June 15, 2000

OPINION
OF
PATRICIA A. MADRID
Attorney General

Opinion No. 00-03

BY: Martha A. Daly
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TO: The Honorable Michael Montoya, CPA
State Treasurer
NEA Building, P.O. 608
Santa Fe, New Mexico 87504

QUESTION:

Would investments in mutual funds and unit investment trusts made by the State Treasurer pursuant to NMSA 1978, § 6-10-10(O)(1) (1999) constitute investment in interest-bearing securities in accordance with the New Mexico Constitution?

CONCLUSION:

Under the limited circumstances set forth by § 6-10-10(O)(1), and with the prior approval of the State Board of Finance, if the mutual fund is acting as an investment conduit (i.e. an open-end mutual fund or a unit investment trust), an investment in such a fund would be constitutional. N.M. Att'y. Gen. Op. No. 57-279 (1957) is superseded to the extent it conflicts with this opinion.

FACTS:

In 1997, the legislature enacted a provision authorizing the State Treasurer to invest in mutual funds which themselves invest in specified investments, subject to certain limitations. See NMSA 1978, § 6-10-10(N)(1)(1997) (recompiled in 1999 and hereinafter referred to as subsection O (1)).[1] Prior to the adoption of this legislation, the Attorney General had opined

[1] On January 1, 2000, this provision became § 6-10-10(O)(1). It reads, in pertinent part:

that investment in mutual funds did not constitute an investment in "interest-bearing securities", as required by Article VIII, Section 4 of the New Mexico Constitution. See AG Op. 57-279, supra. In light of the 1997 legislation, the State Treasurer has requested clarification on the constitutionality of subsection O(1).

> The state treasurer, with the advice and consent of the state board of finance, may also invest in:
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> (1) shares of a diversified investment company registered pursuant to the federal Investment Company Act of 1940 that invests in United States fixed income securities or debt instruments authorized pursuant to Subsection I, J and N of this section, provided that the investment company has total assets under management of at least one hundred million dollars ($100,000,000); …

Subsections I, J and N read, in pertinent part:

> I. The state treasurer, with the advice and consent of the state board of finance, has the power to invest money…The investment shall be made only in securities that are issued by the United States government or by its departments or agencies and are either direct obligations of the United States or are backed by the full faith and credit of the United States government or agencies sponsored by the United States government.
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> J. The state treasurer may also invest in contracts for the present purchase and resale at a specified time in the future, not to exceed one year or, in the case of bond proceeds, not to exceed three years, of specific securities at specified prices at a price differential representing the interest income to be earned by the state. No such contracts shall be invested in unless the contract is fully secured by obligations of the United States or other securities backed by the United States having a market value of at least one hundred percent of the amount of the contract.
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> N. The state treasurer, with the advice and consent of the state board of finance, may also invest in any of the following investments in an amount not to exceed forty percent of any fund that the state treasurer invests:
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> (1) commercial paper rated "prime" quality by a national rating service, issued by corporations organized and operating with the United States;
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> (2) medium-term notes and corporate notes with a maturity not exceeeding five years that are rated A or its equivalent or better by a nationally recognized rating service and that are issued by a corporation organized and operating within the United States; or
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> (3) any asset-backed obligation with a maturity not exceeding five years that is rated AAA or its equivalent by a nationally recognized rating service.

ANALYSIS:

Article VIII, Section 4 of the New Mexico Constitution declares, in pertinent part, that

> …All public money **not invested in interest-bearing securities** shall be deposited in [certain types of financial institutions]… .

In AG Op 57-279, this office was asked specifically whether assets of the previously existing teacher retirement fund which the legislature had directed to be transferred into the educational retirement fund and invested by the state treasurer could be invested in mutual funds. Any such investment was to be invested in the same manner and subject to the same limitations as the investment of other trust funds of the state. See NMSA 1953, § 73-12-49 (1957). Importantly, at the time of that opinion, the legislature had not authorized investment of such funds in mutual funds. In concluding that investment in mutual funds was illegal, this office did not limit its analysis to the lack of legislative authorization; rather, it looked expressly to the language of Article VIII, Section 4, employing what we believe today to be an incorrect definition of securities:

> The term "securities", as used in the Constitution and the Enabling Act, is used in its technical sense, in which it applies to obligations such as a mortgage or pledge, given by a debtor… "…in order to make sure the payment or performance of his debt, **by furnishing the creditor with a resource to be used in case of failure in the principal obligation** (citing the 1933 edition of Black's Law Dictionary as authority)." In this technical sense, the term refers to interest-bearing obligations which are **more than mere naked promises of liability by the debtor**. (Citing C.J.S. as authority).

AG Op. 57-279 (Emphasis and explanatory notes added).

