall* diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[44] The official Comment to the Act identifies two situations in which resisting diversification might be appropriate: first, when the tax cost of selling low-basis securities would outweigh the gain from diversification; and second, when the settlor mandates that the trust retain a family business. When, however, the trust investor starts with cash in hand, failing to diversify is inexcuseable.

The emphasis on diversification also underlies another prominent feature of the Uniform Act, the portfolio standard of care in section 2(b), which reads: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of

39. *Id.* § 2(b).

40. *Id.* § 9.

41. *E.g.*, Dickinson, Appellant, 152 Mass. 184, 25 N.E. 99 (1890); Restatement (Third) of Trusts § 227 (1992). Many states have no explicit authority on point. In *In re* Saegers Estates, 340 Pa. 73, 16 A.2d 19 (1940), the Pennsylvania Supreme Court questioned the duty to diversify. In view of the growing emphasis on the duty to diversify discussed in the text above, I think it unlikely that *Saegers* would remain good law in Pennsylvania. Older New York cases resistant to, or hesitant about, the duty to diversify are collected in 3 Scott & Fratcher, supra note 32, § 228, at 505-06 n.10. A recent New York case imposes liability for a trust's excess concentration of 71% of its assets in a single blue chip stock (Eastman Kodak) which experienced a long decline in value. Estate of Jones, N.Y.L.J., Jul. 5, 1995, at 31 (Sur. Ct. Monroe Cty. 1995) (I owe this reference to Richard Covey.) The New York prudent investor act, supra note 16, mandates diversification and thus resolves the matter for New York prospectively.

42. ERISA mandates "diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." Employee Retirement Income Security Act § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1988).

43. Restatement (Third) of Trusts: Prudent Investor Rule § 227(b) (1992).

44. UPIA § 3 (emphasis added).

the trust portfolio as a whole . . . ."[45] The official Comment says: "An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets."[46]

This insistence on diversifying investments responds to one of the central findings of Modern Portfolio Theory, that there are huge and essentially costless gains to diversifying the portfolio thoroughly. To understand why, begin with the obvious truth that some securities are riskier than others. Investors demand to be paid to bear the greater risk. For example, a start-up computer software company in Silicon Valley entails a far larger risk of disappointing returns or total failure than does a seasoned blue chip such as Mobil Oil or General Electric. If you are a Silicon Valley entrepreneur who wants me to invest in your start-up firm, you must offer me an expected return (that is, a combination of dividends and capital appreciation on the securities) that is higher than Mobil or GE will pay me in order to induce me to invest in your riskier venture. This calculation is called the risk/return curve: The higher expected return on the investment compensates me for bearing the greater risk of the investment being disappointing.

Modern Portfolio Theory isolates three distinct components of the risk of owning any security: market risk, industry risk, and firm risk. Market risk is common to all securities; it reflects general economic and political conditions, interest rates, and so forth. Industry risk, by contrast, is specific to the firms in a particular industry or an industry grouping. Finally, firm risk refers to factors that touch the fortunes only of the individual firm. Thus, if we take the international oils for an example, we recall that all the producers suffered from the 1973 Arab oil embargo (industry risk), but only Exxon incurred the liabilities arising from the great Alaskan oil spill of March 1989 (firm risk).

The capital market investigators have actually been able to compute the approximate weight of the three elements that comprise the risk of securities ownership. In round numbers, market risk has been reckoned at 50 percent; the risk of industry and other groupings at 30 percent; and firm risk at 20 percent.[47] These numbers underlie the intense preoccupa-

45. *Id.* § 2(b).

46. *Id.* § 2 cmt. ("Portfolio standard"). The UPIA's portfolio standard of care derives from comparable language in the Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992), which states that the prudent investor rule is "to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy . . . ." The total portfolio standard decisively rejects the contrary strand in the older case law that is "[t]he focus of inquiry . . . is . . . on the individual security as such, and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions." *In re* Bank of New York (Spitzer), 323 N.E.2d 700, 703 (N.Y. 1974).

47. Brealey, supra note 21, at 117. Brealey's actual numbers are 31% market risk; 12% industry risk; 37% other groupings; and 20% firm risk. The passage in the above text consolidates industry and other groupings and rounds it to 80%.

tion with diversification as the means of reducing the risk of investing. By definition, market risk cannot be eliminated through diversification, since market risk is common to all securities. But industry risk and firm risk can be reduced greatly through diversification. To continue with the example of the oil industry, contrast an investor who owned only international oil shares in 1973 with an investor whose portfolio was broadly diversified across many industries. The oil embargo damaged the international oils and the automobile and airline industries, but it triggered a boom in domestic oils, in coal stocks, in synthetic fuels, in the energy conservation firms, and in the oilfield equipment industry. We see, therefore, that industry risk is often negatively correlated. Owning stocks in these other industries would, in part, have offset the damage to the industries harmed by the embargo.

Likewise, within an industry, diversification reduces risk. Since I cannot predict the Alaskan oil spill, or any other firm-specific hazard, I can lower my exposure to such firm-specific risks by investing not only in Exxon, but also BP, Shell, Mobil, Texaco, and the others. Indeed, it commonly happens that the performance of firms in the same industry is negatively correlated—the success of one firm comes at the expense of its competitors. Efficient market theory instructs us that it is impossible to outsmart the market by predicting which securities will do better or worse.[48] Owning many securities enhances the chances of offsetting losers with winners.[49]

In the literature of Modern Portfolio Theory, a telling expression has been coined to describe what is wrong with underdiversification: *uncompensated risk*. No one pays the investor for owning too few stocks. Recall that when I spoke of the difference between the Silicon Valley start-up and Mobil Oil, I said that the greater risk intrinsic to the start-up was reflected in its expected return. The investor faced with a choice between mature blue chips and an imperiled new venture will prefer the blue chips unless the new venture offers a superior return, a risk premium. Moving out on the risk/return curve in this way, we routinely observe that the investor who bears the greater risk is compensated for it. By contrast, no one compensates the investor for having a portfolio that neglects to hold securities in enough industries and firms to achieve effective diversification. Underdiversification entails needless risk, risk that can be avoided by constructing a sufficiently large and representative portfolio.

Diversification tends to push the investor toward very large portfolios. Although much of the benefits of diversification can be achieved with a carefully selected smaller portfolio,[50] optimal diversification probably

48. *See* infra text accompanying notes 94-98.

49. Brealey computes that a one-stock portfolio will exhibit 49% variability in a year. A market-matching portfolio exhibits 22% variability in a year. Thus, optimal diversification cuts risk by almost half. Brealey, supra note 21, at 111-12 & Tbl. 7.1.

50. Brealey estimates that ten stocks exceptionally well-selected for diversification can achieve 87% diversification; twenty such stocks, 93%; 50 such, 97%; 100 such, 98%. Id. at 112 & Tbl. 7.1.

requires a portfolio containing hundreds of issues. Relatively few investors, or for our purposes, relatively few trust funds have that much money to invest. Accordingly, an investor who seeks to eliminate the uncompensated risk of underdiversification will usually need to invest in some form of pooled investment vehicle, such as mutual funds or bank common trust funds.

B. Sensitivity to the Risk/Return Curve in Place of the Ban on Speculation

The Uniform Prudent Investor Act eliminates the old categoric restrictions on particular types of investments, such as the prohibition on junior mortgages. Section 2(e) of the Act provides: "A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]." The official Comment explains:

> The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility—in this case, inflation risk—that had not been anticipated.[51]

The idea that some securities are intrinsically too risky for trust investors collides with the central findings of Modern Portfolio Theory. MPT teaches that the risk intrinsic to any marketable security is presumptively already discounted into the current price of the security. Hence, on an expected return basis, the risk is compensated risk. Thus, for example, there is no reason to think that the shares of a bankrupt company are mispriced. The securities markets are so efficient at discounting information about future profitability that today's price fully impounds the future prospects for any firm, even a bankrupt firm, on an expected value basis.

Furthermore, the risk of a high-risk investment can be materially reduced through diversification. That is why sophisticated investors who invest in start-up or otherwise fragile firms commonly employ venture capital funds, which spread the risk of failure of any single firm across a portfolio of many firms. The same logic underlies so-called vulture funds that invest in bankrupt or troubled firms. Some of the firms will fail, but many will thrive. A basket of such securities offers the likelihood of a high net return on an expected return basis.

The drafters of the Uniform Prudent Investor Act reasoned that "trust beneficiaries are better protected by . . . emphasis on close attention to risk/return objectives . . . than in attempts to identify categories of

& Tbl. 7.1.

51. UPIA § 2 cmt. ("Abrogating categoric restrictions").

investment that are per se prudent or imprudent."[51] The heart of the Act, section 2(b), states that the "trustee's investment and management decisions" are required to "have risk and return objectives reasonably suited to the trust."[52] The Act recognizes that investment returns correlate strongly with risk. However, as the official Comment explains, "tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries."[53] By way of illustration, the Comment observes that if the "main purpose" of the particular trust "is to support an elderly widow of modest means," that trust "will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth."[54]

Thus, the Act aspires to free trustees from the old preoccupation with avoiding speculation. Should we expect to see future trust portfolios stuffed with penny stocks, Polish zloty futures, and Czarist Russian bonds? The answer, of course, is no. For most trusts and trustees, the outer reaches of the risk/return distribution will be every bit as unsuitable as before. What has changed is that the trustee is now able to examine the risk tolerance of each particular trust and to tailor that trust's investment policy accordingly.

