HOUSE COMMITTEE ON GENERAL INVESTIGATING
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2002

A REPORT TO THE
HOUSE OF REPRESENTATIVES
78TH TEXAS LEGISLATURE

PETE P. GALLEGO
CHAIRMAN

COMMITTEE CLERK
ARTURO LOPEZ

Committee On
General Investigating

January 13, 2003

Pete P. Gallego
Chairman

P.O. Box 2910
Austin, Texas 78768-2910

The Honorable James E. "Pete" Laney
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on General Investigating of the Seventy-Seventh Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Seventy-Eighth Legislature.

Respectfully submitted,

Pete P. Gallego, Chairman

D.R. “Tom” Uher

Joe Crabb

Craig Eiland

Terry Keel

[Click here and type the Vice-Chairman's Name]
Vice-Chairman

Members: [Click here and type the rest of the Members' Names]

Forward

At the beginning of the 77th Legislature, the Honorable James E. "Pete" Laney, Speaker of the Texas House of Representatives, appointed five members to the House Committee on General Investigating. The committee membership included the following members: Pete P. Gallego, Chairman; D.R. "Tom" Uher, Vice-Chair; and members: Joe Crabb, Craig Eiland, and Terry Keel.

During the interim, the Committee was assigned four charges by the Speaker:

1. Review the state's laws and procedures for the creation of special purpose districts whose jurisdiction is limited to a specific geographic area or areas and whose powers may include the imposition of taxes, the creation of public debt, the exercise of eminent domain, or the exercise of police power. Consider the proliferation of special purpose districts, and investigate whether the activities of these districts comport with the legislative intentions and public purposes for which they were created.

2. Examine policies and procedures governing the Texas Department of Public Safety's crime lab to ensure high standards for the testing of evidence for law enforcement agencies throughout the state.

3. Monitor procedures governing the State Board of Education in its management of the Permanent School Fund.

4. Review the compliance of state agencies with state law related to Historically Underutilized Business (HUB) Participation.

The Committee has completed its hearings and investigations and issue the report that follows. The members of the committee have adopted and approve all the recommendations.

Finally, the Committee wishes to express appreciation to all who contributed their time and effort for the betterment of the state of Texas.

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and whose powers may include the imposition of taxes, the creation of public debt, the exercise of eminent domain, or the exercise of police power. Consider the proliferation of special purpose districts, and investigate whether the activities of these districts comport with the legislative intentions and public purposes for which they were created.

EXECUTIVE SUMMARY

In response to concerns voiced by the general public and public officials at all levels of government, this committee is looking into the use and powers of certain development districts. These special purpose districts cover a broad scope of subjects, from water resource management to amoeba control. Due to the sharp criticisms aimed at administrators of the special districts, the Senate Committee on Intergovernmental Relations also conducted a review of this issue during the 77th Interim period.

In order to best maximize resources, this committee monitored the actions of the Senate Intergovernmental Relations Committee as part of its research efforts. The committee has based many of its observations and recommendations on the testimony given before the Senate Committee at hearings held in Austin, Houston, and Dallas. Further information in this report was obtained from documents provided by the Texas Commission on Environmental Quality (TECQ).

BACKGROUND

Political subdivisions in the state with limited powers are created as financing mechanisms to achieve a specific purpose. Special districts were created to address needs at the state, county, and municipal levels to undertake large scale public improvement measures. Because the state, cities and counties were limited in the rate of tax that they could levy, the Constitution was amended in 1904. Article 3, Section 52, was modified to allow for the creation of special taxing districts which could issue bonds and levy property taxes to pay for conservation and reclamation projects.

Following severe flooding in 1913 and 1914, the Constitution was again amended in 1917 with what is commonly known as the "conservation amendment," found in Article 16, Section 59. In 1987, the Constitution was again changed to allow for the making of loans and grants of public money to encourage economic development (Article 16, Section 3-a). Legislation creating special districts that deal with water cites these articles as the facilitators for special district creation.

The powers of special districts have expanded significantly over the years through judicial and legislative action. The legislature has continued to create new types of special districts, making it easier for these districts to grow in size and number. The number of special districts in the state is difficult to determine because there is no one source of data to document the creation and continued use of special districts. It is known, however, that in 1999, 1241 special districts assessed property taxes and 515 special districts assessed sales taxes. Further compounding the inability to quantify the precise number of districts in the state are the various types and titles and multiple powers attributed to each special district.

Water-related districts are the most numerous special districts in Texas and include:

- Water Control and Improvement Districts
- Underground Water Conservation Districts
- Fresh Water Supply Districts
- Municipal Utility Districts
- Water Improvement Districts
- Drainage Districts
- Levee Improvement Districts
- Irrigation Districts
- Navigation Districts
- Water Import Authorities
- Special Utility Districts

Further growth in the number of districts created around the state is directly attributable to the recent creation of special districts in 2001 such as Fire Control and Prevention and Emergency Services Districts.

IMPACTS OF SPECIAL DISTRICTS

The advantage of a special taxing district is that it allows a particular area to address its specific needs by taxing only within its jurisdiction and for the economic benefit of those within its boundaries. Using taxes levied, the special district is able to construct, acquire, provide and maintain facilities, services, or projects. To that end, hundreds of districts have provided essential public services to millions of Texans that would not have been available from any other source.

There is a concern, based on fact or perception, that popularity and ease of creation of special districts have resulted in the proliferation of "mini bureaucracies" with overlapping, confusing, and conflicting powers of taxation and regulation that should be limited to the state, cities, and counties. Specific areas of concern include the operation of special districts, accessibility of information regarding district boundaries and meetings, taxing authority, oversight, annexation powers, voting procedures, and conversion abilities or ease of creation.

Based on interviews with certain stakeholders, testimony taken by legislative committees and briefings with the TCEQ, this committee generally approves and endorses the recommendations found below which, in large part, echo the findings of the Senate Committee on Intergovernmental Relations. This committee finds that most purposes of special districts are appropriate and proper governmental functions.

The committee has completed its review of the issues and finds that, while certain important reforms are justified and appropriate, it would be a disservice to unduly restrict the operations of special districts, particularly because of the size of the state and the current rapid rate of growth in urban and suburban areas. More stringent controls on certain activities of special districts, more consistency among very similar types of special districts, and better communication with the public, residents of districts, and other governmental officials should be imposed.

