THEODORE R. KULONGOSKI
ATTORNEY GENERAL

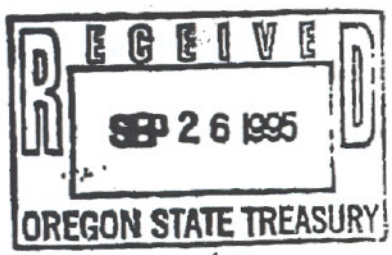
OMAS A. BALMER
DEPUTY ATTORNEY GENERAL

100 Justice Buildin
1162 Court Street N
Salem, Oregon 9731
FAX: (503) 378-378
TDD: (503) 378-593
Telephone: (503) 378-462

DEPARTMENT OF JUSTICE
GENERAL COUNSEL DIVISION

September 18, 1995

Gary H. Bruebaker
Deputy State Treasurer
Office of the State Treasurer
100 Labor & Industries Building
350 Winter Street N.E.
Salem, OR 97310-0840



Re: Mutual Fund Investment and Oregon Constitutional Prohibitions on Government Investment in Stocks - Two Level Inquiry
DOJ File No. 170-001-TX032-94

Dear Mr. Bruebaker:

This letter addresses your request for clarification of the application of the Oregon Constitution's prohibitions against state and local government investments in stock, Article XI, sections 6 and 9, of the Oregon Constitution,[1] in determining whether the state or a local government unit may invest in mutual funds. I conclude, consistent with a letter dated May 17, 1993, from Assistant Attorney General Robert W. Muir to Randall Edwards, Executive Assistant to the State Treasurer, that a two-level examination is required in determining whether a governmental investment in a mutual fund would violate the stock prohibitions. Because this advice is based on constitutional provisions that prevail over state statutes, it applies to proposed mutual fund investments of the state under the state's investment statutes, ORS 293.701 to 293.790,[2] as well as to local government investments under ORS 294.035(10).

First, the mutual fund in which governmental investment is proposed must be examined to ensure that the mutual fund does not invest, in whole or in part, in stock or equities. If the mutual fund's investment portfolio contains investments in stock, then the state's or local government unit's acquisition of an interest in the mutual fund confers on the state or local government an interest in stock that violates the constitution.

Second, if the mutual fund does not invest in stock, then the state or local government unit must determine whether the interest in the mutual fund that it acquires, commonly referred to as "shares" in a mutual fund, constitutes the equivalent of stock or of an equity interest in the mutual fund itself. If the interest acquired by the government body constitutes stock or an equity interest in the mutual fund, then the acquisition of that interest likewise

constitutes the purchase of stock which the constitution prohibits. Therefore, unless the contractual documents which establish the character of an investment clearly demonstrate that the nature of the state's or local government unit's interest in the particular investment constitutes the equivalent of a debt security rather than stock or an equity security, an investment in a mutual fund or investment trust probably will violate the proscription against the purchase of stock.

I. First Level of Analysis - Does the Mutual Fund Invest in Stock?

The first level of analysis inquires whether the portfolio of the mutual fund in question contains investments in stock or equities. *ICMA Retirement Corp. v. Executive Department*, 92 Or App 188, 757 P2d 868, *rev den* 306 Or 661, 763 P2d 152 (1988), represents the controlling Oregon precedent at this level of analysis. In that case, ICMA Retirement Corporation, a provider of deferred compensation plans, challenged a declaratory ruling by the former Oregon Executive Department which held that the state would violate Article XI, section 6, of the Oregon Constitution, if the state invested deferred compensation moneys in one of ICMA's compensation plans.

The proposed ICMA plan involved the placement of state deferred compensation moneys in a trust. The trust in turn would invest, at least in part, in the stock of private corporations. *See* 92 Or App at 191. Under federal law and corresponding state statutes, state deferred compensation moneys, and any property or rights purchased with those moneys (*i.e.*, investment interests purchased with state deferred compensation moneys), must remain the property of the state. *See* 45 Op Atty Gen 27, 30 (1985) (analyzing the proposed ICMA investment program prior to the filing of the court case). Therefore, any interest in an investment of state deferred compensation moneys constitutes, as a matter of statutory law, property of the state.