C. Delegation

The last of the great reforms of the Uniform Prudent Investor Act is to put the final nails in the coffin of the much criticized former rule that forbade trustees to delegate investment and management functions.[55]

1. The Received Nondelegation Rule

The rule against delegating investment functions was a branch of the general nondelegation rule of trust law. As formulated in the 1959 Restatement, the nondelegation rule places the trustee "under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform."[56] The rationale for the nondelegation rule has always been murky.[57] The core notion is to protect the settlor's reliance when the personality of the trustee is a vital component of the settlor's intention. We can well imagine the case in

51. Id.
52. Id. § 2(b).
53. Id. § 2 cmt. ("Risk and return").
54. Id.
55. UPIA § 9. The nondelegation rule for investment matters as formulated in the second Restatement reads: "A trustee cannot properly delegate to another power to select investments." Restatement (Second) of Trusts § 171 cmt. h (1959).
56. Restatement (Second) of Trusts § 171 (1959). The second Restatement carries this language forward from the first Restatement, see Restatement of Trusts § 171 (1935).
57. For discussion of the purposes of the rule, see John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Mo. L. Rev. 105, 108-10 (1994).

which the settlor's decision to establish a trust is motivated by confidence in the good judgment of the particular trustee, especially when the trust bestows discretion upon the trustee in matters of distribution, that is, in allocating shares among beneficiaries. Accordingly, we can understand a rule that says that if the particular trustee accepts the trust, the trustee cannot dump it off on someone else—at least not without following the procedures for trustee resignation and trustee succession that are contained in the trust instrument or in the default law.

The traditional nondelegation rule was, however, overbroad. Courts tended to read the requirement that the trustee not delegate "acts which the trustee can reasonably be required personally to perform"[58] as a prohibition on delegating any function that looked to be important. The courts attempted to distinguish pedestrian activities, so-called ministerial functions, which the trustee could delegate, from discretionary functions that were nondelegable. The drafters of the second Restatement perpetuated this standard even while admitting that they could identify no "clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate."[59] The nondelegation rule effectively forced the trustee to conduct personally all major aspects of administering the trust, necessarily including investment. The second Restatement was crystal clear about investing: "A trustee cannot properly delegate to another power to select investments."[60]

As the investment function has grown ever more complex, there is ever less reason to believe that nonspecialists are fit to conduct it. Especially when family members or other amateurs serve as trustees, the need for outside investment expertise is often acute. The old nondelegation rule permitted such trustees to take advice from outside specialists, but required the trustees to go through the motions of appearing to evaluate the advice and to form an independent judgment about whether or not to follow it. Often enough, this resulted in de facto delegation. "When the investment advisor 'recommends' and the trustee routinely 'decides' to follow the advice, the trustee in reality is delegating the selection of investments."[61]

Dissatisfaction with the nondelegation rule in investment matters

58. Restatement (Second) of Trusts § 171 (1959). The second Restatement carries this language forward from the first, see Restatement of Trusts § 171 (1935).
59. Restatement (Second) of Trusts § 171 cmt. d (1959). Instead of a standard, the second Restatement pointed to some illustrative factors, including "the amount of discretion involved," the size of the assets in question, and the trustee's ability to deal with the matter." Id. The emphasis on distinguishing delegable ministerial functions from nondelegable discretionary functions has proved to be a labeling game, because "even the most menial of tasks involves some discretion . . . ." William L. Cary & Craig B. Bright, The Delegation of Investment Responsibility for Endowment Funds, 74 Colum. L. Rev. 207, 224 (1974) (emphasis in original).
60. Restatement (Second) of Trusts § 171 cmt. h (1959).
61. John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, Am. B. Found. Res. J. 1, 20 (1976).

became intense. In recent decades a variety of special-purpose statutes reversed the nondelegation rule for investment and other specialized functions, the Uniform Trustees' Powers Act in 1964,[63] the Uniform Management of Institutional Funds Act in 1972,[64] and ERISA,[65] the federal pension reform law, in 1974.[66] Early in the history of the mutual fund industry, it was feared that a trustee could not properly invest in mutual fund shares without violating the nondelegation rule (on the theory that the trustee was delegating the investment choices to the mutual fund manager).[67] The mutual fund industry responded by securing legislation that remains in force in most states expressly authorizing trustees to invest in mutual funds.[68]

2. *Abrogating the Nondelegation Rule*

The 1992 Restatement achieves a major reform of the nondelegation rule. Nominally, the Restatement leaves the general nondelegation principle intact, but effectively reduces it to a subrule of the duty of prudent administration and makes it easy to overcome. The new rule reads: "A trustee has a duty personally to perform the responsibilities of the trusteeship *except as a prudent person might delegate* those responsibilities to others."[69] Applying that norm to the investment function, the new Restatement not only empowers the trustee to delegate investment and management powers, it provides that the trustee "may sometimes have a duty . . . to delegate [investment] functions . . . in such manner as a prudent investor would delegate under the circumstances."[70]

The Uniform Act follows the Restatement in crafting a delegation regime. Section 9(a) empowers the trustee to "delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances."[71] As replacement safeguards, the Act imposes duties of care, skill, and caution on trustees in selecting agents, in formulating the terms of the delegation, and in reviewing "the

63. 7B U.L.A. 741 (1985).
64. 7A U.L.A. 705 (1985).
65. ERISA § 402(c)(3), 29 U.S.C. § 1102(c)(3).
66. The predelegation measures in these statutes are discussed in Langbein, supra note 58, at 111-14.
67. So held in Marshall v. Frazier, 199 Or. 491, 80 P.2d 42 (Or. 1938), *rejected in In re* Rees, 85 N.E.2d 563 (Ohio 1949).
68. *E.g.*, Cal. Prob. Code § 16222 (Deering 1991); Mo. Rev. Stat. § 362.650 (1994); N.J. Rev. Stat. § 3B:14-13 (1994).
69. Restatement (Third) of Trusts: Prudent Investor Rule § 171 (1992) (emphasis added).
70. Id. § 171 cmt. j. The new Restatement makes clear that the trustee must "exercise prudence in the degree or manner of delegation. Prudence thus requires the exercise of care, skill, and caution in the selection of agents and in negotiating and establishing the terms of delegation." Id. § 171 cmt. a.
71. UPIA § 9(a).

agent's performance and compliance with the terms of the delegation."[72] The Act provides that the trustee who complies with these standards "is not liable . . . for the decisions or actions of the agent to whom the function was delegated."[73] Instead, an aggrieved beneficiary must look exclusively to the agent, who "owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation."[74]

The official Comment explains the "tension"[75] inherent in a permissive delegation rule. "If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate."[76] However, "if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries."[77] The requirement that the trustees use care, skill, and caution in selecting agents, in formulating the terms, and in monitoring compliance "is designed to strike the appropriate balance between the advantages and the hazards of delegation."[78]

3. *Minimizing Costs*

In connection with delegation, I conclude this survey of the main features of the Uniform Act by directing attention to a seemingly unrelated provision of the Act, section 7, which deals with investment costs. It provides that "[i]n investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."[79] There is nothing novel about the trustee's duty to minimize costs in every facet of trust administration.[80] As the official Comment remarks, "Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs."[81]

72. Id. § 9(a)(3).
73. Id. § 9(c).
74. Id. § 9(b).
75. Id. § 9 cmt. ("Protecting the beneficiary against unreasonable delegation").
76. UPIA § 9 cmt.
77. Id.
78. Id. The Comment continues:

> The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation.

Id.
79. Id. § 7.
80. *See* Restatement (Second) of Trusts § 188 (1959).
81. UPIA § 7 cmt.

The Uniform Act foresees that practice under the Act's permissive delegation regime will be a main sphere for applying the duty to minimize costs. The official Comment observes: "The trustee must be alert to protect the beneficiary from 'double dipping.' If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager."[82]

III. The Future of Trust Investing

What will the future bring under this new legal regime for trust investing?

A. *Greater Use of Equities*

This Article has emphasized that the new Restatement and the Uniform Prudent Investor Act are designed to liberate trust investors from the former preoccupation with "avoiding speculation." Extremely conservative investing will continue to be appropriate for trust accounts that cannot bear the volatility of riskier assets. But for trusts that can bear some exposure to the greater volatility characteristic of equities, the superior long-term returns will justify the risk. As a practical matter, therefore, the Uniform Act's invitation to trustees to tailor investments to the risk tolerance of the particular trust is likely to result in greater use of equities, apart from the most risk-averse trusts.[83]

Charitable trusts and foundations are particularly likely candidates for increasing their exposure to equities. The Prefatory Note to the Uniform Act observes that although the "Act is centrally concerned with the investment responsibilities" of private trusts, "the prudent investor rule also bears on charitable" trusts.[84] Because charitable trusts and foundations

82. Id. § 9 cmt. ("Costs"). For more on the concern with double dipping in delegation policy, see Langbein, supra note 58, at 108-09.