Accordingly, the committee has listed below recommendations for improvements to the functioning of special districts in Texas.

RECOMMENDATIONS

1. The Committee recommends that written municipal consent be required in order for a water district to annex land within the extraterritorial jurisdiction (ETJ) of a municipality.

   Consent of a municipality is required for the creation of a water district if that district's boundaries are within the ETJ of a municipality. However, if a water district annexes land within the ETJ of a municipality, no consent is required.

2. Require a certified copy of the order creating a water district to be recorded in the county deed records.

3. Require a "Notice to Purchasers" to include specifics about the governing body of a special district along with distributing contact information to purchaser prior to the execution of a binding contract or at closing.

   Potential property buyers are often unaware that the land they are considering for purchase is within a special district and notice that a particular district exists is not required to be given until after the confirmation election of a district.

4. Require Water Control and Improvement Districts and Fresh Water Supply Districts to obtain consent from its creating entity prior to division. If the creating district is a general law district, require the prior approval of the Texas Commission on Environmental Quality.

   Upon approval by qualified voters in the district, Water Control and Improvement Districts (WCIDs) and Fresh Water Supply Districts (FWSDs) may divide. These divided districts are governed by separate boards and retain the powers of the original district without the prior approval from the creating entity.

5. Require that a special district converting to a WCID or FWSD obtain prior approval from the entity that would normally approve the creation of a WCID or FWSD.

   Special districts may convert to another type of district solely upon the order of the district's governing board (with the exception of conversion to a municipal utility district).

6. Authorize a commissioners' court to consider the feasibility, necessity, and benefit of a proposed FWSD when making a decision to grant or deny a petition for creation.

   Chapter 53 of the Water Code does not contain specific language allowing a commissioners' court to grant or refuse a petition for the creation of a WCID based on the feasibility of the district, the necessity of the district, and whether there is a public benefit from creation of the district.

7. Require the affidavit to truthfully affirm that the voter was not promised anything of value in exchange for voting for any proposition on the ballot.

   Following "on the ground inspections" in 1995 of special districts confirmed by fewer than 10 voters, the Office of the Attorney General concluded that the inspections were an "unproductive use of resources". Currently, voters must submit a signed affidavit in lieu of the "on the ground inspection."

8. Require consent of the landowner prior to annexation or exclusion of property from a County Development District as well as provide notice to a municipality if the land is within its ETJ. The commissioners' court order should be filed with the county clerk.

   The Board of Directors of a County Development District (CDD), on its own motion, may petition the commissioners' court for the addition to or exclusion of land from the district without the consent of the landowner. Additionally, there is no notice to the municipality regarding whether said land is in its ETJ. Furthermore, potential land buyers have limited ability to determine if land is included in a special district.

9. Require municipal consent for creation of a CDD if within the corporate limits or ETJ of the municipality.

   CDDs can be created without municipal consent provided that landowners are petitioned and the public has had an opportunity to provide input.

10. Require sellers within County Development Districts, County Assistance Districts, Municipal Development Districts, or Public Improvement Districts to disclose tax rate and outstanding debt as well as file information with the county clerk.

    Potential buyers of property within a CDD, County Assistance District (CAD), Municipal Development District (MDD), or Public Improvement District (PID) do not receive specific information regarding the existence, indebtedness, and potential tax burden of the district.

11. Require these districts to post signs at the principal entrances of the district.

    Currently, no public notice of the boundaries of an existing CDD, CAD, MDD, or PID is available to area residents.

12. Require these districts to perform annual audits and file with the Comptroller of

Public Accounts.

CDDs, CADs and MDDs are not required to perform or file audits.

13. Require the Comptroller of Public Accounts to assess the feasibility of maintaining a database in which special districts would be required to register certain information.

Special districts may perform a necessary function, but a problem may arise if it is perceived that they are a form of hidden government.

14. Codify AG Opinion JC-0291.

Attorney General Opinion JC-0291 concluded that a CDD is not authorized to levy ad valorem taxes and may undertake only those projects that provide incentives for the location and development of projects in certain counties to attract visitors and tourists.

15. Require that the order canvassing the results of the confirmation election contain a description of the district's boundaries and be filed with the executive director and in the deed records of the county or counties in which the district is located.

Potential land buyers have difficulty determining whether or not their land is located within the boundaries of a special district.

16. Require districts which establish offices outside of district to give notice of a meeting to the governing body and publish the notice in a local newspaper. The districts should designate a meeting place and meet in the district upon request of 25 qualified residents from the district. Appropriate notice of the meeting to residents should be posted in a place convenient to the public.

Open Meetings Act provisions relating to CDDs and MDDs do not require adequate notice and opportunity for participation to interested parties.

Investigate Recent Actions of the crime lab of the Texas Department of Public Safety Relating to Personnel Accountability and Integrity

EXECUTIVE SUMMARY

The House Committee on General Investigating conducted an interim investigation on the policies and procedures governing the Texas Department of Public Safety's (DPS) crime lab to ensure high standards for the testing of evidence for law enforcement agencies throughout the state. As DPS Criminalists provide an integral service to the criminal justice process, the legislature has undertaken efforts to improve crime lab circumstances and procedures in recent years.

For example, a proposal by Senator Brown in 1997 stipulated the following:[1]

- A Criminalist pay raise, increasing total budget for Criminalists' salaries to $2,362,142. This was an average individual pay increase of about $802 a month.
- A detailed plan including policies and procedures for implementing recommendations made by the State Auditor related to timely back up and off site storage of Automated Fingerprint Information System (AFIS) data, and limiting physical access to computer rooms to those individuals justified by relevant daily job responsibilities.
- A detailed plan for implementing recommendations made by the State Auditor for information systems, including, but not limited to: access controls, disaster recovery, and system development.
- A timetable to achieve complete implementation, with appropriate milestones and deliverables. The plan shall be subject to approval by the Quality Assurance Team.

