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ATTORNEY GENERAL OPINION NO. 88-1

TO: W. Floyd Ayers, Chairman
Idaho Endowment Fund Investment Board
Statehouse Mail

Per Request for Attorney General's Opinion.

QUESTIONS PRESENTED:

1) Can the Endowment Fund Investment Board enter into a securities lending agreement under art. 9, § 11, of the Idaho Constitution?

2) Does the Endowment Fund Investment Board have authority under Idaho Code § 57-722 to sell covered call options against securities held in the funds?

3) If the Fund has authority to sell covered call options, would the monies derived from the sale of said calls be treated as income to be distributed, or as securities gains, remaining as part of the corpus, pursuant to Idaho Code § 57-724?

CONCLUSION:

The Idaho Endowment Fund Investment Board could constitutionally enter into securities lending agreements and sell covered call options provided legislation is enacted permitting such transactions. Covered call options must be used in a manner consistent with the board's fiduciary obligations. Sale of calls should be accounted for as securities gains.

ANALYSIS:

Idaho Constitution, art. 9, § 11, sets forth the primary constitutional limitation upon permissible investments of the permanent endowment funds. That section provides:

> **§ 11. Loaning permanent endowment funds.** -- The permanent endowment funds other than funds arising from the disposition of university lands belonging to the state, shall be loaned on United States, state, county, city, village, or school district bonds or state warrants or on such other investments as may be permitted by law under such regulations as the legislature may provide. (Emphasis added.)

The leading case construing this section's limitations upon investments is Engelking v. Investment Board, 93 Idaho 217, 458 P.2d 213 (1969). In that case, the Idaho Supreme Court held that §§ 9(6) and 9(8) of S.B.1277 (S.L., 1969), which permitted purchase of stock and conversion of bonds, violated Idaho Const., art. 8, § 2, and art. 9, § 11.

In construing Idaho Const., art. 9, § 11, the court found that the legislature was limited to authorizing loans of endowment funds in view of the operative verb "shall be loaned" which is used in that section. In defining loan, the court held:

> In this situation we believe the important word "loan" must not be loosely construed to include all types of "investment." Instead, the word "loan," as used in Idaho Const., art. 9, § 11 and as extended in scope by the 1968 amendment, must carry the meaning that there must be a guarantee of full repayment of principal as well as interest. There must be an unconditional promise to repay the principal sum originally lent. (Emphasis by court.)

93 Idaho at 223, 458 P.2d at 219.

Thus, investments which the legislature may authorize are limited to loans in which there is a "guarantee of full repayment of principal as well as interest."

Securities Lending Agreements

In securities lending agreements, an owner of securities agrees to lend the securities to another party. The other party agrees to later return the securities plus any interest or dividends paid on the securities while borrowed plus an additional sum for the right to borrow the securities.

In such transactions, the borrower guarantees unconditional repayment of principal, e.g., the bonds, plus interest plus an additional sum. Also, many custodian banks handling such transactions for customers will indemnify customers against loss in such transactions. Thus, it is our understanding that security lending agreements are safe investments which provide additional income to owners of securities.

Such a transaction is consistent with the "loan" limitation of Idaho Const., art. 9, § 11, as interpreted in Engelking. The transaction includes "a guarantee of full repayment of principal as well as interest."

As noted previously, Idaho Const., art. 9, § 11, provides that permanent endowment funds shall be loaned on investments "as may be permitted by law under such regulations as the legislature may provide." Idaho Code § 57-722 enumerates the endowment fund investments currently permitted by law. That section does not provide for securities lending. However, amendment of that section to permit securities lending would not violate Idaho Const., art. 9, § 11.

Covered Call Options

You have also asked if the Idaho Endowment Fund Investment Board could sell covered call options. The use of covered call options is not currently authorized by chap. 7, title 57, Idaho Code. However, as discussed hereafter, such legislation would not be contrary to the Idaho Constitution.

