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April 26, 1989

State Board of Investments
c/o D. Jerry Simpson
Assistant Treasurer of State
Building 1, Suite E-147
Charleston, West Virginia 25305

Dear Mr. Simpson:

We are in receipt of your letter of March 27, 1989 on behalf of the State Board of Investments. You have requested our opinion regarding allocation of losses sustained by the Consolidated Investment Fund, as disclosed by special audit reports from Touche Ross & Co. Specifically, the Board has requested the following:

"[P]lease provide the Board with your opinion as to the permissible method or methods of allocating losses among fund participants, as well as the restrictions on the authority and discretion we have in allocating these unamortized losses. We would like you to include in your analysis a review of the discretion of the Board to amortize all or a portion of the losses."

Our answer must begin with an analysis of the statutory and regulatory framework which both creates and limits the authority and discretion of the Board. Chapter 12, Article 6, Section 1 et seq. of the West Virginia Code of 1931, as amended (hereinafter "Code") vests the responsibility for investment of funds of the State and its political subdivisions in the West Virginia State Board of Investments (hereinafter "Board").

Pursuant to Code 12-6-5, "The board may exercise all powers necessary or appropriate to carry out and effectuate its corporate purposes." Under Code 12-6-1 these purposes are "to modernize the procedures for the investment of funds of the State and its political subdivisions for the purpose of increasing the investment return of such funds." Included in the powers granted the Board by Code 12-6-5 is the authority to "[p]romulgate and enforce bylaws, rules and regulations for the management and conduct of its affairs."

Code 12-6-8 establishes both the "consolidated pension fund" and the "consolidated fund" as special investment funds to be managed by the Board. We are here only concerned with the Consolidated Fund, comprised of the "state account" and the "local government account". Code 12-6-8(b). Code 12-6-8(f) specifically provides, with respect to the management of these investment funds, that:

". . . The board shall also establish such rules and regulations for the administration of the various funds and accounts established by this section as it shall deem necessary for the administration thereof, including, but not limited to: . . . (3) provision for payment of expenses from earnings; and (4) distribution of the earnings in excess of such expenses or allocation of losses to the several participants in an equitable manner"

Pursuant to this statutory authority, the Board has adopted rules and regulations to govern the administration of the Consolidated Fund. See Legislative Rules, West Virginia State Board of Investments, Title 113 Code of State Rules, Series I (effective March 10, 1984). Rule 5.1 provides:

"5.1 Nature of ownership. -- Each participant shall own an undivided interest in the portfolio of the Consolidated Fund based on the participant's pro rata contribution of assets at any time. Ownership shall be expressed in terms of units. One dollar (\$1.00) shall equal one (1) unit of ownership. Each participant, by participating in the Consolidated Fund, is deemed to have consented to the methods of sharing gains and losses and all other accounting methods required or adopted by the Board."

The only method of sharing gains or losses formally adopted by the Board is Rule 5.3:

"5.3 Trading gains and losses. -- The Board recognizes that it is impractical to amortize trading gains and losses over the life of all securities sold. Therefore, the Board may authorize the Treasurer to amortize all gains and losses over a period of time commensurate with the average life of the entire portfolio. Since the average life of short-term portfolios can vary greatly from day to day, the Board may authorize the Treasurer to amortize all gains and losses from the sale of securities over the month in which they are realized and the subsequent eleven (11) months."

To the extent that the Board has adopted rules and regulations, it must abide by them. Tasker v. Mohn, 165 W.Va. 55, 267 S.E.2d 183 (1980); Trimboli v. Board of Education, 163 W.Va. 1, 254 S.E.2d 561 (1979). Therefore, to the extent that losses to the Consolidated Fund may be characterized as "trading losses", the Board's discretion as to amortization of such losses, if desired, is limited by Rule 5.3. As to those losses that may not be properly characterized as trading losses, the rules of the Board are silent.

Accordingly, we must resort to the above-quoted language of the statute creating the Board, which evinces a Legislative intent to give it broad authority and discretion in the management of its affairs. However, broad grants of authority do not mean that authority is unrestrained. A number of factors must be considered in any action by the Board relative to the allocation of unamortized losses suffered by the Consolidated Fund.

Code 12-6-8(b) allows the combination of monies in the state and local government accounts "for the common investment of the consolidated fund on an equitable basis." (Emphasis added.) As previously cited, Code 12-6-8(f) contemplates "allocation of losses to the several participants in an equitable manner." (Emphasis added.) Therefore, we conclude that any plan for the allocation of losses between Fund participants should be based upon equitable considerations.