Nonetheless, the Committee has reviewed DPS interoffice situations in which a caseworker had tampered with or hidden evidence altogether, one such case leading to an indictment by a grand jury on thirteen counts. Reports submitted to this committee for the 76th and 77th interim periods describe the circumstances that most likely contributed to these procedural violations. Here are a few probable factors taken from a report compiled by Forensic Specialists called in to investigate policy violations by caseworkers:[2]

- Examiner autonomy. Examiners personally received evidence and were personally responsible for releasing and reporting it to agencies. This lax procedure allowed caseworkers the autonomy required to falsify reports and fail to return evidence without detection by management.
- Supervisory oversight. It appears that the casework results were not monitored effectively, if at all. The high percentage of evidence examinations which resulted in no latent prints being developed was also not noted or investigated.
- Workload standards. Interviews with latent print examiners revealed a requirement to reach a "target number" of completed cases each month. A minimum of five cases was assigned to examiners each week, regardless of the examiner's caseload or absence due to vacation or attendance in training classes. Pressure to complete the steady assignment of casework, whether real or perceived, may have been a contributing factor in secreting evidence and falsifying reports.

ROLES AND RESPONSIBILITIES FOR CASE MANAGERS

The Crime Lab's workplace environment up to 1997 was a very volatile one. As a result of better pay and incentives in other states, DPS lost twenty-five percent of its personnel over a two-year period, a time frame which also denotes how long it takes to adequately train case managing personnel.[3]

Taken from a request of the Director of the Crime Laboratory in 1997:[4]

- Crime Laboratories greatly need to add at least three additional staff members. The many crime scene investigations we are called to conduct necessitate the services of a Forensic Photographer.

- A large increase in drug investigations in Northeast Texas make adding a Chemist in Tyler important.

- The case load in this laboratory and court appearances are becoming a heavy burden for the personnel in Tyler. One additional Crime Lab Technician to aid the handling of toxicology evidence in the Austin Laboratory will give the analysts much more time in analysis and help reduce their case backlog.

This request also voiced the need for the adequate funding to pay the salaries of thirty-one Criminalist and Crime Lab Technician positions. The Legislature was correct in identifying discrepancies in staffing and pay across the nation and reclassified the salary bracket for Criminalists, undoubtedly avoiding a major loss of valuable employees.

Per the Department of Public Safety, a Criminalist collects and preserves evidence and performs varied and complex tests and analyses of physical substances in the Crime Laboratory as a part of the scientific investigation of crimes. A Criminalist could be called upon to do such varied tasks ranging from analyzing body tissues, tire treads, handwriting, fingerprints, chemical reagents, and physiological stains to quantifying evidence and testifying in court. A Criminalist is responsible for determining the presence of drugs, narcotics, alcohol, and poisons for toxicological purposes.

A case manager such as this is also required to perform complex case management work, which involves providing training and consultation to staff; processing specialized or difficult cases, and assigning and supervising the work of others.[5] An occupation such as this one is understandably stressful, as it consists of a myriad of factors, including precision, time constraints, in-depth analyses, supervisory tasks and many obligations.

RECOMMENDATIONS AND THEIR IMPLEMENTATION

A stressful work environment does not justify a caseworker's lack of integrity. No degree of policies, procedures, or security can codify human behavior.[6] However, problems are more easily detected when a strong laboratory management system is employed and used to its fullest potential to track cases and evidence, avoiding a high incidence of missing files and reports.

Since the interoffice investigation, DPS has improved procedures and enforced corrective actions. Some of the following procedural changes were not as a result of the discovered problems; they were placed into operation prior to the discovery of the problem and may have contributed to a reduction in severity of the problem.[7]

The following corrective actions were also taken by DPS to institute procedures to reduce or eliminate similar circumstances from occurring in the future:[8]

- Evidence Tracking System. In March 1999, the DPS Crime Lab put an electronic evidence tracking system into operation. Evidence, although still received directly by the examiner, was given a bar code. The bar code was united with a laboratory report number which opened a case file. The bar code on the evidence was scanned, updating the system as to the location of the evidence. Cases that did not receive an update of a completed report could be tracked. However, it was still incumbent upon the examiner to return the evidence to the agency, either by mail or in person. This electronic tracking system also provided a laboratory management system, capable of providing information about case assignments, completed work and evidence location.

- Evidence Coordination Section. In August 1999, the Evidence Coordination Section was placed into operation. It became the responsibility of Evidence Technicians to receive evidence for the laboratory, deliver evidence to evidence vaults, and release or mail evidence back to the submitting agency.

- Quarterly inspections of examiner's personal evidence lockers is now required.

- Personal evidence lockers can only be used for short-term evidence storage.

- Re-examinations are being made on five "no prints developed" processing cases for each examiner per month. During the re-examination, the supervisor or designated staff directly evaluates the evidence, verifying that it was thoroughly and properly processed. While this procedure of re-examining evidence consumes considerable staff resources, conducting processing verifications is innovative in the latent print discipline.

ADDITIONAL CORRECTIVE ACTIONS

In response to audit suggestions, the Crime Laboratory Service put in place more measures to ensure the integrity of crime lab results:[9]

- **Suggestion**: Improve Laboratory Management System. A strong laboratory management system will not only provide the means to monitor activities, evidence and casework, it may also serve to deter similar circumstances from occurring. Many supervisors rely on personal systems and methods to track staff casework; however, it is suggested that supervisors be required to utilize the laboratory management system. Administration would then have access to the most current information regarding all cases and evidence.

  Action Taken: On January 3, 2001, a new version of the "DRAGNet" Laboratory Information System was installed in the DPS Austin Laboratory. This system had already been installed in twelve field laboratories. The new version of DRAGNet allows supervisors to perform laboratory case management by individual case assigned to each examiner, total cases assigned to examiner, and the dates that the cases were assigned. This will allow laboratory supervisors and management to routinely audit casework of laboratory sections and individual examiners. This electronic record of cases will be routinely checked by supervisors monthly and by management quarterly.

- Suggestion: Expand Evidence Coordination Section Responsibilities. The Evidence Coordination Section should be responsible for picking up completed evidence from

evidence vaults. This will streamline evidence handling and eliminate an opportunity for an examiner to maintain evidence.

Action Taken: Effective April 1, 2001, the Evidence Coordination Section is not only responsible for delivering evidence to individual laboratory section vaults, they will also be responsible for picking the evidence up from the vaults for return of the evidence to police officers/agencies. The Evidence Coordination Section will pick up the evidence from laboratory section vaults, inventory the evidence and return the evidence to the investigating agency.