A covered call option is an agreement in which the seller of the option owns securities such as stocks or treasury bonds. The seller grants to the option buyer the option to purchase the securities on or before a certain date at a fixed price. The option buyer pays the option seller a sum of money ("premium") for the option.

The buyer of the option may profit if the price of the security involved, such as a treasury bond, appreciates in value. For example, the buyer will profit if the option is exercised at a

time when the market value of the treasury bonds exceeds the agreed purchase price by more than the price paid for the option. Conversely, the seller of the option will profit if the option is not exercised at a price exceeding the agreed purchase price by more than the price paid for the option. In such transactions, the seller, in effect, agrees to offer securities for sale at an acceptable price for the term of the option.

The sale of covered call options would not violate the constitutional requirement that "endowment funds. . .shall be loaned." If endowment funds have been loaned to purchase a security such as a bond, the funds would remain loaned if the board sold a covered call option. The option would simply be an agreement establishing acceptable terms of sale of the bond during the period of the option. When call options are sold upon bonds or notes held by the endowment board, the legal rights of the board are substantially the same as when the board holds bonds in which the issuer retains a call option.

For example, bonds are frequently issued with call provisions. An issuer of 20 year bonds may include a provision in the bond agreement that the bonds may be called at par beginning 10 years after issuance of the bonds. This does not change the character of the agreement to something other than a loan. As discussed previously, Engelking held that to constitute a loan:

> . . .there must be a guarantee of full repayment of principal as well as interest. There must be an unconditional promise to repay the principal sum originally lent.

The 20 year bond in the example above would satisfy the court's definition of loan. Exercise of the option to call the bond would result in repayment of the sum originally lent. Exercise of the option to call the bonds would not affect interest earnings to the date of call. Likewise, the sale of a covered call option would not change the character of an investment to something other than a loan if the option exercise price provides "an unconditional promise to repay the principal sum originally lent."

Thus, if authorized by the legislature, the endowment board could use covered call options. However, this advice must be qualified by two caveats discussed below. First, we would recommend that calls not be sold at exercise prices which would not repay the principal sum originally lent. Second, speculation in covered calls is not a permissible use.

As discussed previously, Engelking required endowment investments to include "an unconditional promise to repay the principal sum originally lent." If the exercise price of the option plus the option premium are not sufficient to repay the sum originally lent, the option agreement would not satisfy this requirement. Accordingly, we recommend that options be sold only if the exercise price and premium would be sufficient to repay the sum originally lent.

We recognize that an argument can be made that the option exercise price need not be high enough to guarantee repayment of the principal sum originally lent. In State ex rel. Moon v. State Board of Examiners, 104 Idaho 640, 662 P.2d 221 (1983), the court recognized that the board can sell investments at a loss, noting:

> For example, the Fund frequently holds bonds, which if held to maturity would yield a certain profit, but which if sold before maturity at a loss, and with the proceeds elsewhere reinvested, would yield a higher long range profit. This flexibility and opportunity for higher profit would likely not be exercised if the legislature would be forced to make up the loss on the sale of the bonds.

104 Idaho at 642.

Similarly, the courts might hold that it is permissible to sell options with exercise prices below the prices paid for securities in order to provide flexibility and the opportunity for higher long range profit. However, the courts could view covered call options as agreements modifying the original terms of the underlying loan agreements. If viewed this way, it is unlikely that the courts would allow use of covered calls at exercise prices below the principal sum originally lent. To do so would eliminate the "unconditional promise to repay the principal sum originally lent." The promise in the underlying bond to repay the original investment would be replaced by the option to repay something less than the original investment.

Such a distinction might be considered to be an anachronism by the modern investment community. However, Idaho courts would likely reach such a result based upon the language of the constitution and the definition of "loan" stated in Engelking.