This concept of "equity" allows for some flexibility in distribution, within statutory and regulatory constraints. However, the concept that "interest follows principal" must also be considered with respect to losses. Regarding monies deposited with the Board of Investments, the West Virginia Supreme Court of Appeals has held that "[i]n the absence of lawful separation, it is generally presumed that interest is an accretion to the fund earning it." Syl. pt. 1, Queen v. Moore, W.Va., 340 S.E.2d 838 (1986). As a corollary, losses should be presumed to follow principal as well.

If losses follow principal, the question then becomes how to distribute the loss among the various participants in the Fund. Rule 5.1, supra, grants to each participant in the Consolidated Fund an "undivided interest" in the Fund portfolio, "based on the participant's pro rata contribution of assets at any time." This concept of pro rata ownership is consistent with the pro rata distribution of costs required by Code 12-6-6:

"All costs and expenses of the board including fees of professional consultants, advisors and auditors,

brokerage commissions and all other necessary expenses of the board incurred in the performance of its functions shall be proper charges against, and payable on a pro rata basis from, the earnings of the various funds managed by the board." (Emphasis added.)

Based on these examples, we would conclude that any equitable allocation of losses by the Board must have as a major component the pro-rata involvement of participants.

In addition, monies in the Consolidated Fund may have been collected or received for specific purposes, which may be "used and expended only for the purposes for which the same are authorized to be collected by law." See Code 12-2-2. Allocation of losses to these special revenue accounts by any method in excess of their pro rata share in the Consolidated Fund would clearly constitute a transfer of funds forbidden by Code 12-2-2.

Finally, the Board's discretion is limited by prevailing standards in the investment community. Code 12-6-5(14) provides that the Board may "[e]xercise all powers generally granted to and exercised by the holders of investment securities with respect to management thereof." This standard has been recognized by the Board through its Legislative Rules. See Rule 3.2(f) [requiring computation of accrued interest on securities "by using the method which is most widely used in computing accrued interest for each such security by the financial community"]; and Rule 5.2 [providing for adoption of procedures for determining yields on investments "as determined by investment practices of the investment community"].

If it should be determined that any loss allocated to a participant of the Fund is uncollectable, the claim may be referred to the Commissioner of Finance and Administration pursuant to Code 14-1-18a. Under this statute, if the collection of a participant's loss would impose an undue, unjust, unfair or unreasonable hardship or burden upon a participant, the Commissioner may, with the review and approval of the Attorney General, **compromise**, settle or dismiss the claim for the loss.

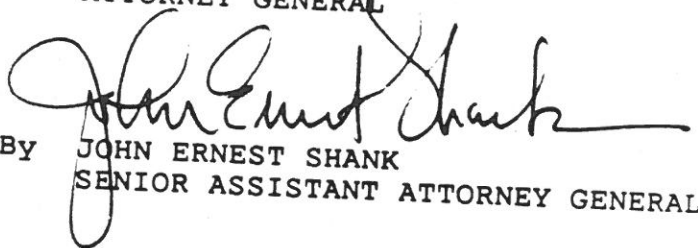
As previously noted, the Board of Investments is granted broad powers to carry out and effectuate its corporate purpose to increase investment returns for Fund participants. In our opinion, the additional grant of powers found in 12-6-5(14) creates a concurrent responsibility for the Board to conduct itself in a manner consistent with accepted management and accounting practices for similar funds, and the Board may not devise a plan of distribution or amortization that is not consistent with such practices.

In summary, we conclude that:

- 1) The Board is empowered with broad discretion in the performance of its duties.
- 2) To the extent that losses may be considered "trading losses", the Board is bound to act within the scope of Rule 5.3.
- 3) Losses should be distributed in an equitable manner among Fund participants.
- 4) When determining an equitable distribution of non-trading losses, the Board should consider the following:
 - (a) Contributions to the Consolidated Fund which are dedicated to a specific purpose should not have losses allocated to their accounts in excess of their pro rata contribution.
 - (b) Losses should be generally treated the same as gains, in that they should be charged against the principal from which they came.
 - (c) As contributions to the Fund consist of undivided pro rata interests, in absence of good cause to equitably vary the distribution of losses, losses should be allocated according to the pro rata contribution of participants.
 - (d) Distribution of losses should be made in a manner consistent with commonly accepted practices within the investment management community.

Very truly yours,

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BY JOHN ERNEST SHANK
SENIOR ASSISTANT ATTORNEY GENERAL