- **Suggestion**: Handling of Completed Reports. Completed Reports should not be returned to the examiner. Another method should be created to ensure that completed reports are transferred, after approval, from the supervisors to the area where the laboratory management system is updated.

  Action Taken: Completed reports that have passed technical review and administrative review of the laboratory section supervisor shall be transferred by the section supervisor directly to DRAGNet update for case closure in the Laboratory Management System and mailed after case closeout.

COMMITTEE EVALUATION AND RECOMMENDATIONS

The Committee has reviewed the dynamics of the laboratory management system and found the enhanced regulatory procedures to be adequate and innovative developments to ensure that high standards for the testing of evidence are maintained throughout the state by law enforcement agencies.

The Committee supports a strict and efficient system to monitor the location and return of evidence, completed reports, statistics of examiner workloads and examination results. DPS has actively recruited and successfully installed systems to justify evidence and uphold the high standard of scientific research in the criminal detection field. This is evident in their updated laboratory information systems such as DRAGNet for case managing, stronger regulation of evidence, and a supervisory system that closely monitors staff casework.

It is true that such an extensive regulatory system is expensive in terms of supervisor time; however, it is an essential method for keeping employees accountable.

An in-depth review of the laboratory sections has been completed, and DPS has been found to be in compliance with an effective system for evidence management.

However, the Committee would like to reinforce key regulatory measures with the following recommendations:

1. Encourage section supervisors to maintain a cooperative work environment by utilizing the DRAGNet System for laboratory casework monitoring.

2. Require the Evidence Coordination Section to pick up completed evidence from evidence vaults to eliminate opportunity for an examiner to maintain evidence.

3. Require DPS to perform an annual review to audit procedures and make changes as necessary.

4. Establish a peer review system, called PR², to denote peer review and performance review, which would take place every 3 months for co-workers and supervisors to

come together and discuss their individual case loads, case management techniques, and performance concerns. It is important to encourage and stimulate input on behalf of the criminalists to their supervisors to promote a cooperative, rather than competitive and repressive environment. By giving it the flexibility to respond to the changing environment, PR² would help the crime lab stay ahead of the times.

ENDNOTES

1. Senator Brown's proposal, DPS file

2. Letter to the Office of the Governor, by Forensic Experts M. Black and R. Young

3. Per Ron Urbanovsky, current director of the DPS crime lab**

4. Letter sent to the Honorable Pete P. Gallego, by Director J.R. Urbanovsky

5. Texas Department of Criminal Justice Position Description--Case Manager III

6. Letter sent to the Office of the Governor, by Forensic Experts M. Black and R. Young

7. Letter sent to the Office of the Governor, by Forensic Experts M. Black and R. Young

8. Letter sent to the Office of the Governor, by Forensic Experts M. Black and R. Young

9. Crime Laboratory Service Response to Audit Suggetions

Monitor procedures and activities of the State Board of Education in its management of the Permanent School Fund

EXECUTIVE SUMMARY

The 77th Interim marks the third consecutive interim period in which the House Committee on General Investigating (committee) evaluates the State Board of Education's (SBOE) management of the Permanent School Fund (PSF). Testimonies provided by State Auditor's Office (the SAO) staff, members of the SBOE's standing committee on School Finance/Permanent School Fund (School Finance/PSF Committee), and other parties taking part in the investment of the PSF portfolio suggested, at minimum, the appearance of impropriety in allowing members of the SBOE to have undisclosed, informal advisors making recommendations on investments.

The committee, in past reports, established the following:[10]

- Questionable and undisclosed relationships existed between SBOE members and informal financial advisors.
- Informal advisors received private rewards for profits generated by their asset management recommendations.
- Prior to the 77th Interim, the SBOE failed to develop and implement an ethics policy to protect SBOE decisions from self-interested influences.

Reports submitted by this committee for the 75th and 76th Interim periods, including a report completed by the SAO in January '01, confirm instances where the board's management of the PSF has been highly susceptible to self-interested influence. Here are a few examples taken from this committee's report to the 76th Legislature:[11]

- Perhaps starting as early as 1998, a PSF consultant transferred at least $60,000 to the informal advisor of the Chair and Vice Chair of the School Finance/PSF Committee and that informal advisor's business partner.
- According to an IRS Form 1099, a business controlled by the President of the broker-dealer receiving the largest share of commissions under the SBOE's Historically Underutilized Business policy (a San Antonio HUB) paid $28,000 to an informal advisor of a School Finance/PSD Committee member in 1999.

Additionally, the SAO report of January '01 mentions another instance where existing board policies allowed for conflicts of interest to occur. The report indicates that an informal financial advisor profited from PSF brokerage commissions after the advisor's associate convinced the board to modify its PSF brokerage policies.[12] These individual items represent a mere fraction of the 100-plus pages in findings produced by the four-year probe into the SBOE's management of the PSF.[13]

The two hearings held during the 77th Interim period suggest a closer examination of board management of the PSF, implementation of board policies, and the protection of public confidence in the administration of a public fund worth almost $17 billion. These three mutually unexclusive elements rely on transparent and relentless application of stringent ethics policies in order to insulate the PSF from entities seeking to abuse the fund's profitability.

There is no question, after careful analysis and evaluation of the SBOE's management of the PSF, that the fiduciary duty of the board is indeed exposed to abuse on the part of investment advisors seeking personal monetary gain. These facts have been established and duly published. The public record contains a number of glaring failures on the part of the SBOE to protect itself from external influences, thus compromising the board's obligations as a fiduciary of a public fund. And yet, it is one thing for these susceptibilities to exist and another them to remain shrouded until the legislature moved forward with an investigation.

BOARD MANAGEMENT OF THE PSF

A number of concepts have been proposed to improve board governance. During this interim period, the SAO and committee members discussed some proposals--requiring School Finance/PSF Committee members to have investment expertise, appointing investment experts to advise on PSF management, and appointing an investment advisory committee (IAC) to manage the PSF.[14] The IAC would be responsible for providing asset management recommendations to board members. It is precisely this concept that the legislature passed during the 77th legislative session as S.B. 512.