83. A leading New York corporate fiduciary, Bankers Trust, has published a statement on the investment ramifications of New York's version of the prudent investor act, see supra note 10. Bankers Trust foresees as "a probable result of Prudent Investor legislation . . . an increase in the proportion of equities in trust accounts." Bankers Trust New York Corp., Investment Implications of the Prudent Investor Act 5 (1995) (on file with author) [hereinafter Bankers Trust Statement]. The statement reasons: "Generally, a higher equity exposure produces higher variability of trust values, and therefore, more risk. However, this incremental risk can be mitigated through diversification." Id.

Using a variety of empirical data, a recent finance study concludes that the traditional prudent man standard explains the tendency of bank fiduciary investors to overemphasize the equities of large mature companies, by comparison with the greater risk-tolerance shown by mutual funds and other types of institutional investors. Diane Del Guercio, The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments, 40 J. Fin. Econ. 31 (1996).

84. UPIA, Prefatory Note ("Implications for charitable and pension trusts") (citing the 1959 Restatement for the familiar proposition that "[I]n making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust. Restatement of Trusts § 389 (1959).").

have exceptionally long time horizons in comparison with the typical private trust, they are uniquely suited to ride out the down-market cycles that inhere in stock-market investing.[85]

B. *More Pooling, Less Individual Security Selection*

My most confident prediction is that the future will see trustees making ever greater use of pooled investment vehicles. It will be ever less common for a trustee to construct a portfolio of individually selected securities. Increasingly, the main work of the fiduciary investor will be what has come to be called asset allocation. The trustee will form a view of the needs, resources, and risk tolerances of the beneficiaries of the particular trust. The trustee will then decide what proportion of the portfolio to invest in what classes of assets. These choices will take the form of allocating the trust assets among large, diversified portfolios, primarily mutual funds and bank common trust funds. Under the Uniform Act, both the enhanced duty to diversify and the portfolio standard of care point us in that direction. As I have previously emphasized, few trusts have the resources to achieve thorough diversification without using pooled vehicles.

The movement away from individual stock selection responds to the two central discoveries of Modern Portfolio Theory. One of these findings I have already discussed—the large and essentially costless returns to be had from optimizing diversification. The other great lesson from MPT is the understanding of why individual stock selection is so perilous—why, that is, investors find it so hard to pick winners and to avoid losers. For persons who are not familiar with the remarkable insights of MPT on this subject, a brief overview may be useful.

1. *Empirical Evidence on Institutional Portfolios*

Over the past generation, dozens of research projects, mostly conducted from university finance departments, have produced astonishing empirical data on the investment performance of professional portfolio managers. The early studies were based on data from investment companies, that is, mutual funds, but subsequent studies have replicated the results for other types of institutional portfolios. These studies have found that professionally managed institutional portfolios as a group actually underperformed the broad stock market averages such as the Standard and Poor's 500 stock index.[86] "The funds did not show superior

85. The case for greater equity exposure in charitable portfolios is developed in John A. Edie & Lowell S. Smith, Let Go of Your Old Investment Assumptions, Foundation News, Jan.-Feb. 1994, at 34. *See also* John A. Edie & Lowell S. Smith, Investing in U.S. Securities Is a Violation of Your Fiduciary Duty, Foundation News, Nov.-Dec. 1993, at 24; John A. Edie, The Prudent Investor and Charitable Trusts, 133 Trusts & Estates, Dec. 1994, at 38.

86. *See* Brealey, supra note 21, at 84-85 (summarizing data for mutual funds from 1955-1984 and for bank, insurance company, and investment managers' portfolios from 1968-77).

judgment either in picking stocks or anticipating general market movements."[87] Further, no individual fund outperformed the market with a consistency greater than the law of averages would predict.[88] A fund that performed well one year was as likely to perform poorly the next year as it was to continue doing well.

Similar results continue to be reported. For example, across the ten years ending in 1995, the Morningstar mutual fund research organization found that "diversified U.S. stock funds returned an average 12.8%, compared with 14.9% for the Standard & Poor's 500-stock index."[89] An important scholarly examination of pension fund investments in common stocks published in 1992 concluded that "pension fund equity managers seem to subtract rather than add value relative to the performance of the Standard & Poor's 500 Index."[90] The authors of the study computed that managed U.S. pension equity portfolios underperform the unmanaged averages by about 1.5 percent, which translates to a loss of about $15 billion a year.[91]

I began learning about this empirical work on securities prices in the early 1970s as a young law teacher at the University of Chicago, which was then a hotbed of efficient market research. I still remember my initial sense of disbelief about the findings, because they were so counterintuitive. How was it possible that the sophisticated and experienced investment professionals managing the great institutional portfolios could achieve results so disappointing? These managers were the best and the brightest. They worked under compensation arrangements that gave them powerful incentives to achieve the best possible results in the portfolios that they managed. Yet the data showed that they couldn't even hit the side of the barn, in the sense that they had been unable to match the performance of the broad market averages.

In 1973 Burton Malkiel published his celebrated popularization of Modern Portfolio Theory, titled *A Random Walk Down Wall Street*, a book now in its fifth edition. He taunted the professionals with the claim "that a blindfolded chimpanzee throwing darts at the [stock tables in the] *Wall Street Journal* can select a portfolio that performs as well as those managed by the experts."[92] The book caused some resentment, because as Malkiel

87. James H. Lorie & Mary T. Hamilton, The Stock Market: Theories and Evidence 95 (1973) (summarizing study done by Peter Williamson, Measuring Mutual Fund Performance, Fin. Analysts J., Nov.-Dec. 1971, at 78-84).

88. *See* Brealey, supra note 21, at 55.

89. Jonathan Clements, Boggled by Fund Picking?, Wall St. J., May 20, 1996, at C1.

90. Josef Lakonishok, Andrei Schleifer, & Robert W. Vishny, The Structure and Performance of the Money Management Industry, *in* Brookings Papers on Economic Activity: Microeconomics 339, 378 (M. Baily & C. Winston eds., 1992) [hereinafter Lakonishok].

91. Id. at 379.

92. Burton G. Malkiel, A Random Walk Down Wall Street 14 (5th ed. 1990).

later acknowledged, "financial analysts in pin-striped suits do not like being compared with bare-assed apes."[93]

2. *Efficient Markets*

What explains this astonishing evidence? Why have the professional investment managers performed so poorly? Modern Portfolio Theory supplies a crisp answer to that question. In a nutshell, the insight is that the professional portfolio managers are *not* incompetent bunglers. Indeed, just the opposite. They are so good at what they do that they effectively cancel each other out.

To understand why, start with the basics.[94] The price of a security represents the present discounted value of its future earnings. Further, for every buyer there must be a seller—someone who has formed an opposite judgment about the value of that future earnings stream at the security's current price. If all investors agreed that a particular security was a bargain at its current price, no one who owned the security would sell it at that price. Only an increase in price would induce sellers to sell. This is why we can say that, presumptively, any security is correctly priced at its current trading level.

To outperform the market—that is, consistently to identify undervalued or overvalued securities in advance of other investors—an investor must predict future earnings with superior speed and accuracy. But here the task becomes daunting. New information about individual companies is disseminated rapidly as a result of modern communications systems. The securities laws have largely choked off inside information as a source of advantage in trading. Economic developments, technological innovation, foreign affairs, political events, social changes—all profoundly affect the prices of securities, yet these phenomena are notoriously difficult to foresee.

Professional securities analysts are thus largely limited to interpreting information already in the public domain and available to other analysts. In order to outperform the market the portfolio manager has to be consistently better at making such interpretations than the thousands of competing professionals who are interpreting the same data. The theory of efficient markets posits that everything that is known or knowable about the price of a publicly traded security is *already fully reflected in its price*. The securities markets are so efficient in discounting information and pricing securities that not even the professionals can consistently identify undervalued and overvalued securities before other investors get there. The indifferent performance record of professional investment managers is, therefore, "exactly what we should expect in an efficient market."[95]

93. Id. at 24.

94. The following three paragraphs derive from John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A. J. 887, 888 (1976).

95. Brealey, supra note 21, at 55.

One response to the lesson that you cannot beat the market is that you might make a considered judgment to cease attempting it, especially if you can pocket the savings from not trying. A vast proportion of all fiduciary investing is now conducted "passively," in so-called index or market funds. These funds undertake simply to replicate the performance of the broad market indexes.[96] In the mid-1970s when market funds first appeared, they attracted only a few hundred million dollars, most of it from the AT&T pension funds. Today, hundreds of billions of dollars in American equities are indexed.[97]

3. *Inefficient Markets*

Not all markets are efficient. The reason that Malkiel's dart-throwing chimpanzee can outperform most of the professionals is that the chimp is throwing darts at a table of market prices. The chimp is a free rider, taking advantage of the accuracy of the information already impounded in the published prices for publicly traded securities. But some assets do not have a market price. Two such classes of assets that are prominent in family wealth, and hence tend to show up in trusts, are real estate and close corporations. There is no market price for your house. Your house is unique, hence yesterday's trade of a house nearby does not accurately value your house. Likewise, because there is no orderly market for close corporation shares, the chimp with the darts cannot hit a market price for them.