The definition of the term "securities", however, has been substantially expanded, and is currently defined by that same legal authority upon which the prior opinion relied to be:

> Stocks, bonds, notes, convertible debentures, warrants, or other documents that represent a share in a company or a debt owned by a company or government entity. Evidences of obligations to pay money or of rights to participate in earnings and distribution of corporate assets. Instruments giving to their legal holders rights to money or other property; they are therefore instruments which have intrinsic value and are recognized and used as such in the regular channels of commerce.

Black's Law Dictionary (6th Ed. 1990). We believe the 1957 opinion confuses the term "security", used in reference to the collateral that is pledged for a debt, with "securities", which are instruments evidencing ownership rights in an entity or the right to receive repayment of an obligation.

Our decision today to apply this current (1990) definition is governed, in large part, by the action of the 1997 legislature in authorizing investment in mutual funds that satisfy certain requirements set out in that legislation. See subsection O(1). We are required, by principles of statutory construction, to indulge every presumption "in favor of the validity and regularity to legislative enactments." Wylie Bros. Contracting Company. v. Albuquerque-Bernalillo County Air Quality Control Board, 80 N.M. 633, 638, 459 P.2d 159 (Ct. App. 1969) (citing authorities). Thus,

> [a] statute will not be declared unconstitutional unless the court is satisfied beyond all reasonable doubt that the Legislature went outside the constitution in enacting the challenged legislation.

Id. at 639 (citing authorities).

One must search out and declare the true meaning and intent of the constitution and amendments thereto. Id. In so doing, we recognize that, in 1914, when the relevant language in Article VIII, Section 4 was adopted, mutual funds did not exist. Arguably, its drafters did not contemplate mutual funds within the scope of the term "interest-bearing securities". However,

> A constitution is a practical instrument adapted to common wants and designed for common use, and it is made and adopted by the people themselves. It must be construed as if intended to stand for a great length of time. Since **it is an instrument of progress, its meaning should not be too narrowly or literally interpreted, but rather it should be given a meaning which will be consistent with new or changed conditions as they arise. If words are used therein that have both a restricted and a general meaning, the general must prevail, unless the context clearly indicates that the restricted meaning was intended.**

Id. (Emphasis added.) Today, mutual funds have a seven decade history in this country, and have become the largest financial institution, with assets exceeding those of commercial banks, savings and loans, and insurance companies. In light of the emergence of this form of investment and the legislature's enactment expressly authorizing the state treasurer to invest in mutual funds that satisfy the statutory prerequisites, we believe the term "securities", as it appears in Article VIII, Section 4, should be interpreted using the current definition set out above, rather than the restrictive definition employed in 1957. To the extent that the use of the term "securities" was intended to reduce investment risks, we note the requirements of subsection O(1), including the restriction of investment in mutual funds to those that are registered under the federal Investment Company Act of 1940. That act, along with other federal legislation, heavily regulates registered companies to reassure investors in those companies.[2]

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[2] The Texas Attorney General, in determining that the absence of legislation authorizing investment in mutual funds doomed such investments, went on to note that "…[i]n short, it would appear that investment in [mutual funds]offers all of the security of ownership of individual securities but further provides other advantages not available through individual

Further, the 1957 opinion understands shares of mutual funds or investment trusts to evidence an equitable interest or ownership of the assets of the investment company, rather than any secured obligation. In contrast, the United States Supreme Court has defined a mutual fund as "a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." Burks v. Lasker, 441 U.S. 471, 480 (1979). Similarly, a mutual fund has been characterized as a "mere shell". Tannenbaum v. Zeller, 552 F.2d 402, 405 (2nd Cir. 1977).

We have been advised that, under the 1940 Act, an investment company can be organized as an open-end fund. An open end fund is usually referred to as a mutual fund, and is how 95% of the registered investment companies are structured. Such funds permit investors to buy their shares of the fund directly from the fund itself, and permit investors to dispose of their shares by direct redemption from the fund, with prices for purchase and sale determined by the net asset value of the fund.[3] Additionally, an investment company may be organized as a unit investment trust, which buys a fixed portfolio of securities and holds these securities to the end of the trust's term, at which time the trust distributes the portfolio *pro rata* to the owners of the shares in the trust. Under either of these two structures, the investment company acts as a conduit for the flow of security earnings from underlying assets to the shareholders of the fund. See Burks; Tannenbaum; and Fogel, supra. Each investor is entitled to his or her share of the investment company's income (which earnings are the interest paid on the underlying securities), and the value of the investor's interest is equivalent to the value of the underlying assets. To the extent that the open-end investment companies and unit investment trusts in which investment is authorized in subsection O(1) function strictly as investment conduits, ownership interests in these funds evidence ownership of, and are valued at the value of, the underlying interest-bearing

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ownership." Tex. Atty. Gen. Op. JM-570 (1986). Those advantages include, in his opinion, better liquidity (allowing for better management of financial affairs and the earning of an appropriate rate of interest), along with reductions in the risk inherent in the transaction and in transaction costs. The Indiana Attorney General recognized these same advantages, plus the experience of the fund managers, in finding mutual fund investments legal under the Indiana Constitution, disapproving a prior opinion to the contrary. See Ind. OAG No. 3 (1996). He also recognized that limiting such investments to companies governed by the Investment Company Act limited any risk involved and probably ends up with less risk than investing in individual securities. Id.