Senate Bill 512 passed by the 77th Legislature would have transferred the authority to manage and invest the PSF from the SBOE to an IAC within the Texas Education Agency (TEA).[15] The TEA would create an IAC composed of:

- Nine members--three appointed by the governor and not subject to Senate confirmation, three appointed by the lieutenant governor, and three appointed by the speaker of the House of Representatives.
- Members would be required to possess extensive experience in investments.
- Members would not receive compensation for their service except for travel expenses.

Significant protections were put in place, requiring appointees to disclose any possible conflicts of interest. S.B. 512 also prohibited members with conflicts from making any decisions regarding asset management. These protections were crafted to insulate those persons making decisions for the PSF, thus maintaining the board's integrity.

S.B. 512 was vetoed by the governor because the bill eroded "the constitutional power of the State Board of Education."[16] The veto proclamation states that the SBOE is currently able to develop and implement its own safeguards. However, while the SBOE has an ethics policy in place, the propensity for conflicts of interest inherent to the current system of management precludes the board from actually enforcing their policies. This brings us to the second element of concern--implementation of board policy.

IMPLEMENTATION OF BOARD POLICY

It follows that the number of external forces bending and influencing the method in which the PSF is managed hinder the smooth implementation of new policy. For example, it is

common and sound practice to balance invested assets by adjusting the sums invested in various types of funds (i.e., stocks, mutual funds, securities, etc.). During the August 13 hearing of this committee, Paul Ballard, Executive Administrator of the PSF for the TEA, stressed the importance of balancing a fund. [17] As markets fluctuate, it is necessary to vary the investment mix of a public fund to accommodate short-term and long-term needs. But in less dynamic markets, keeping a standard mix is essential for responsible long-term returns. According to the January '01 SAO report, the SBOE has balanced PSD investments in a manner inconsistent with PSF investment staff recommendations.[18] The SAO report cites a number of possible motivators for the SBOE's refusal to adhere to staff recommendations, none of which are grounded in sound financial principals. The report lists personal vendettas and racial discrimination as the reasons behind why the SBOE has failed to balance PSF investments in a prudent fashion.

Board members, if influenced by individuals in pursuit of personal gain, cannot be expected to implement sound policy. As fiduciaries, the SBOE should demonstrate adequate justification for following a course of action in managing the PSF which runs counter to the advice of professionals on staff with the TEA.

PROTECTION OF PUBLIC TRUST

Implementation of policy relies on an unfettered desire to protect public confidence. This third element is not so easily substantiated. There is no universal method available to meter public confidence in a fiduciary. Yet the facts in this investigation are not novelty. This committee has produced a significant amount of material suggesting, and in many cases, specifically outlining flaws in the systemic operation of the SBOE's management of the PSF. After almost four years of investigation by legislative committees, the SAO, and most recently a series of indictments produced by the Travis County Attorney's office, it is evident that a problem exists. The factual merits of these investigations are published and public. All that remains is devising a remedy.

FIDUCIARY REVIEW OF THE PSF

It is imperative that the legislature determine whether or not the investment practices employed by the SBOE in managing the PSF follow sound fiduciary principles. The SBOE's constitutionally demonstrable obligation to protect and prudently invest the PSF leaves little room for miscalculations of judgment and absolutely no margin for external interference. For this simple reason, the legislature, the SAO, and the TEA have authorized a fiduciary review of the PSF's investment.

The review, expected to be complete in January '03, will determine if the PSF's organizational structure and governance allow for prudent and ethical management of the PSF. The review should convey a clear understanding of those areas where the PSF's investment practices, organizational structure, and governance exceed, meet, or fall short of similar funds. At the review's conclusion, it should be known where the SBOE can improve in its investment practices of the PSF. However, this review is not intended to be a conclusive investigation of any individual allegations or occurrences.

After requesting proposals for bids, Cortex Applied Research of Toronto was

awarded the contract and is currently conducting a fiduciary review of the PSF. Cortex submitted a summary of how the firm will proceed with the audit.

CORTEX EXECUTIVE SUMMARY[19]

The firm intends to establish comparative benchmarks and parameters by:

- Identifying the current legislative framework and governance and fiduciary practices of the PSF.
- Identifying all relevant issues and concerns on the part of individuals or entities involved with PSF.
- Identifying the corresponding practices of a relevant peer group of industry funds, which will serve as a comparison or benchmark in analyzing the PSF.
- Confirming and/or refining our view of "best practices" as they apply to the governance of large public investment funds.

Cortex will conduct a thorough fact-finding review of statutes and documentation relating to the PSF and entities who participate actively in the investment of the fund. Interviews of at least 40 individuals involved with the PSF will also be a part of Cortex's review.

Given the aforementioned benchmarks and parameters, Cortex's analysis will consist of:

- An evaluation of whether the SBOE, PSF staff, service providers and other are currently subject to appropriate fiduciary principles and standards, along with recommendations concerning additional principles or standards that should be introduced, if necessary, to ensure proper management of the PSF.

- An analysis of the authorities that have been granted to the SBOE in managing the PSF, particularly as they pertain to investment, asset allocation, employment of external investment advisors and managers, budgeting and implementing spending policy, along with recommendations for expanding or otherwise modifying such authorities in order to address any deficiencies that may be identified.

- A review of the clarity and appropriateness of the current governance and organizational structures and practices of the PSF and whether such structures and practices support or impede the decision-making process. Any deficiencies that may be identified will be accompanied by recommendations for addressing or mitigating them.

- An assessment of PSF ethics and conflict of interest policies and their implementation, as regards to all parties managing, advising, investing, or doing business with the PSF. This will also include a cost-benefit analysis of internal versus external investment management and related recommendations on how best to protect the PSF from conflicts of interest

arising from those seeking to do business with the PSF.

- Present detailed opinions as to what constitutes accepted principles and standards of fiduciary conduct in managing the key elements of the investment management process within a public investment fund, including asset allocation, rebalancing, use of active and passive investment styles, etc.

- An analysis of the PSF's experience in maintaining inflation adjusted and per-capita adjusted spending, and recommendations to maximize the likelihood that such spending will be maintained or increased in the foreseeable future.

- An evaluation of the appropriateness and accuracy of the PSF's income projection model using standard financial modeling techniques and analytics.