To conclude: Modern Portfolio Theory has taught us that the game of stock picking is costly and futile for most investors, especially small investors, while emphasizing the large and essentially costless gains that are to be had from maximizing diversification. These twin insights point the fiduciary investor—that is, the prudent investor—strongly toward the use of pooled investment vehicles that are large enough to achieve high levels of diversification at reasonable cost. The investment path of the future for trusts, especially smaller trusts, is the mutual fund or the bank common trust fund.

96. The 1992 Restatement makes clear that investing in index funds is prudent. Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmt. h (1992); id. reporter's note, § 227, at 78-79.

97. It has recently been computed that the 200 largest defined benefit pension funds hold $377 billion in index funds, of which $286 billion is in domestic equities, $35 billion in foreign equities, and the rest in bonds. The 200 largest defined contribution funds hold $84 billion in index funds, $60 billion of it in equities, the rest in bonds. Pensions & Investments, Jan. 22, 1996, at 62 63. The same journal reported total domestic indexed assets of tax-exempt investors (mostly pension funds) at above $600 billion as of December 1, 1995. Indexed Assets Leap 39.9% for Year, Pension & Investments, Feb. 19, 1996, at 1.

C. *International Investing*

By freeing trustees from the old concern to avoid speculation, and by relieving them of the categoric restrictions forbidding particular sorts of investments, the Restatement and the Uniform Act will make it easier for the trust investor to include in the portfolio relatively novel types of assets, when such assets are likely to enhance diversification or to improve expected return on a risk-adjusted basis.

The best example of this new openness to fiduciary investing is occuring in foreign securities. Until the 1980s, it was relatively uncommon to find foreign securities in American trust portfolios.[98] There have been a variety of quite legitimate concerns about investing abroad. The liquidity of most foreign markets is inferior to that of the American markets, transaction costs on foreign exchanges are higher, the regulatory and accounting standards abroad are often less exacting than in the United States, and currency risk introduces a further source of volatility. Nevertheless, these drawbacks pale when contrasted against the great advantages of international investing.

Foreign securities enhance diversification. As of year-end 1994, American equities constituted 35.1 percent of the capitalization of the world's equity markets. "To ignore non-U.S. markets is to ignore 64.9 percent of the total global market."[99] Furthermore, the world's securities markets tend to move against each other rather than in alignment. Back in the early 1980s Richard Brealey showed "that a well diversified international portfolio is only about . . . two thirds as risky as a diversified portfolio of U.S. stocks."[100] Returns so superior led Brealey to conclude: "You need a very positive reason not to invest a significant proportion of your stock portfolio overseas."[101]

Investing abroad has boomed. Between 1975 and 1992, total international equity mutual fund assets increased from $800 million to over $45 billion.[102] There has been a comparable increase in international investing among pension funds, charitable endowments, bank common trust funds, and other fiduciary investors. Using data from the National Association of College and University Business Officers, the *New York Times*

98. The 1959 Restatement recalled: "In the earlier decisions the courts were inclined to look with disfavor on investments outside the United States or even outside the State in which the trust was administered. It is quite otherwise today." Restatement (Second) of Trusts § 227 cmt. l (1959).

99. Ibbotson Associates, "World Equity Market Capitalization" (1995) (on file with author).

100. Brealey, supra note 21, at 118. Extensive supporting data is reviewed in Bruno Solnik, International Investments 91-116 (3d ed. 1996). It has recently been argued that most of the superior returns associated with foreign stocks in recent years result from currency fluctuations, and that among foreign stocks, only the small stock and riskier so-called "value" stocks enhance returns. Rex A. Sinquefield, Where are the Gains from International Diversification?, Fin. Analysts J. 8 (Jan-Feb. 1996).

101. Brealey, supra note 21, at 121.

102. Ibbotson Associates, "Growth of International Investing" (1995) (on file with author).

recently reported that 7.5 percent of college and university endowments are now invested in foreign equities. For Yale University, the *Times* reported 12 percent of the endowment in foreign equities.[103] Foreign holdings constituted 7.2 percent of the assets of United States pension funds as of 1993 and are projected to reach 11.5 percent in 1998.[104]

The 1992 Restatement expressly endorses trust investment in foreign securities.[105] The Uniform Act does not single out any asset class for special approval, but by emphasizing diversification, the total-portfolio standard of care, and the abrogation of categoric restrictions on types of investment, the Uniform Act leaves no doubt that it buttresses international investing.[106]

D. Derivatives

Derivatives constitute another category of unconventional assets destined to become more prominent in fiduciary portfolios. Scandals connected with the use of derivatives have been front page news in recent months. Rogue traders have inflicted huge losses on the Daiwa Bank, on the Common Fund, and on the venerable but now defunct Barings Bank. Companies as sophisticated as General Electric and Procter & Gamble are litigating about large losses sustained from investments in derivatives. Orange County, California, is in bankruptcy thanks to the county treasurer's penchant for investing in derivatives.[107] From a distance, therefore, derivatives seem to be well worth avoiding, especially if you are a trustee charged with investing prudently for your beneficiaries.

As is so often the case, however, the headlines tell only part of the story. The scandals involve cases in which derivatives were used in a fashion that increased portfolio risk enormously. Embarrassed investors were effectively placing immense bets on the future of interest rates, or in the case of Barings, on the future price levels of the Japanese stock market.

---

103. Universities Taking on Risks to Overcome Fiscal Squeeze, N.Y. Times, July 24, 1995, at A1, A7.

104. Solnik, supra note 100, at 576.

105. Restatement (Third) of Trusts: Prudent Investor Rule § 227, cmts. *f*, *l* (1992); id. reporter's note, at 97-98.

106. The Bankers Trust Statement, "Investment Implications of the Prudent Investor Act," accords:

> Many non-U.S. investments behave differently from U.S. equity and fixed income securities, thereby providing incremental returns without increasing risk levels. In many cases, [non-U.S. investments] can actually reduce risk. This reduction of volatility, or risk management, is the primary reason for the trend toward global portfolio management.

Bankers Trust Statement, supra note 83, at 4.

107. Some of these adventures are recounted in George Crawford, A Fiduciary Duty to Use Derivatives?, 1 Stan. J.L. Bus. & Fin. 307 (1995); and Donald L. Horwitz, Derivatives: The Basics on Terms and Risks, 5 Bus. L. Today 38 (Sept.-Oct. 1995), which also contains a useful introduction to the typology of derivatives. For an extensive discussion of the characteristics of derivatives and their use in portfolio management, see The Handbook of Fixed Income Securities 1077-1274 (Frank J. Fabozzi et al. eds., 4th ed. 1995).

Such investments are highly unlikely to qualify in a private trust account under any formulation of prudence, because the downside risk is larger than the risk tolerance of almost any trust investor.

There are, however, risk-reducing uses of derivatives. The Uniform Act's abrogation of categoric restrictions on types of investments allows trustees to use derivatives in such cases. George Crawford, in his intriguingly titled article, "A Fiduciary Duty to Use Derivatives?," illustrates a particularly compelling case.[108] Crawford posits a situation involving an elderly woman whose assets consist disproportionately of a large block of shares in the Philip Morris Company. She bought the shares decades ago, and they have appreciated hugely. She goes to the local bank and sets up a trust for herself for life, with the remainder to her siblings. She transfers the Philip Morris shares to the trust, together with her other holdings. The trust is seriously underdiversified; sixty percent of its assets are tied up in Philip Morris stock. Alas, the bank as trustee faces a difficult problem: Selling Philip Morris stock would result in a taxable gain, with perhaps 30 percent of the proceeds being lost to taxation. Under the rule that allows stepped-up basis at death, that tax liability would be completely avoided if the trust retained the stock until the settlor's death.

In traditional trust administration, the trustee would be faced with a choice between selling the shares, thus incurring the tax cost; or holding the shares and running the risk of underdiversification. In Crawford's parable, the trustee opts to hold and remain underdiversified. Soon thereafter, Philip Morris plunges from $78 per share to $52 per share.[109] Crawford suggests that the trustee had a third alternative, an alternative so compelling that the trustee might be liable for breach of the duty of prudent investing for failing to have taken it. The trustee should have bought a derivative, a put option on Philip Morris common, that would have increased in value in the event that the price of the underlying common stock declined. Buying put options can be costly, but for a number of large capitalization stocks, including Philip Morris, low-cost put options called LEAPS ("long-term equity appreciations") can be purchased. Crawford runs the numbers and shows that the advantage to holding the Philip Morris and offsetting the risk of decline by buying LEAPS is so overwhelming by comparison either with selling the shares and paying the tax bill or doing nothing and risking the loss from underdiversification that the prudence standard should compel the use of the derivative.

As Crawford's example suggests, I think we can confidently predict that the coming decades will witness ever greater use of risk-reduction strategies employing derivatives in trust portfolios.