Also, it should be noted that a finding that call options are permissible requires that they be considered in terms of their relationship to the underlying securities. Call options could not

be sold on securities which are not owned by the endowment fund. Such transactions by themselves are not loans. Rather they are speculative investments of a type not permitted by fiduciaries. However, as noted above, if a call option is viewed as an agreement to add additional terms to the underlying security, the courts would likely require the exercise price to be sufficient to provide an "unconditional promise to repay the principal sum originally lent." Prudence requires that we recommend that covered call options be sold only if the exercise prices and premiums would be sufficient to repay the principal sums originally lent.

The second caveat regarding use of covered calls is that they may not be traded in a speculative manner. Whether use of call options is prudent depends upon the manner in which they are used.

Covered call options are sometimes used by portfolio managers to mitigate the effects of price changes in the market value of securities held. For example, assume an investor owns a bond with a market price of $1,000. The owner might sell an option for $20 giving the option buyer the right to purchase the bond for $1,000 within the next 30 days. If the market price of the bond appreciated four percent (4%) in 30 days to $1,040, the option buyer would exercise his option. The option buyer would now own the bond worth $1,040. The seller would have received $1,020 ($1,000 for the bond plus $20 for the option).

In the example above, the option seller received only half of the appreciation in the value of the bond. However, assume the market value of the bond dropped four percent (4%) in 30 days. The bond would now have a market value of $960. The option buyer would not exercise the option to purchase the bond for $1,000 and the option seller would continue to own the bond. The option seller would have a bond worth $960 plus $20 which was received from the sale of the option.

In the first example, the option seller lost half of the four percent (4%) appreciation in the value of the bond. In the second example, the option seller avoided half of the four percent (4%) loss in market value of the bond. Thus, covered call options can be used as a means of mitigating the effects of changes in the market value of securities held.

Such a use of covered call options is consistent with fiduciary duties and is consistent with the intent of the constitutional provisions. For example, in Moon v. State Board of Examiners, 104 Idaho 640, 662 P.2d 221 (1983), the court considered Idaho Const., art. 9, § 3, provisions regarding the

public school fund which constitutes the majority of the state's endowment funds. Therein, the court said:

> The Fund is a trust of the most sacred and highest order. See State v. Peterson, 61 Idaho 50, 97 P.2d 603 (1939); I.C. § 57-715. In United States v. Fenton, 27 F.Supp. 816 (D.Idaho 1939), the court stated:
>
> > "The express purpose of the Admission Act and the State Constitution is to protect and hold inviolate and intact the fund from the Acts of the Legislature or acts or failures of the officers of the State." 27 F.Supp. at 818.

104 Idaho at 642.

Similarly, in Moon v. Investment Board, 96 Idaho 140, 143-144,, 525 P.2d 335 (1974), the court quoted from the constitutional debates in part as follow:

> Mr. McConnell: Mr. Chairman, I think no fund is more sacred than the school fund, and perhaps there is no other fund so sacred; it should be guarded in every manner possible, and by having this provision in here, the children will always be made sure there will be that much money to their credit, and we will have that much at stake in our schools. But if there is no provision for making this fund good in every way, it may be squandered, and the first thing we know our school fund will be so small that we can only maintain the schools by local taxation.

The Endowment Fund Investment Board clearly has fiduciary responsibilities of the highest order deriving from the Idaho Constitution. The board is charged with the responsibility to preserve the fund over time. This responsibility is also recognized by Idaho Code § 57-715 which provides:

> Permanent endowment funds of the state of Idaho are hereby declared to be trust funds of the highest and most sacred order and shall be controlled, managed and invested by the board and the investment manager(s) or custodian(s) in accordance with the highest standard, and as hereinafter provided.

Idaho Code § 57-723 provides that the board and its investment managers shall be governed by the Idaho Prudent Man Investment Act. That act provides in pertinent part at Idaho Code § 68-502:

> In acquiring, investing, reinvesting, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of 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 their capital. (Emphasis added.)

The statutory provisions are consistent with the trust nature of the endowment funds and the fiduciary obligation to preserve and protect the fund reflected in the constitutional provisions.

As discussed previously, an investment program can be designed utilizing covered call options in a manner which reduces portfolio risk resulting from market fluctuations. Such a program to reduce portfolio risk would be consistent with the constitutional goal of preserving the endowment funds.