FIDUCIARY PRINCIPLES

At first, we mentioned the importance of the SBOE fulfilling its duty as a fiduciary. Fiduciary is generally defined as an entity which holds something in trust for another. In this case, the SBOE manages the PSF for the state, but in light of the findings of the last four years, the element of trust is at issue here. Cortex, in submitting its proposal to the SAO, set forth its fiduciary principles[20] and those principles have been summarized here.

Definitions of Fiduciary Principles and Standards--Fiduciaries must carry out numerous duties stemming from different sources: the trust instrument, legislation, common law. While these may vary somewhat from jurisdiction to jurisdiction, Cortex believes that the following represents generally accepted fiduciary duties:

Collective Board Duties

Duty to Protect the Fund--Fiduciaries are obligated to secure the assets of the fund, to safeguard, preserve and enhance their value, and to distribute the assets of the fund in accordance with the terms of the trust agreement.

Duty with Respect to Delegation--A trustee has a duty personally to perform the responsibilities of the trusteeship except as a prudent person might delegate those responsibilities. It is important for the trustee to establish which decisions they are required to make, and which they may delegate. Once the decision is made to delegate, the fiduciary still has the following responsibilities:

A. The duty to use reasonable care in selecting qualified personnel to whom to delegate powers.
B. The duty to instruct appropriately as to the nature and extent of the tasks delegated.
C. The duty to supervise or monitor whether the agent has properly carried out the function entrusted to it.

Duty to Act Impartially--Trustees must act impartially when they deal with beneficiaries or different classes of beneficiaries. In the context of an investment fund, this applies to intergenerational classes of beneficiaries and their successive interests in the assets of the fund.

Duty to Account--Trustees must keep proper accounts of how they deal with trust property. In the case of a state investment fund, this means disclosure and transparency to the various government officers overseeing the administration of the fund, and, in accordance with state law, to the public at large.

Individual Duties

Duty of Loyalty--The fiduciary is to put the beneficiary's interests first in the performance of any act and the exercise of any powers or duties. This duty translates into other duties such as:

A. The duty to act honestly and with integrity.
B. The duty to avoid conflicts of interest, real or perceived.
C. The duty to exercise reasonable diligence, care and skill.

Below is an more in-depth look at Individual Duties:

Duty to Act Honestly and with Integrity--The fundamental duty for a fiduciary is that of loyalty to the beneficiary, and essential to this is a commitment to honesty and integrity. This involves not intentionally deceiving or attempting to deceive fellow board members, staff or agents of the government that oversee the fund, staff members and other stakeholders. It also implies that trustees will be familiar with and comply with all applicable legislation and laws and with the by-laws and policies of the board.

Duty to Avoid Conflict of Interests--Trustees have a duty to avoid personal or business relationships that could reasonably be expected to impinge upon, complicate or interfere with the trustee's ability to discharge his duty solely in the interests of the fund. As perceived and real conflicts are distinguishable in practice, though not necessarily in law, perceived conflicts should be avoided as well.

Duty to exercise reasonable prudence, care, skill and diligence--The trustee has a duty to employ reasonable prudence, care, skill and diligence when investing fund assets an in making other decisions in the administration of the fund. A trustee shall discharge his or her duties with the prudence, skill and diligence under the circumstances then prevailing that a prudent person acting in a similar capacity and familiar with these matters would use in the conduct of an enterprise of similar character and with similar aims.

The Cortex plan also outlines some key principles that are critical in carrying out the fiduciary duties listed in their proposal. Below is a summary:

Roles and Responsibilities--Clear roles and responsibilities should be documented for all key parties involved in the decision-making process, including the board, board chair, board committee, and other service providers. Such documents are essential in demonstrating prudence by the board in delegating powers to staff and advisors.

Delegation--Given the size and complexity of managing a public investment fund, effective governance requires prudent delegation of authority. Delegation should be commensurate with risk, technical expertise and knowledge, and availability of time.

Policies--The board should establish a comprehensive policy framework that documents its position on important issues such as the selection of service providers, conflicts of interest, ethical conduct, risk management, and planning.

Controls Systems--The board should establish a system of checks and balances, including the use of external third parties to verify certain aspects of the administration and operation of the fund, including investment performance measurement, auditing of financial statements, asset/liability and other studies.

Knowledge and Skills--There should be a commitment to a high standard of fiduciary knowledge and skill. This involves mechanisms to provide for ongoing fiduciary education to ensure that trustees have the knowledge necessary to effectively carry out their roles and responsibilities. This can also involve a process to assist in the selection of qualified and skilled individuals to serve on the board.

Monitoring and Reporting--The board should have a documented monitoring and reporting framework, clearly establishing the board's expectations on the information it is to receive from management and from third-party advisors. Specifications for reporting must include content, form, and frequency. Review of the framework by the board over time can help to identify gaps or overlap in existing reporting.

Board Operating Procedures--Documented operating rules are critical to ensure the efficient and effective board operations. Such guidelines would cover the appointment of board officers, scheduling and frequency of meetings, procedures at meetings, the form and scope of committees, and procedures for making policy decisions and passing resolutions.

CONCLUSION

In lieu of recommendations, the committee deems it appropriate for the legislature to consider the results and conclusions of the fiduciary review to serve as legislative remedies. The legislature, this committee, and the SAO have invested a great deal of confidence in a thorough review of the fiduciary audit process. The review, as made clear by Cortex, will not expose details related to isolated incidents or individuals. Rather, this fiduciary review will employ a macro perspective in determining how the SBOE's management of the PSF can be improved and, ultimately, how to restore and maintain integrity within the SBOE's fiduciary scope.

ENDNOTES

1. General Investigating Interim Report; 76th Interim, p 2.1.

2. General Investigating Interim Report; 76th Interim, p 2.1.

3. The SAO report; January 2001, p 60.

4. McCabe, General Investigating Hearing; April 10, 2002.

5. McCabe, General Investigating Hearing; April 10, 2002.

6. McCabe, General Investigating Hearing; April 10, 2002.

7. Texas Legislative Council; enrolled version of SB512.

8. Proclamation by the Governor of the State of Texas relating to SB512.

9. Ballard, General Investigating Hearing; August 3, 2002.

10. The SAO report; January 2001, p 60-61.

11. Cortex; proposal to perform a fiduciary review, Texas Permanent School Fund, p 2-4.

12. Cortex; proposal to perform a fiduciary review for the Texas Permanent School Fund, p 17-19.

Review the compliance of state agencies with state law related to Historically Underutilized Business (HUB) Participation

EXECUTIVE SUMMARY

Historically Underutilized Businesses (HUBs) have created new opportunities for more individuals to do business with the State of Texas. HUBs are Texas corporations, sole proprietorships, partnerships or joint ventures which are primarily owned by ethnic minorities or women.[21] The goal of HUB legislation was to ensure that new and small businesses were given an opportunity to do business with the State of Texas.