---

108. Crawford, supra note 107.

109. Crawford, supra note 107, at 313.

E. Reduced Deference to the Paper Trail

An odd trait of the older trust investment law in deciding whether a trustee has invested prudently has been the inclination to give great weight to the trustee's internal procedures for investing and monitoring investments. If a corporate trustee's file recites a plenitude of deliberation —an investment committee, a securities selection committee, and a portfolio manager for the particular trust, all busily pumping quarterly memoranda about their due deliberateness into the file—the courts have sometimes been willing to treat this paper trail as presumptive evidence of prudence.[110] A practitioner treatise remarks on this phenomenon: "In cases involving the propriety of investments, the decision-making process may be as important as the decision itself, at least for purposes of determining the trustee's responsibility."[111]

I suspect that the courts have tended to fall back on evidence of seemingly sound internal procedures because the substantive standard of prudent investing has been so imprecise. Proceduralism is a common retreat in fields in which substantive law provides inadequate guidance —American administrative law is a prominent example. For the future, however, particularly as regards the intensified duty to diversify under the new Restatement and the Uniform Act, I predict that the courts will feel less need to retreat to the proceduralism of the paper trail. No amount of paper trail can excuse the five-bond or ten-stock portfolios still found in too many trust accounts.

The greater objectivity and precision of the modern standards for prudent investing manifest themselves well beyond the duty to diversify. For example, as trust investing moves toward ever greater use of broad-based portfolios, it will become easier to measure investment performance and to identify substandard returns. Many types of mutual funds and common trust funds are easily comparable. Most sponsors offer the chocolate, vanilla, and strawberry of corporate bond portfolios—short, intermediate, and long term. Most offer a comparable array of U.S. treasury bond funds. And we are now seeing ever increasing standardization of types of equity funds.

Consider, therefore, a simple case. Suppose that a trustee determines to invest twenty percent of the trust in an intermediate-term bond fund. Suppose, further, that the particular intermediate bond fund that the trustee chooses persistently underperforms other intermediate-term bond funds on account of drastically higher expense ratios. In view of the trustee's duty to monitor,[112] the burden will more easily shift to the trustee to explain why the trustee chose that particular fund. Under the prudence standard, the comparability of increasingly standardized fund types will allow trustees (and the courts who oversee trustees when beneficiaries are unhappy) greater precision in examining investment performance. The point is not that a disappointing fund or fund year is ipso facto imprudent—far from it. The point is that the growing comparability of fund types provides a more precise and objective benchmark for evaluating claims that a certain fund is so manifestly inferior to competitors that investing in it, or retaining it, is imprudent.

110. Perhaps the most exaggerated example is Stark v. United States Trust Co., 445 F. Supp. 870 (S.D.N.Y. 1978), a gullible opinion by the normally perceptive Judge Edward Weinfeld.

111. A. Walter Norcaman et al., Trust Administration and Taxation § 29.05[2] (1995).

112. UPIA § 9(a), supra text accompanying note 72.

F. Increased Scrutiny of Uneconomic Settlor Instructions

I would also predict that the greater clarity of the new trust investment law will result in less deference to the wishes of the trust settlor in an uncommon but troubling case—the case in which the settlor attempts to impose a manifestly stupid investment restriction on the trust.

Take as the starting point the proposition, strongly endorsed in section 1(b) of the Uniform Act,[113] that almost all trust law is default law, rules that yield to the contrary wishes of the settlor. Trust law presumes that the settlor has the best interests of the beneficiaries at heart when the settlor imposes restrictions on the disposition of trust property. If, for example, I leave my summer cottage on Lake Adams in trust for my children with instructions that it not be sold but kept in the family for recreational use, that instruction will be honored even if the beneficiaries would rather not set foot on the shores of Lake Adams ever again.[114] Under conventional American trust law, the settlor's property rights are indulged. As settlor, I am entitled to decide what is best for my beneficiaries, subject only to the rule against perpetuities.

There are, however, limitations. If I devise property to a trust directing that the trustee erect equestrian statues of me in public squares in Iowa, that provision will be invalidated. A private trust must be for the benefit of the beneficiaries; a charitable trust must satisfy standards of public benefit. The trust to endow Iowa with bronze, equestrian Langbeins achieves neither.[115]

Even when the settlor's instruction is not manifestly loony, the deviation doctrine allows a court to alter an unwise investment restriction "if necessary to carry out the purposes of the trust."[116] The leading case

113. "The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." UPIA § 1(b), 7B U.L.A. 18 (Supp. 1996).

114. "If the continuance of the trust is necessary to carry out a material purpose of the trust, the beneficiaries cannot compel its termination." Restatement (Second) of Trusts § 337(2) (1959).

115. Id. § 376(c) (invalidating trusts for capricious purposes); *accord* id. § 124 cmt. g. *Compare* M'Caig v. University of Glasgow, [1907] Sess. Cas. 231 (Scotland), voiding a trust to erect statues of the testator and other family members on lands devised by the testator, *discussed in* 2 Scott & Fratcher, supra note 32, § 124.7, at 277-78. On the public benefit standard, the so-called doctrine of charitable purposes, see Restatement (Second) of Trusts § 368 (1959).

116. Restatement (Second) of Trusts § 167(1) (1959).

involved a trust set up by Joseph Pulitzer for his children, in which he forbad the trustees to sell the *New York World* newspaper. When the paper became unprofitable, the trustees received judicial approval to sell it anyhow.[117] The reasoning in such cases is that subsequent experience has revealed a conflict between the settlor's dominant purpose, which is to benefit the trust beneficiaries; and the settlor's subsidiary purpose, which is to benefit them in a particular way—in *Pulitzer*, by keeping the *New York World* in the trust. The court is simply preferring the dominant purpose, in order to carry out the settlor's presumed intent.

Suppose, however, that the trust instrument in *Pulitzer* had foreseen and recited the danger that the paper might become unprofitable, and had directed retention of the investment in any event. I have no doubt that the court in *Pulitzer* would have ordered the trustees to sell the newspaper despite the settlor's direction to retain it. The settlor's instruction to retain the newspaper at all costs would come to resemble my instruction to litter the Iowa landscape with equestrian statues. If the settlor directs an objectively stupid investment policy, the court will direct deviation even though the settlor anticipates the circumstance.[118] The settlor is presumed to intend to benefit the beneficiaries, but if it can be shown that a term of the trust manifestly harms their interests, the court will order deviation from it. A private trust must be for the benefit of the beneficiaries.

Now consider a type of investment instruction that is closer to reality.[119] The settlor has worked all his life for, let us say, IBM. Through stock options and company sponsored investment plans, he has accumulated a large block of IBM common stock. He dies, leaving the block in trust with instructions not to sell it. The block is the only substantial asset of the trust, and because the settlor's death results in a stepped-up basis, selling the block incurs no tax cost. Suppose, further, that the settlor leaves a letter explaining his thinking. "I worked for IBM for 35 years, they were wonderful to me, they helped me buy the stock, and the stock zoomed in value throughout my career. You just cannot do better."

What is happening in this case is that the settlor is imposing his supposed investment wisdom on the trust in circumstances in which the investment strategy is objectively stupid and imprudent. We now know that the advantages of diversifying a portfolio of securities are so great that it is

117. *In re* Pulitzer, 249 N.Y.S. 87 (N.Y. Sur. Ct. 1931), *aff'd mem.*, 260 N.Y.S. 975 (N.Y. App. Div. 1932).

118. *E.g.*, Colonial Trust Co. v. Brown, 135 A. 655, 664 (Conn. 1926) (holding void certain restrictions as to the height of buildings to be erected on trust real estate because "the restrictions are opposed to the interests of the beneficiaries of the trust").

119. The reported cases instance trusts with permission to retain rather than outright direction. *See, e.g.*, Bahlus v. Bank of Cal., 530 P.2d 1350 (Wash. Ct. App. 1975); Warmack v. Crawford, 105 S.W.2d 910 (Mo. Ct. App. 1936); First Nat'l Bank of Boston v. Truesdale Hosp., 192 N.E. 150 (Mass. 1934).

folly not to do it. I am not saying that you can never have an underdiversified trust fund. It will remain common to place a family firm or a family farm in trust, notwithstanding that such a trust will often be underdiversified. There's nothing wrong with using a trust as part of the succession arrangements for a family enterprise. I further concede, following the official Comment to the Uniform Prudent Investor Act,[120] that there will remain cases in which the tax cost of diversifying a low-basis asset may outweigh the gain.[121] When, however, the trust assets are cash or cash-equivalent, in the sense that diversification can be achieved at little cost, I believe that the courts will come to view the advantages of diversification as so overwhelming that the settlor's interference with effective diversification will be found to be inconsistent with the requirement that a private trust must be for the benefit of the beneficiary.

C. *Fractionation of Trusteeship*

Trusteeship entails three relatively distinct functions: investment, administration, and distribution. *Investment* includes not only the initial selection of securities or other assets, but also the tasks of monitoring the investments for continuing suitability, investing new funds, and voting the shares. *Administration* includes the range of accounting, reporting, and tax filing. The responsibility for taking custody of securities is another branch of trust administration. Unusual trust assets may require other administrative work—maintaining and leasing real estate, insuring and safekeeping the Picasso and the diamond tiara, and so forth. *Distribution* is sometimes mechanical, but trust instruments often bestow upon trustees the discretion to spray, sprinkle, invade, accumulate, terminate, and so forth. Distribution, therefore, requires interpreting and applying the sometimes complex language of the trust instrument; and it commonly involves contact with the current beneficiaries, in order to keep abreast of their needs and circumstances.