However, the constitutional provisions regarding the endowment board's fiduciary duties would not sanction speculation in covered call options. It would not be permissible, in our opinion, to trade covered call options in the manner a speculator might. For example, a speculator might sell and repurchase call options on a short term basis in an effort to outsmart the markets at every turn. Such trading could produce large profits or large losses depending upon the skill and luck of the speculator.

Such a trading approach would not be consistent with the endowment board's fiduciary responsibilities even if the call options were "covered." As noted previously, Idaho Code § 68-502 requires Idaho fiduciaries to manage investments "not in regard to speculation, but in regard to the permanent disposition of their funds."

The endowment board manages funds of "a trust of the most sacred and highest order." Moon v. Board of Examiners. Legislation could be enacted authorizing the use of covered call options. However, it would certainly be interpreted in light of the board's constitutional fiduciary obligations. Those

obligations are at least as great as those generally applied to fiduciaries in Idaho by Idaho Code § 68-502.

In summary, if legislation were enacted authorizing use of covered call options, such legislation would be constitutional. Covered calls should be used only if the exercise price of the call plus premium would be sufficient to repay the principal sum originally lent. The board would need to establish policies ensuring that covered call options were not used in a speculative manner. They could be used as part of a general risk strategy related to the permanent disposition of endowment funds.

Accounting for Covered Call Options

You have also asked if money derived from the sale of covered call options should be treated as income or as securities gains pursuant to Idaho Code § 57-724. That section currently has no provisions specifically addressing covered call options. If legislation is proposed authorizing sale of covered call options, we would recommend that the legislation include provisions regarding the accounting for such sales.

In our opinion, receipts from the sale of covered call options should be treated as securities gains rather than income. The sale of a covered call option is the sale of the right to a portion of potential appreciation of the underlying security. The call buyer obtains no interest income and the seller does not give up interest income for the period of the option. If the option buyer exercises the option, payment of the exercise price at time of settlement must be accompanied by payment of accrued interest on the underlying bond or note through and including the exercise settlement date. Thus, sale of covered call options does not involve the sale of any income interest in the underlying securities.

If receipts from the sale of covered call options were accounted for as income, the principal of the endowment funds would gradually be depleted. Previously, we discussed covered call option examples involving a four percent (4%) increase and a four percent (4%) decrease in the market value of the underlying securities. In the appreciation example, the covered call seller, starting with $1,000, received $1,000 upon exercise of the call plus $20 from the sale of the call. In the declining market example, the covered call seller continued to hold a bond worth $960 and received $20 from the sale of the option.

In the examples, the market value gains and losses were equal. Thus, if both transactions occurred in sequence, the principal of the fund should remain at $1,000. However, if the

call option sales were accounted for and distributed as income, the principal of the fund would be depleted. In the appreciation example, after distributing the premium, the endowment fund would still have principal of $1,000 with which to buy the second bond. However, after the depreciation example, the fund would own a bond worth only $960. The $20 received from each call option sale would have been distributed, leaving a portfolio value of $960. Accounting for the transactions in this way would therefore deplete the fund over time, contrary to the constitutional purpose previously discussed of preserving and maintaining the fund over time.

If use of covered call options becomes authorized by legislation, sales of the options should be accounted for as securities gains.

AUTHORITIES CONSIDERED:

Constitutions:

Idaho Constitution, art. 9, § 3
Idaho Constitution, art. 9, § 11

Statutes:

Idaho Code § 57-722
Idaho Code § 57-723
Idaho Code § 57-724
Idaho Code § 68-502

Cases:

Engelking v. Investment Board, 93 Idaho 217, 458 P.2d 213 (1969)

State ex rel. Moon v. State Board of Examiners, 104 Idaho 640, 662 P.2d 221 (1983)

United States v. Fenton, 27 F.Supp. 816 (D.Idaho 1939)

DATED this 16th day of February, 1988.

Sincerely,

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