Though policies and procedures regarding Historically Underutilized Businesses (HUBs) have existed for some time, the issue of HUBs came of age in 1995 with the passage of Senate Bill 958 by the 75th Legislature. Senate Bill 958 recodified the old Article 601b of the Vernons Annotated Civil Statutes into the newer Texas Government Code. While entitled a "nonsubstantive" revision of statutes relating to state purchasing and general services, Senate Bill 958 contained several new provisions which arguably were rather substantive.

Due to the newness of various provisions, the vague language of the statute, and inconsistent application of the new law, the Texas Legislature revisited the issue of HUB's in 1999 with the passage of Senate Bill 178. This legislation attempted to set out in more detail what was expected of the various state agencies with regard to doing business with HUBs.

HUBs and HUB contracting have continued to be somewhat controversial within the context of state government. Critics of the program have decried the use of quotas, although Texas law on state contracting HUBs does not provide for the use of mandatory quotas but rather provides for specific goals. Supporters have championed the new opportunities for businesses owned by women and minority entreprenuers.

At the request of James E. "Pete" Laney, Speaker of the Texas House of Representatives, the Committee on General Investigating (committee) undertook a review of state agency contracting procedures as relates to business conducted by state agencies with HUBs across the state. As part of its review, the committee took testimony from the State Auditor's office (SAO), various state agencies, organizations and individuals representing various industries, and members of the general public.

The use of HUBs by state agencies has been reviewed previously staff of the State Auditor's Office (SAO).[22] For the most part, the findings of the committee are consistent with the findings of the State Auditor. The committee determined that state agencies, in general, are not making a good faith effort to find or otherwise establish relationships with HUBs. Further, the committee determined that most state agencies do not actively encourage their contractors to use HUBs.

The HUB statutes and the rules which implement them are at times rather unclear. For example, each agency seems to have a different standard for the words "good faith effort." The agency designated as the "lead" agency for HUB purposes has a poor relationship with other state agencies, particulary the larger agencies. Agency rules are inconsistent and unnecessarily complicated. Contractors are given every opportunity to opt out of HUB subcontracting requirements. In short, there is little affirmative effort on the part of state agencies to ensure opportunities for women and minority-owned business.

ROLES AND RESPONSIBILITIES

The Texas Building and Procurement Commission (TBPC) is designated as the lead agency for purposes of HUBs[3]. The TBPC certifies HUB's, conducts random compliance reviews of HUB applicants, works with other agencies to increase HUB participation by state agencies, maintain a directory of all HUBs in the state, develop a "mentor-protégé" program, develop subcontracting plans for all contracts over $100,000 to ensure HUB opportunities, assist agencies with "good faith effort" requirements and generally serve as a resource for state agencies.

Each individual agency must also meet several requirements. For purposes of clarity, the report will refer only to state agencies which receive appropriations of over $10,000,000.00. These responsibilities of these state agencies can be broken down into four areas: planning, outreach, reporting, and subcontracting.

The planning area involves adoption of rules and a written plan to increase the agency's use of HUBs which outlines specific goals and the steps to be taken in reaching those goals. The planning area also sets forth the agency's "good faith effort" in achieving HUB participation.[4]

As part of their outreach, state agencies must designate an employee to serve as the HUB coordinator. This coordinator must be responsible to the agency's executive director and be a position equivalent to the agency's procurement director. Further, the agency must identify and invite HUBs to make presentations on the types of goods and services they provide, participate in HUB forums, and implement a "mentor-protégé" program.[5]

Agencies are required to report their HUB information to the TBPC. Agencies must report the total number of contracts bid out and subsequently awarded as well as the number of these contracts which were awarded to HUBs. In addition, TBPC may request additional information from the individual agencies.[6]

Perhaps one of the most important agency responsibilities with respect to HUBs is subcontracting. State agencies must determine whether subcontracting opportunities are probably under a contract, identify HUBs that might be eligible or available to provide the goods or services necessary, and require bids from contractors to contain subcontracting plans which maximize the opportunities for HUBs.[7]

The State Auditor's office also plays a role in the HUB process by continually monitoring state agency compliance with the HUB statutes. However, the SAO may not consider the success or failure of an agency to contract with HUBs in any specific quantity. The SAO's review of an agency's HUB performance is strictly limited to the agency's procedural compliance with HUB statutes and rules. Thus, the SAO has no authority to enforce any type of compliance by a state agency.[8]

The only sanction against an agency for failure to comply with HUB statutes and rules is in the purview of the Legislature. In the event that an agency is not in compliance with HUB law, the SAO reports that fact to the TBPC, which in turn relates that information to the Legislative Budget Board. If, after the passage of one year, the agency continues to defy state law, the Legislative Budget Board may transfer the funds appropriated for purchases away from the non-compliant agency and to another appropriate state agency.[9] The committee has found no instance where this has actually occurred.

FINDINGS OF THE COMMITTEE

1. The TBPC is designated as the lead agency in state government for HUB purposes. A poor relationship exists between the TBPC and the agencies it is supposed to assist.

2. Most state agencies fail to live up to their own HUB plans. Agencies are required to outline specific HUB goals and the steps to be taken in reaching those goals. However, as the findings in the 2001 SAO report show, none of the 19 agencies reviewed fully complied with their plans.

3. Most state agencies fail to use their HUB coordinator in the manner intended by the Legislature. Most HUB coordinators are given little access to agency executive directors. In fact, they have little authority in the purchasing process and are unable to make a meaningful contribution to the agency.

   HUB coordinators in general make an effort to be of assistance to HUBs and to guide the agency in the right direction. However, they are all too often ignored or overruled by agency procurement directors or by other individuals who are higher in the chain of command.