The court held that an investment in an investment trust that, in turn, invested state money in stocks resulted in a violation of Article XI, section 6, of the Oregon Constitution:

> Here, the state would have a "proprietary" or "ownership" interest in the deferred compensation money that would be invested in ICMA's plan. The purchase of corporate stock with deferred compensation money, therefore, is barred by the "general prohibition" of Article XI, section 6, against the state's purchase of corporate stock.

92 Or App at 193 (footnote omitted).

Thus, the *ICMA Retirement Corp.* case stands for two propositions. First, Article XI, section 6, of the Oregon Constitution, prohibits the state's purchase or acquisition of

ownership of a beneficial interest in stock. Second, the facts of that case compel the conclusion that the constitutional restriction cannot be circumvented through the employment of a trust structure to arrange the state's investment in stock.[3] Therefore, the state and local government units may not invest in a mutual fund or investment trust which, in turn, invests in corporate stock.

Only if the mutual fund or investment trust makes no investment in stock or equities does the analysis proceed to the second level.

II. Second Level of Analysis - Does the Investment in the Trust or Mutual Fund Result in the Acquisition of Stock or an Equity Interest in the Mutual Fund or Investment Trust Itself?

If the mutual fund or investment trust which is under consideration for investment makes no investments in stock, then the second level of analysis applies. 43 Op Atty Gen 186, 191, note 5 (1983) stated:

> Whether an investment violates the constitutional provision depends on whether it confers upon the government an ownership interest in stock; it does not turn upon the degree of risk involved. Thus, for example, the purchase of shares of a mutual fund might be prohibited if the fund was invested entirely or partially in stock, so that ownership of shares in the fund carried with it *pro rata* ownership in the underlying stock. However, if the fund were invested entirely in commodities, mortgages or other non-stock investment media, government ownership of shares in such a fund would be permissible. The risk associated with investment in the two types of mutual funds might be identical, but one is permitted while the other was not.

The foregoing commentary, standing alone, could be read as approving the acquisition of shares in a mutual fund so long as the mutual fund's portfolio contains no investments in stock or equities.

However, that passage was drafted in the context of answering whether the state could purchase, with deferred compensation moneys, variable annuity contracts. There was no need for that opinion, therefore, to proceed to the question whether the shares or other interest that a government body acquires through its investment in a mutual fund (as distinct from the government body's interest in the underlying investments made by the mutual fund) themselves could constitute stock or an equity interest in the mutual fund itself.

The May 17, 1993, letter from Assistant Attorney General Robert W. Muir to Randall Edwards (copy enclosed),[4] at 2, recognized that no Oregon appellate decision answers the

question whether the shares or other interest acquired by a government body when it invests in a mutual fund may themselves constitute stock that the State of Oregon and Oregon local government units are prohibited from purchasing. The letter warned, however, that it was very likely that the courts "would conclude that shares in a mutual fund are stock for purposes of constitutional prohibition."[5]

The organization of, and the nature of an investor's interest in, (at least most) mutual funds supports the conclusion that shares in a mutual fund probably constitute stock that may not be purchased under Article XI, sections 6 or 9, of the Oregon Constitution. The vast majority of United States mutual funds are in the form of corporations. Wang, *Corporate vs. Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 Wash L Rev 927, 930 (1994). The following definition of a mutual fund or management investment company, strongly suggests that a share in a mutual fund represents an equity interest in that corporate entity:

> * * * a voluntary organization that issues securities to the public representing a pro rata share in the assets held by the company * * *.

The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Law 732, 740 (1969).

Similarly, a share of stock is a unit of interest in a corporation which represents a distinct and undivided share or interest in the common property of the corporation, and entitles the shareholder to a proportionate part of those assets when distributed according to law and equity. *Estate of Mellott*, 1 Kan App2d 709, 574 P2d 960, 969 (1977). *See also* Downes & Goodman, *Dictionary of Finance and Investment Terms* (3d ed) at 411.