In former centuries, when ancestral land was the prototypical trust asset, these three functions of trusteeship were inextricably merged. The trustees were often not much more than nominees—mere stakeholders—and the family that lived on the land managed it. As financial assets have become the characteristic asset of the modern managerial trust, there is ever less reason for these three relatively disparate functions—investment, administration, and distribution—to remain consolidated in a single pair of hands. No deep connection exists between, for example, being good at working with beneficiaries on the distribution side, and being expert at investing trust funds or preparing fiduciary tax returns.

As Modern Portfolio Theory and the modernized prudent investor norm drive fiduciaries to use ever larger portfolios, there will be ever less reason to think that family trustees, and even small bank trustees, can

120. UPIA § 3 cmt.

121. *But see* supra notes 108-09 and accompanying text.

competently conduct the investment function in-house. The delegation doctrine that is legitimated under the 1992 Restatement and the Uniform Act[121] facilitates the use of outside investment products and outside investment managers. Bank trust departments are making ever greater use of mutual funds.[122] When the funds are internally managed, they constitute a close alternative to bank-operated common trust funds. When the bank as trustee uses externally managed mutual funds, the trustee commonly retains the asset allocation decisions for the particular trust in-house while effectively delegating detailed portfolio management to the outside investment company. This is an intermediate position between completely internalized investment management and complete delegation of the investment function.

One consequence of legitimating the delegation of investment functions will likely be a greater willingness on the part of lawyers to serve as trustees.[123] Lawyers bring expertise to the interpretation of trust instruments, and the typical law firm exhibits more stable personnel practices than the perennial revolving door that has been such a troubling feature of bank trust departments. Thus, on the distribution side, lawyers and law firms have formidable comparative advantages as fiduciaries. By contrast, lawyers have no particular reason to be in the investment business—at least if the investment function entails the work of actively constructing and maintaining portfolios as opposed to making or overseeing asset allocation decisions among externally managed portfolios. The delegation doctrine may encourage more lawyers and law firms to accept trusteeships, by keeping distribution work in-house, while facilitating the delegation of detailed investment and administrative functions to specialized providers.

II. Principal and Income

I conclude my efforts to peer into the future of trust investing by turning to a seemingly quite distinct subject: the rules governing how trustees allocate the receipts from trust investments between principal and income. The new trust-investment law is undermining the practices that trustees have long followed for discharging their duty of impartiality to multiple beneficiaries. We are learning that the duties of prudent investing and of impartiality have had a more intimate connection than has been understood. Traditional principal-and-income concepts will not survive in the world of MPT-driven investing.

122. *See supra* notes 58-62 and accompanying text.

123. The subject has its own treatise: Melanie L. Fein et al., Mutual Fund Activities of Banks (1993).

124. I have elsewhere had occasion to point to some of the advantages that lawyers can bring to trusteeship as well as some of the dangers. John H. Langbein, Taking a Look at the Pluses and Minuses of the Practice, 128 Tr. & Est. 10 (Dec. 1989). The American Bar Association's most recent guidance on the topic is reported in Bradley R. Cook, Principles for Attorneys Acting in Other Fiduciary Roles, 6 Prob. & Prop. 8 (Mar./Apr. 1992).

Most trusts provide for multiple interests, commonly a life estate, followed by remainders—for example, to my widow for her life, remainder to my issue. Trust law requires the trustee in such cases to adhere to what is called the duty of impartiality. The Restatement version says: "If a trust is created for beneficiaries in succession, the trustee is under a duty to the successive beneficiaries to act with due regard to their respective interests."[125] In allocating the receipts and expenses of the trust, the current beneficiary "is entitled to, and only to, the net income"[126] of the trust. Other investment returns, especially capital appreciation, accrue to the corpus of the trust. The Uniform Principal and Income Act[127] and comparable nonuniform legislation regulate corporate distributions, assigning dividends and interest to income, while accruing stock splits and other capital-account transactions to the remainder interest.

In former centuries, when agricultural real estate was the typical trust asset, the concept of net income had an intuitive, largely self-defining basis, which left scant discretion to the trustee. The life tenant was entitled to the fruits and rents of the land. Difficulty in ascertaining what was income arose only at the margin, with gravel pits and timber stands and the like.[128] As the portfolio of financial assets displaced agricultural land from the prototypical modern trust, the concept of trust income became vastly more manipulable in the hands of the trustee.

In modern circumstances, the trustee's investment decisions largely determine the income allocation to the current beneficiary. If the trustee loads the portfolio with the shares of so-called growth companies that retain their profits for internal expansion and pay little or no dividends, conventional income will be impaired. By contrast, were the trustee to skew the portfolio toward high-yielding stocks and bonds, which tend to deliver most of their return in dividends and interest rather than to experience much capital appreciation, the trust's investment policy would favor the current beneficiary and impair the remainder interest. At either extreme, or anywhere between, the trustee who has investment discretion *effectively chooses the income level by choosing the investments.* The duty of impartiality constrains the trustee by requiring "due regard" to the interests of principal and income, but within the sphere of discretion that the duty of impartiality permits, trustees commonly make investment decisions with a view to achieving the desired income level.

By distorting investment choices in order to maximize a particular form of return (whether dividends and interest or capital appreciation), conventional trust investment practices that are designed to satisfy

125. Restatement (Second) of Trusts § 232 (1959).

126. *Id.* § 233(1)(a). Manifestly, this default regime is altered when the trust grants the trustee discretion *over* whether or in what shares to distribute income, or when the trust grants the trustee a power to invade corpus for the income beneficiaries.

127. Unif. Principal & Income Act (1931 & 1962 Acts), 7B U.L.A. 183 (1985).

128. Notable topics in the early treatise, Edwin A. Howes, Jr., The American Law Relating to Income and Principal 5-12 (1905).

principal-and-income concerns come into tension with Modern Portfolio Theory. Thus, for example, the trustee who is administering a trust that needs to achieve a high level of current income may feel obliged to invest heavily in bonds, even though it is known that equities outperform bonds across the long term on a total-return basis. The conventional principal-and-income rules drive that trustee to accept a *lower* total return in order to obtain a particular *form* of return—interest rather than capital appreciation. In many trust portfolios that could prudently tolerate greater risk by holding a higher proportion of equities, the trustees have refrained from investing appropriately in equities because such a portfolio commonly produces less current income.

The lesson, in the words of Joel Dobris, is that "Investing should not be connected with principal and income allocation."[129] Instead, the trustee should first invest to maximize total return, and then, in a separate and subsequent step, "allocate the return as fairly as possible."[130] In a prominent article published in 1986, Jeffrey Gordon observed that skewing the portfolio to achieve a particular income/principal allocation also impairs diversification.[131]

Our traditional notion that the current beneficiary automatically receives all the "income" has concealed from us the truth that the trustee's investment policy largely determines how much that income will be. Accordingly, an MPT-driven regime that would allow the trustee to invest for the maximum return suitable to the trust, regardless of form, and then to allocate to income that portion that the trustee determines to be appropriate for discharging the duty of impartiality, would involve no fundamental departure from the inner functional balance of the present law. Under either scheme, the trustee decides how much of the trust's investment return to devote to the income interest. But greater candor about the relationship between investing and allocating would allow the trustee to follow investment practices that would produce superior returns for both current and remainder beneficiaries.

Two main suggestions have been made for devising allocation formulas to facilitate total-return investing: the unitrust, and equitable reallocation. The unitrust is common in the world of foundations and charitable trusts,[132] (and in tax planning for individuals after the enactment of Chapter 14 of the Internal Revenue Code).[133] Under a unitrust, all the investment gains for the accounting period are initially assigned to principal, without regard to form (that is, whether dividends, interest, or capital appreciation). Thereafter, a spending formula (for example, five percent of principal, or the inflation rate plus two percent) is used to determine the share for current-year distribution. It is no accident that the unitrust has thus far thrived mostly in the tax-exempt world of the IRC § 501(c)(3) organization, where there is no tax reward for preferring capital gains over dividends and interest, and no tax penalty for recognizing capital gains. That is to say, our rules of taxation, as well as our rules for allocating principal and income, can impede total-return investing for taxable trusts.

Under a system of equitable reallocation, the trustee would retain the conventional form-driven categories as the initial stage of principal-and-income allocation. If, however, the trustee were to determine that the outcome achieved for the particular trust by applying those form-driven rules did not correctly balance the needs of current and remainder beneficiaries, the trustee would have the duty to reallocate the returns in order to discharge the duty of impartiality.

As I write, a Uniform Law Commission drafting committee is wrestling with proposed revisions to the Uniform Principal and Income Act, including the challenge of adapting the principal-and-income rules to the world of total-return investing under the Uniform Prudent Investor Act. The committee considered unitrust solutions but is presently inclined to recommend a limited form of equitable reallocation.[134] It remains to be seen whether this proposal will survive in the draft, and whether the full Commission will endorse it.

I suspect that some decades will be needed to harmonize fully the present tensions among total return-investing as facilitated by the prudent investor paradigm, recognition-based income taxation, and principal-and-income law. The Uniform Prudent Investor Act does not even address these issues. But by committing American trust-investment law to the main principles of Modern Portfolio Theory, the Act has brought awareness of these tensions onto the agenda that confronts legal policymakers and practicing lawyers in trust and estate law, and that is a giant first step.

---

129. Joel C. Dobris, The Probate World at the End of the Century Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob. & Tr. J. 393, 412 (1993).