[3] In contrast, a closed-end fund requires an investor, after the fund's original issuance of shares, to buy and sell shares of the fund as they are traded on a securities exchange, with prices determined by supply and demand factors, which can differ from the underlying net asset value of the fund's assets.

securities in which the funds have invested, rather than equitable interests or ownership of the assets of the company. [4]

To the extent that a mutual fund or a unit investment trust is a conduit investment, permitting the state treasurer to invest in that company is analogous to permitting the treasurer to invest directly in those interest-bearing securities already permitted by statute (see § 6-10-10 (I), (J) and (N)).[5] The credit and market risks of investing in these investment companies independent of the risks associated with investing directly in the underlying securities appear to be minimal.[6] The level of risk associated with this type of investing would naturally be much less than that associated with investment in common stocks and other potentially speculative equity securities, which form of investments the drafters of Article VIII, Section 4 apparently sought to prevent in their use of the limiting phrase "interest-bearing securities."

Additionally, the Uniform Commercial Code recognizes an investment company security to be a security. See NMSA 1978, § 55-8-103(b) (1996). In that section, investment company security is defined to include "a share of similar equity interest issued by an entity that is registered as an investment company under the federal investment company laws" and "an interest in a unit investment trust that is so registered." Id.

In short, open-end funds and unit investment trusts which act as conduits may properly be classified as securities under the alternative definition of "securities" we employ in this opinion.[7]

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[4] As noted in footnote 3, a closed-end fund does not share this characteristic of a value based strictly on the value of the underlying securities in which the fund has invested.

[5] Each of the types of investments authorized under subsections I and N pay interest; either during the term or at maturity, and thus satisfy the "interest-bearing" component of Article VIII, Section 4's investment directive. Further, the repurchase agreements authorized in subsection J must be priced "at a price differential representing the interest income to be earned by the state." Thus, interest income is contemplated here and specifically factored into the terms of the agreement.

[6] While there may exist some independent risk to the extent of subsequent trading by the manager of an open-end fund, that risk is subject to control by the state treasurer by monitoring the fund, and selling the state's shares in the fund, if such action is necessary.

[7] In so opining, we are aware that Attorneys General in other jurisdictions have considered the "conduit" analysis employed here, with mixed results. The Nebraska Attorney General, in analyzing the propriety of investing in mutual funds under a different (but analogous) constitutional provision barring investments in private associations, determined that mutual fund investments did not constitute investing in private associations since the mutual funds were acting as conduits, and thus the investments were not in the private, mutual fund associations but were actually in the securities in the fund's portfolio. See Neb. Op. Atty. Gen. No. 05041 (1995). Similarly, the Indiana Attorney General, in disapproving an opinion by a prior Attorney General

Additionally, investment in these forms of mutual funds does not appear to implicate the risk which the drafters of our constitution sought to avoid by the restriction imposed in Article VIII, Section 4. Further, because shareholders in such companies are entitled to and receive earnings from the securities owned by these companies, and those securities themselves are interest-bearing, shares in these types of investment companies may be properly regarded as "interest-bearing securities". Upon approval by the State Board of Finance, which approval is required by statute, investment by the State Treasurer in open-end funds and unit investment trusts which meet the requirements of subsection O(1) and function solely as conduits are constitutional. To the extent that AG Op. 57-279 holds differently, it is herein superseded. We express no opinion here as to closed-end funds.

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barring investments in mutual funds as contrary to that state's constitutional ban prohibiting the state from becoming a stockholder in any bank or other private entity, determined the state university's investment in a mutual fund organized as a business trust resulted in the university's becoming "an equitable owner of an undivided interest in the underlying securities, not a stockholder in some separate 'association'." Ind. OAG No. 3 (1996). In contrast, the Wisconsin Attorney General held that shares in mutual funds represented undivided interests in its total portfolio, and not direct ownership of the underlying securities themselves, and thus were not authorized by legislation allowing investment in specific classes of securities. See Wis. OAG 62-88 (1988). The conduit analysis appears to be the more reasonable approach for purposes of this opinion, in light of the 1997 legislature's adoption of subsection O(1).