Of course, the precise character of the rights and interests that are conferred on a mutual fund investor can vary according to the contractual terms which define those rights and interests. However, to the extent the securities issued to a mutual fund investor give the investor rights in a proportionate share of the assets of the mutual fund organization, that investment very closely resembles, if it does not outright constitute, the rights that a traditional stockholder enjoys in a corporation. The acquisition of such rights by the state or an Oregon local government unit probably would violate the stock prohibition.

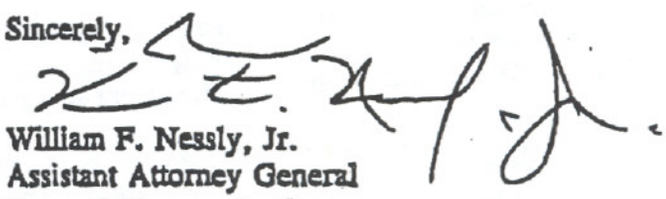
Theoretically, the possibility remains that the terms under which an investor acquires its interest in a mutual fund conceivably could result in the investor obtaining some form of debt security, as opposed to an equity security. *See* 40 Op Atty Gen 333, 335 (1980) (holding that acquisition of debt securities, evidencing no ownership interest in the debtor company, raises no question under Article XI, section 9, of the Oregon Constitution). However, as a practical matter, this form of mutual fund investment might not be available on the market.[6] Therefore, the terms and conditions that establish the legal characteristics

of any particular investment must be examined individually, on a case-by-case basis, to ensure that the investor does not thereby acquire an ownership or beneficial interest in the stock or equity of the mutual fund. Unless the terms of a particular investment clearly establish that the governmental investor will obtain no ownership or beneficial interest in the stock or equity of any organization, an acquisition of mutual fund shares should continue to be regarded as a violation of the constitutional stock prohibitions.

Our previous admonitions that local government units, when proposing investments that implicate Article XI, section 9, of the Oregon Constitution, obtain judicial approval of those investments underscores the need for great caution in examining this character of investment proposals. *See* 39 Op Atty Gen 47, 60 (1978) (recommending no local investment in variable annuity contracts until a court has ruled on their validity); 43 Op Atty Gen 186, 187 (1983) (noting City of Portland and Multnomah County judgments declaring the validity of deferred compensation variable annuity contracts).

Moreover, very few Oregon appellate decisions provide guidance on the application of the stock prohibitions in particular instances. Further, the Oregon Supreme Court has declined to subscribe to any particular theory of the purpose of the stock prohibitions. *See* ***Sprague v. Straub***, 252 Or 507, 512-16, 451 P2d 49 (1969); ***DeFazio v. WPPSS***, 296 Or 550, 575-79, 679 P2d 1316 (1984). That court also has stated that Oregon constitutional prohibitions are to be interpreted in light of their purposes rather than on narrow technical grounds. ***School Dist. 1, Mult. Co. v. Bingham***, 204 Or 601, 611, 283 P2d 670 (1955). In the absence of judicial ratification of the particular purpose underlying the prohibitions, we lack reliable legal benchmarks for the application of the stock prohibitions to concrete investment examples. Therefore, investment proposals that implicate Article XI, sections 6 or 9, of the Oregon Constitution, must be analyzed with caution and in dubious cases, such investments should be avoided.

Sincerely,



William F. Nessly, Jr.
Assistant Attorney General
Tax and Finance Section

WFN:mkh/JGG0C41C
Enclosure
c: w/out enclosure
Robert W. Muir, Attorney-in-Charge
Tax and Finance Section
Randall Edwards, Special Assistant to the State Treasurer
Office of the State Treasurer

[1] Article XI, section 6, of the Oregon Constitution states, subject to an exception for stock that is donated to the state for higher education purposes:

> The state shall not subscribe to, or be interested in the stock of any company, association or corporation.

A similar prohibition applies to counties, cities and municipal corporations:

> No county, city, town or other municipal corporation, by vote of its citizens, or otherwise, shall become a stockholder in any joint company, corporation or association, whatever * * *.

Or Const Art XI, § 9.