130. Id.

131. Such a portfolio "is not optimally diversified" because it

> has not been assembled with the objective of producing the greatest expected returns for the risk. It is easy to see why systematic exclusion of companies with low dividends but high reinvestment rates upsets a diversification scheme, but there is no assurance that a portfolio that emphasizes balance between high and low dividend paying securities will be well-diversified otherwise. The point is that the allocation of total returns between "income" and "principal" forced by settled trust law is profoundly inconsistent with the portfolio theory paradigm.

Jeffrey N. Gordon, The Puzzling Survival of the Constrained Prudent Man Rule, *in* Longstreth, *supra* note 20, at 105, 110, *substantially reprinted in* Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 81 N.Y.U. L. Rev. 52, 10001 (1987).

132. Joel C. Dobris, Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules, 28 Real Prop., Prob. & Tr. J. 49 (1993).

133. *See* IRC § 2702 (1990) (creating special valuation rules in case of transfers of interests in trusts); Louis S. Harrison, The Real Implications of the New Transfer Tax Valuation Rules: Success or Failure?, 47 Tax L. 885, 918 (1994).

134. Unif. Principal and Income Act (Oct. 1995 draft).

Fiduciary Trust International

Uniform Prudent Investor Act

Investment Legislation Governing Trusts and Foundations

As of November, 1997

Fiduciary Trust Company International

BACKGROUND INFORMATION

Investment Legislation Governing Trusts and Foundations (by State)

As of November, 1997

A model Uniform Prudent Investor Act ("UPIA") was promulgated by the National Conference of Commissioners on Uniform State Laws in 1994 and recommended for enactment by the states. The UPIA allows trustees and similar fiduciaries to employ modern portfolio theory to guide investment decisions, and evaluates a fiduciary's conduct based on a strategy for the total portfolio, rather than on the selection of individual assets. In addition, the UPIA makes the following alterations in the former criteria for fiduciary investment: (A) the tradeoff between risk and return is identified as the fiduciary's central investment consideration; (B) categoric restrictions on types of investments have been abrogated; (C) the concept that fiduciaries should diversify portfolio investments has been integrated into the definition of prudence; (D) the much criticized rule of trust law forbidding the trustee to delegate investment and management functions has been reversed (some jurisdictions impose notice requirements not mandated by the UPIA); and (E) the trustee may be relieved from liability for acts of the agent, if certain requirements are met.

It should be noted that charitable foundations and private trusts are subject to similar investment rules. The UPIA is applicable to foundations organized in trust form. Charitable corporations, on the other hand, are governed in many jurisdictions by the Uniform Management of Institutional Funds Act ("UMIFA"). The far right column of the chart indicates whether a state has adopted UMIFA.

The chart at the right shows the states that have adopted the UPIA, or substantial portions thereof, as of this publication. Additionally, many other states are identified that now require a total portfolio approach to investment management, but which do not otherwise have provisions resembling the UPIA. If a state has no total portfolio statute, the chart makes no representation regarding whether that state's laws contain any other provision resembling the UPIA.

State	Uniform Prudent Inv. Act (or most UPIA provisions) Effective Date	Total Portfolio Statutes (minimal UPIA provisions) Effective Date	Authority
Alabama		5/16/89	Ala. Code §§
Alaska			
Arizona	7/20/96		Ariz. Rev. Stat
Arkansas	3/31/97		Act 940 of 19
California	1/1/96		Cal. Prob. Cod
Colorado	7/1/95		Colo. Rev. Sta
Connecticut	6/2/97		Public Act No
Delaware		7/3/86	Del. Code An
Dist. of Columbia		2/1/95	D.C. Super. C
Florida	10/1/93		Fla. Stat. Ann
Georgia		1/1/98	Ga. Code Ann
Hawaii	4/14/97		30 Hawaii Re
Idaho	7/1/97		Idaho Code §
Illinois	1/1/92		760 Ill. Comp
Indiana			
Iowa		4/22/91	Iowa Code An
Kansas	7/1/93		Kan. Stat. Ann
Kentucky		7/15/96	Kent. Rev. Sta
Louisiana			
Maine	1/1/97		Me. Rev. Stat
Maryland	10/1/94		Md. Est. & T
Massachusetts			
Michigan			
Minnesota	1/1/97		Minn. Stat. A
Mississippi			
Missouri	8/28/96		Mo. Ann. Sta
Montana		10/1/89	Mont. Code
Nebraska	4/2/97		Legislative B
Nevada		4/17/89	Nev. Rev. Sta
New Hampshire			
New Jersey	3/7/97		N.J. Stat. An
New Mexico	7/1, 95		N.M. Stat. A
New York	1/1/95		N.Y. Est., P
North Carolina			
North Dakota	8/1/97		N.D. Cent.
Ohio			
Oklahoma	11/1/95		Okla. Stat.
Oregon	9/9/95		Or. Rev. Stat
Pennsylvania			
Rhode Island	8/6/96		R.I. Stat. §§
South Carolina		6/5/90	S.C. Code A
South Dakota	7/1/95		S.D. Codified
Tennessee		7/1/89	Tenn. Code
Texas		6/16/91	Tex. Prop.
Utah	7/1/95		Utah Code
Vermont			
Virginia	4/6/92		Va. Code A.
Washington	7/23/95		Wash. Rev.
West Virginia	7/1/96		W. Va. Code
Wisconsin			
Wyoming			

	(A) Risk/Return Objectives Emphasized	(B) Unrestricted Investment Types Authorized	(C) Diversification of Portfolio as Prudent	(D) Delegation of Investment Management Author	(E) Trustee/Agent Liability Severed	(F) Notice of Delegation Required	Uniform Management of Institutional Funds Act (UMIFA)
120.2 and 19-3-322	No	No	No	Yes	No	No	Yes
							No
§§ 14-7601 to 14-7611	Yes	Yes	Yes	Yes	Yes	No	No
	Yes	Yes	Yes	Yes	Yes	No	Yes
16045 to 16054	Yes	Yes	Yes	Yes	Yes	No	Yes
a. §§ 15-1.1-101 to 15-1.1-115	Yes	Yes	Yes	Yes	Yes	No	Yes
140	Yes	Yes	Yes	Yes	Yes	No	Yes
12, § 3302	No	Yes	No	No	No	No	Yes
b. R. 5(a)	Yes	Yes	No	No	No	No	Yes
18.11 and 518.112	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3-8-2	No	Yes	No	No	No	No	Yes
statutes 554C	Yes	Yes	Yes	Yes	Yes	No	Yes
10	Yes	Yes	Yes	Yes	Yes	No	Yes
Ann. §§ 5/5 and 5/5.1	Yes	Yes	Yes	Yes	Yes	Yes	Yes
							Yes
33.123	No	No	No	No	No	No	Yes
S-1202 and 17-5004	Yes	Yes	Yes	Yes	Yes	Yes	Yes
277—applies only to corporate fiduciaries	Yes	No	Yes	Yes	No	No	Yes
							Yes
t. 18-A, § 7-302	Yes	Yes	Yes	Yes	Yes	No	Yes
ode Ann. § 15-114	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
							Yes
501B.151 and 501B.152	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
56.900 to 456.913	Yes	Yes	Yes	Yes	Yes	No	Yes
72-34-114	No	Yes	No	No	Yes	No	Yes
	Yes	Yes	Yes	Yes	Yes	No	Yes
050	No	Yes	No	No	No	No	No
							Yes
20-11.1 to 3B:20-11.12	Yes	Yes	Yes	Yes	Yes	Yes	Yes
5-7-601 to 45-7-612	Yes	Yes	Yes	Yes	Yes	No	No
Trusts Law § 11-2.3	Yes	Yes	Yes	Yes	No	No	Yes
							Yes
02-08.1 to 59-02-08.11	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
175.60 to 175.72	Yes	Yes	Yes	Yes	Yes	No	Yes
194 to 128.218	Yes	Yes	Yes	Yes	Yes	No	Yes
							No
o 18-15-13	Yes	Yes	Yes	Yes	Yes	No	Yes
7-302	No	Yes	No	No	No	No	Yes
Ann. §§ 55-5-6 to 55-5-16	Yes	Yes	Yes	Yes	No	No	No
5-3-117	No	Yes	No	No	No	No	Yes
§ 113.056	No	Yes	No	No	No	No	Yes
7-302	Yes	Yes	Yes	Yes	Yes	No	No
							Yes
45.1	No	Yes	Yes	No	No	No	Yes
§ 11.100.010 et seq.	No	Yes	Yes	No	No	No	Yes
1 to 44-6C-15	Yes	Yes	Yes	Yes	Yes	No	Yes
							Yes
							Yes

Fiduciary Trust Company International
Two World Trade Center
New York, New York 10048-0772
Telephone: 212-466-4100
Fax: 212-524-5011

Fiduciary Trust International of California
444 South Flower Street
Suite 3010
Los Angeles, California 90071-2961
Telephone: 213-489-7400
Fax: 213-489-2078

Fiduciary International, Inc.
1717 Pennsylvania Avenue, NW
Suite 630
Washington, DC 20006
Telephone: 202-393-7900
Fax: 202-393-7906

Fiduciary Trust International of the South
International Place
100 S.E. Second Street
Suite 2300
Miami, Florida 33131
Telephone: 305-372-1260
Fax: 305-372-0654