   In field visits and private interviews conducted by committee staff, many of the agency HUB coordinators feared retribution from agency administrators if they did advocated for women or minority-owned businesses or otherwise did their job too well.

   HUB coordinators are often placed in an awkward situation. They have worked closely with an individual HUB, helped the HUB qualify for participation in the program, and reviewed the HUBs opportunities to provide goods or services to the state. However, in the end, agencies ignore HUB opportunities and choose non-HUB providers.

4. The definition of "good faith" must be made more specific. In the HUB process, the

term "good faith" is used in several contexts. The term is used by the SAO in their review of individual state agencies. The term is also used by agencies in their review of individual contracts and the subcontracting opportunities involved in those contracts.

The SAO determined that "an agency did not make a "good-faith effort" if it had noncompliance in *at least* three of the four basic HUB areas" (emphasis added). In other words, an agency is making a good faith effort whether or not it fully complies with even half of its legal obligation.

At the agency level, the definition of "good faith" involves merely a cursory review. Agencies are required to make a good faith effort to ensure that such HUB opportunities exist. However, they frequently accept bids from contractors which indicate that there are no HUB subcontracting opportunities.

Agencies routinely accept the contractors statement that there are no HUB subcontracting opportunities without making a real effort to independently verify the statement. In this way, many HUB subcontracting opportunities are lost.

5. Agencies do not maximize opportunities for HUBs either by purchasing directly from HUBs or by encouraging contractors to use HUBs as subcontractors. Testimony indicated that some agencies already had various providers of choice and were not interested in doing business with other providers.

6. There are no effective sanctions for failure to comply with HUB goals, HUB laws, or HUB rules. Despite numerous audit reports indicating that agencies have failed to meet the criteria set by statute or rule, no agency has ever been sanctioned. Agencies are never held accountable for their failure to meet their HUB goals.

7. There is a general lack of commitment to the HUB goals enacted by the Legislature. Executive branch agencies do not view the attainment of legislatively-mandated HUB goals as a priority.

RECOMMENDATIONS

1. Strengthen the communication and working relationship between TBPC and other state agencies with respect to HUBs.

2. Require state agencies to list the exact manner in which they have failed to meet their own HUB plans at the time they submit their legislative appropriation request (LAR) and require that agency executive directors provide the same information to their governing boards on a quarterly basis.

3. Emphasize need for a direct line of communication between the HUB coordinator and the agency executive director. Ensure that the agency HUB coordinator has the freedom to get involved in the procurement process.

4. Provide a more clear definition of "good faith effort." A more clear set of guidelines

will avoid multiple interpretations by different state agencies.

5. Require the SAO to review its own definition of good faith. The SAO definition was adopted early on in the HUB process as agencies were working to familiarize themselves with a new law.

6. Clearly require agencies to maximize opportunities for HUBs by requiring that three or more HUBs be contacted on each subcontracting opportunity in a contract.

7. Provide a definition of "subcontract" and use clearer language in the administrative rules regarding subcontracting to minimize loopholes in HUB procedures.

8. Require agencies to hold contractors accountable for HUB participation through their performance bonds.

9. Enforce the provisions of law requiring agencies with more than $10 million in biennial appropriations to establish a mentor/protégé programs.

10. Require all agencies with more than $10 million in biennial appropriations to take part in a specific number of HUB forums or other outreach programs per fiscal year.

11. Create a range of sanctions which would hold noncompliant agencies accountable. The current sanctions provided by law are so impractical as to be non-existent. Suggested sanctions include either a partial, limited or complete transfer of purchasing power, administrative fines payable to the Comptroller, or liability on the part of an agency executive director through a performance bond.

12. Emphasize the importance of HUB policies and goals through the legislative appropriations process and prohibit the granting of salary increases for state agency executive directors whose agencies have failed to make continuing and substantial improvement in achieving HUB goals.

ENDNOTES

1. Texas Government Code §2161.001

2. See State Auditor's Report Number 97-043 (March, 997); State Auditor's Report Number 98-033 (March, 1998); State Auditor's Report Number 99-025 (February, 1999); State Auditor's Report Number 99-046 (August, 1999); State Auditor's Report Number 00--43 (August, 2000); and State Auditor's Report Number 01-035 (August, 2001)

3. Texas Government Code §2161.002

4. Texas Government Code §2161.003 and §2161.123; Texas Administrative Code, Title 1, Part 5, Subchapter B, §111.15

5. Texas Government Code §2161.001 *et seq*.; Texas Administrative Code, Title 1, Part 5, Subchapter B, §§111.11 *et seq*.

6. Texas Government Code §§2161.001 *et seq.;* Texas Administrative Code, Title 1, Part 5, Subchapter B, §§111.11 *et seq*.

7. Texas Administrative Code, Title 1, Part 5, Subchapter B, §111.14

8. Texas Government Code §2161.123(d)

9. Texas Government Code §2161.005

ADDENDUM

Court of Criminal Appeals

In addition to the formal charges given to the Committee, it was brought to the Committee's attention that questions have arisen concerning the propriety of the award by the Court of Criminal Appeals of grant funds pursuant to Rider 3(b) to the General Appropriations Act of Fiscal 2002-03, which states: "The Court of Criminal Appeals is authorized to contract with a statewide professional association of criminal defense attorneys whose purposes include providing continuing legal education courses, programs, and technical assistance for projects for criminal defense attorneys who regularly represent indigent defendants in criminal matters, provided, however, that such contract shall not exceed $1,250,000 in fiscal year 2002 and $1,250,00 and UB in fiscal year 2003." Based on the information reviewed by the Committee, it appears that the grant recipient chosen by a majority of the Court of Criminal Appeals does not satisfy the professional qualification requirements of Rider 3(b). Therefore, the Committee recommends that the remaining balance in the appropriation be rescinded, either by amendment, by the 78th Legislature, of the current appropriation act, or by action of the Governor and the Legislative Budget Board under their Budget Execution authority (Art. XVI, Sec. 69, Constitution).

APPENDIX

DOCUMENT ON FILE WITH
HOUSE COMMITTEE ON GENERAL INVESTIGATING
OR CAN BE ACCESSED ON LINE AT:

http://www.sao.state.tx.us/Reports/report.cfm?report+2000/01-001.