In *DeFazio v. WPPSS*, 296 Or 550, 576, 679 P2d 1316 (1984), the court regarded Article XI, sections 6 and 9, of the Oregon Constitution, as parallel prohibitions. Earlier, *Sprague v. Straub*, 252 Or 507, 517-18, 451 P2d 49 (1969), examined the two sections together, noting that the prohibition which governs counties, towns and municipal corporations appeared to more clearly proscribe the acquisition of stock by local governments. Declaring that it was "unable to think of any reason why the people would want to prohibit the purchase of stock by a county or city and yet allow the state to do so," 252 Or at 517, the court ultimately concluded that the state prohibition, Article XI, section 6, of the Oregon Constitution, "constitutes a general prohibition against the purchase of corporate stocks by the state of Oregon." 252 Or at 518.

In light of this parallel treatment by the Oregon Supreme Court, we have recognized that the two prohibitions, one directed at the state and one at local government units, have the same purpose and meaning. 45 Op Atty Gen 27, 32 (1985).

[2] Certain state funds are not subject to the stock prohibition in Article XI, section 6, of the Oregon Constitution. For example, the newly created education endowment fund, approved by the voters under Measure No. 21 at the May 16, 1995, special election, "shall be invested as provided by law and shall not be subject to the limitations of section 6, Article XI of this Constitution:" Or Const Art XV, § 4(4)(d). Other examples of funds to which Article XI, section 6, of the Oregon Constitution, does not apply include the Public Employes' Retirement Fund and the Industrial Accident Fund. *See Sprague v. Straub*, 252 Or 507, 451 P2d 49 (1969); ORS 293.790(3).

[3] The conclusion that the employment of an investment trust structure cannot insulate an investment in stock from the constitutional prohibition against the governmental purchase of stock is reinforced by *dicta* in *Sprague v. Straub*, 252 Or 507, 524-25, 451 P2d 49 (1969):

> We do not mean to suggest that Article XI, § 6 can be circumvented merely by the transfer of state moneys to a trustee who is granted the power to invest in corporate stocks. In that case the state would continue to have the beneficial ownership of the fund and would be subject to the constitutional prohibition.

[4] The decision whether a particular mutual fund-type investment is lawful requires a second level of analysis - whether the investing body's interest in the investment itself constitutes stock or an equity interest in the mutual fund. My letter dated March 17, 1995, to attorney Steven R. Rinkle addressed only the first level of

the required examination. That letter, therefore, may not be regarded as approval of governmental investment in a mutual fund solely because the mutual fund does not invest in stock or equities.

That letter was based on published Attorney General's Opinions and Letters of Advice that did not address the second level of analysis. The May 17, 1993, letter from Assistant Attorney General Robert W. Muir to Randall Edwards was not formally published, and therefore was not available in the Department of Justice research indexes when I conducted the research on which my March 15, 1995, letter was based. Therefore, my March 15, 1995, letter should be regarded as incomplete and superseded by this letter. Both levels of analysis are required in determining whether a mutual fund investment would violate the stock prohibition in Article XI, sections 6 or 9, of the Oregon Constitution.

[5] The May 17, 1993, letter was drafted in response to proposed amendments to ORS 294.035 by Senate Bill 460 (1993), which was enacted as Oregon Laws 1993, chapter 59, section 1, and further amended by Oregon Laws 1993, chapter 721, section 1. That subsection ultimately added to the list of authorized local government investments:

> Securities of any open-end or closed-end management investment company or investment trust, if the securities are of the types specified in subsections (1) to (6) and (11) to (13) of this section and the investment does not cause the county, municipality, political subdivision or school district to become a stockholder in a joint company, corporation or association.

The amendments to the foregoing subsection by Oregon Laws 1995, chapter 245, section 2 (Senate Bill 199 (1995)), under which the subsection is now codified as ORS 294.035(10), do not call for a different analysis.

[6] In 1993, the Deferred Compensation Investment Program conducted a survey in an attempt to identify "stock-based" growth investment vehicles that did not raise serious questions under Article XI, section 6, of the Oregon Constitution. That search was unsuccessful.