SENATE COMMITTEE REPORT

DATE: 3/25/98

FURTHER: Finance

DATE TURNED IN TO OFFICE: 3-30-98

Judiciary Committee considered HOUSE BILL NO. 321 am

"An Act relating to trusts, to the prudent investor rule, and to standards of care applicable to personal representatives, conservators, and trustees; 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 the _____ Committee

Senate Bill:
[ ] same title
[ ] new title

House Bill:
[ ] same title
[ ] technical title
[ ] new: SCR#_____

SIGNING DO PASS	*DP*	*OTHER RECOMMENDATIONS*	*NR*	*DNP*	*AM*
Mike Miller	✓	Sean Parnell	X		
CHAIR: Johnnie Taylor	✓	*CHAIR:*			

NEW FISCAL NOTE(S):

Department	Date	Zero	Fiscal

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
CLED/Banking & Securities	2-9-98	✓	

[ ] **APPROPRIATION -- no fiscal note**

***include fiscal notes accompanying Governor's bill**

HB

335

Economic Deregulation and Customer Choice: Lessons for the Electric Industry

Robert Crandall
The Brookings Institution
Washington, DC

Jerry Ellig
Center for Market Processes
Fairfax, VA

Executive Summary

Policymakers and regulators are engaged in an ongoing debate about introducing customer choice in electric service. The most comprehensive legislative proposals envision a market in which all customers could choose their electricity suppliers. Electric utilities would no longer have monopoly rights to sell electricity to particular groups of customers. Instead, they would become transporters of electricity, and they could also compete in the generation marketplace. The price of the electricity would no longer be regulated, although the price of transportation still would be.

During the past two decades, numerous industries with many economic similarities to electricity have already undergone price and entry deregulation in at least part of the industry. The most significant include natural gas, telecommunications, airlines, trucking, and railroads. Like electricity, these are "network" industries. Suppliers and customers are connected via a network of pipes, wires, air routes, roads, or rails, and the decisions of one network user can affect the ability of others to use the network.[1] The experience of these five industries can therefore serve as a guide in the debate over customer choice in electricity.[2] A review of the evidence reveals several broad conclusions about the effects of deregulation, and each conclusion carries with it a policy implication.

---

[1] Because of this fact, analysis of these five industries is more relevant to the electricity debate than that of nonnetwork industries that were deregulated at similar times, such as oil production, stock brokerage, or savings and loans.

[2] We are hardly the first to notice the similarities between electricity and other deregulated industries. In August 1996, the National Regulatory Research Institute released a report whose substantive findings largely agree with ours (Costello and Graniere 1996).

Summary of Trends Following Regulatory Change

Industry	% Real price reduction after... 2 years	5 years	10 years	Annual value of consumer benefits due to deregulation
Gas	10-38% (1984-86)	23-45% (1984-89)	27-57% (1984-94)	N.A.*
Long Distance Telecom	5-16% (1984-86)	23-41% (1984-89)	40-47% (1984-94)	$5 billion
Airlines	13% (1977-79)	12% (1977-82)	29% (1977-87)	$19.4 billion
Trucking	N.A.**	3-17% (1980-85)	28-58%*** (1977-87)	$19.6 billion
Railroads	4% (1980-82)	20% (1980-85)	44% (1980-90)	$9.10 billion

Note: All figures are real, in $1995. Consumer benefit figures in the last column measure *total* consumer benefits, including both price reductions and changes in service quality.

Source: For price reductions, see Appendix and/or text of study for data. Consumer benefit figures are from Crandall (1991), Morrison and Winston (1995), and Winston et. al. (1990).

N.A*: For natural gas, no controlled studies quantify the separate effect of deregulation on gas prices. Winston (1993, 1274-75) speculates that the consumer benefits exceeded economists' predereguiation predictions, which were in the range of $2-4 billion in 1995 dollars. If gas prices had remained at 1984 levels, consumers would have paid $50-60 billion more for gas in 1995.

N.A.**: For trucking, no studies have documented the effects for the first couple of years.

***No trucking figure is available for 1980-90; figure quoted is for 1977-87, from Corsi (1994). Because regulation made it difficult to cut trucking rates, the bulk of these rate reductions occurred after 1980.

- **Finding: Deregulation and customer choice lower prices.**

In each of the five industries, prices paid by customers fell significantly as a result of deregulatory reforms. Within the first two years of deregulation, prices had fallen by 4-15 percent, and sometimes more for certain groups of customers. Within 10 years, prices were at least 25 percent lower, and sometimes close to 50 percent lower. Of course, not all of these changes were due to changes in the regulatory regime, but scholarly studies consistently show that regulatory reform created billions of dollars worth of consumer benefits. Consumers gained substantially—not just because of rate reductions, but also because of improvements in the quality of service. All broad consumer groups shared in the price reductions, though some benefited more than others.

Policy implication: *Competition is desirable.*

Policymakers concerned about consumers should open electric service to competition, deregulate rates, and promote consumer choice as quickly as possible.

- **Finding: Deregulation and customer choice align service quality with customer desires.**

The only declines in service quality attributable to deregulation or regulatory reform occurred when regulation previously limited customer choice, forcing customers to pay premium prices for gold-plated service. Crucial social goals like airline safety, reliability of gas service, and reliability of the telecommunications network were maintained or improved by deregulation and customer choice.

Policy implication: *Service quality is no excuse for delay.*

Concerns about reliability and other aspects of service quality are reasons to expedite regulatory reform. Under deregulation, service quality choices will enable consumers to select the services that best meet their needs.

- **Finding: Consumers have experienced genuine benefits, not just reallocation of costs among customer classes.**

Regulatory reform is not a zero sum game; it has generated genuine gains for consumers and society as a whole. It is possible to find narrowly defined groups of customers in special circumstances who paid somewhat higher prices after deregulation, but the gains to the vast majority of consumers far outweighed the effects on these small groups.

Consumers gained for two reasons. First, deregulation or regulatory reform aligned prices more closely with costs, leading to a more efficient use of resources by both firms and customers. Second, firms faced greater incentives to adopt cost-reducing or quality-enhancing innovations in technology, marketing, and business strategy, which often were not predicted beforehand.

Policy Implication: *Transition costs are no excuse for delay.*

Based on the experience in other industries, electricity regulatory reform should produce gains well in excess of the transition costs. Therefore, the presence of transition costs is no excuse for delaying or avoiding reform.

- **Finding: The lower the barriers to customer choice, the greater benefits customers receive.**

Rates fell faster in parts of the market where regulators permitted greater customer choice. In telecommunications, for example, long-distance rates fell faster in the interstate market than the intrastate market, because state regulators have been less tolerant of competition and price cutting. Similarly in the airline industry, during the 1970s proponents made a powerful case for deregulation by showing that tickets were less expensive on the less heavily regulated intrastate routes of Texas and California.

Policy Implication: *Choice for* **all** *customers for all competitive services will provide the most benefits.*

The best way to let all customers reap the benefits of competitive electric service is to let all customers choose their electricity suppliers. Policy proposals that deregulate only the wholesale electricity market, or allow only large customers to choose their suppliers, are thus inferior from a consumer perspective. For similar reasons, states that refuse to allow competition from out-of-state suppliers do their own citizens a disservice.

- **Finding: Competitive markets continue to evolve in response to consumer needs.**

Although prices fell noticeably in response to deregulation, adjustment to the new, deregulated environment was far from immediate for incumbent firms. Regulation affects not just the structure of incentives facing a firm, but also its corporate culture—the shared assumptions about what types of activities generate business success. Regulation can change relatively quickly, but corporate culture often changes slowly, and so corporate strategies may also adjust slowly to the deregulated environment. For the five industries in this study, significant changes and adjustments are occurring even after 10 years. Benefits of regulatory reform continued to accrue long after the market was first opened.

Even if some firms adjust quickly to the deregulated environment, that environment changes much more quickly than the regulated environment. The industries in this study did not move from a "monopoly equilibrium" to a new "competitive equilibrium." Rather, they moved from a fairly stable regulated environment to an evolutionary environment in which competitive rivalry continually forces producers to improve their performance. Since it is unlikely that firms will ever stop learning, and consumers are never satisfied with the status quo, a stable equilibrium is extremely unlikely.

The five industries in this study present a plethora of examples of innovations that were not foreseen or planned beforehand. These include natural gas hubs, airline hub-and-spoke

systems, and a multitude of types of new services and customer-premises equipment in telecommunications. Such developments should give pause to anyone who claims to be able to predict either the likely or the optimal market structure.

Policy implication: ***Open and competitive markets should be allowed to evolve.***

Legislators and regulators should resist the temptation to elaborately plan either the structure of markets or the transition process. The temptation to overplan takes many forms, including mandates that power must be bought and sold through a central "POOLCO" and proposals that would restrict the range of contracts that generators can make with customers.

In any move toward greater reliance on markets, transition problems must be addressed. But the significant ones where government must play a role, such as those dealing with transition costs, involve the assignment or reassignment of property rights to various market participants. The proper role of policy is not to "design market mechanisms" but to create and protect a framework of property rights that allows market institutions to evolve on their own.

ATTITUDES TOWARDS COMPETITION IN THE ELECTRIC INDUSTRY

February 1998

Chugach Electric