



## FULL ANALYSIS

### I. SUBSTANTIVE ANALYSIS

#### A. HOUSE PRINCIPLES ANALYSIS:

**Lower taxes:** A successfully managed investment pool for local governments may mean lower costs and a higher rate of return for local governments, diminishing the need for increased revenue from taxes.

#### B. EFFECT OF PROPOSED CHANGES:

##### Current Situation

##### **State Board of Administration**

The State Board of Administration of Florida (the "SBA" or the "Board") is an agency of Florida state government that provides a variety of investment services to various governmental entities. These include managing the assets of the Florida Retirement System (FRS) Pension Plan (i.e., defined benefit plan) and Investment Plan (i.e., defined contribution plan), the Lawton Chiles Endowment Fund, the Local Government Surplus Funds Trust Fund (also known as the "Local Government Investment Pool" or "LGIP"), the Hurricane Catastrophe Fund, the Lottery Fund and a variety of smaller funds. Total assets under management as of June 30, 2007 were approximately \$184 billion.

The SBA's Trustees are the Governor who serves as Chairman, the CFO who serves as Treasurer and the Attorney General who serves as Secretary. The Trustees delegate authority to the Executive Director, who serves at the discretion of the Trustees and is responsible for managing and directing all administrative, personnel, budgeting, investment policy and investment functions. The Executive Director manages 162 professional and administrative support staff. The Board of Trustees appoints six members to serve on the Investment Advisory Council. The Investment Advisory Council provides independent oversight of SBA's funds and major investment responsibilities. The Council meets on an ongoing basis to discuss general investment policies and broad topics related to the general economic outlook.

##### **History of the Pool**

The Local Government Investment Pool (Pool) was established "to provide local governments a low cost, low risk, fully transparent investment option for their surplus funds".<sup>1</sup> The Pool is open to all units of local government in Florida and has been operated by the SBA since January 1982. As of June 30, 2007, the SBA managed approximately \$31 billion in assets in the Pool serving almost 1000 participants.

Confidence in the Fund began to erode as a result of the Pool's July and August 2007 purchase of four securities, Ottimo, KKR Pacific, KKR Atlantic and Axon (the "Securities"), with a par value at time of purchase of \$947.8 million. These Securities were downgraded in late summer and early fall 2007 below the Pool's investment guidelines. Knowledge of these downgrades, primarily from financial news accounts and rumors that in July and August one or more of the Securities had defaulted, all against the backdrop of the national sub-prime mortgage crisis, prompted participants to withdraw \$14 billion from the Pool in mid- to late- November 2007.

As a result of this run, on November 29, 2007, the SBA Trustees suspended withdrawals from the Pool and on December 4, 2007, split the Pool into two funds, Fund A and Fund B. The four downgraded

<sup>1</sup> [http://sbafla.com/fund\\_pool.aspx](http://sbafla.com/fund_pool.aspx)

Securities with a then-par value of approximately \$867 million together with additional securities with a par value of approximately \$1.2 billion deemed by an investment manager hired by the SBA, BlackRock, to have an unacceptable level of risk, were placed in Fund B and frozen. Additionally, the Trustees transferred to Fund B the Pool's entire \$22 million in accumulated, unspecified reserves and \$96 million representing the Pool's interest earned in November 2007 by all participants in the Pool. The \$96 million was transferred to Fund B in the form of \$82 million in cash and \$14 million in securities. However, following a redistribution of assets the \$96 million consists entirely of securities at present.

The Pool's remaining securities were placed in Fund A and rated by Standard and Poor's as AAA. When Fund A was reopened, the SBA established withdrawal limitations based upon the Fund's liquidity and imposed a 2% fee on participants which elected to withdraw more than they were allowed under the liquidity restrictions on redemptions. The 2% fee was based upon an assessment by the SBA staff that a complete liquidation of Fund A would result in a 2% shortfall. On January 18, 2008, the SBA released the greater of 22% or \$2 million in additional liquidity per fund participant.

On February 12, 2008, the SBA chose Federated Investors Inc. to take over management of the Pool.

Federated reported on March 14, 2008, the following investment management guidelines or practices:

- LGIP Fund A managed in compliance with investment guidelines and Standard & Poor's (S&P) AAA rating criteria
- Dollar-weighted average maturity not greater than 60 days
- Final maturity of an individual security not greater than 397 days
- 5% individual issuer limit
- 10% limit on illiquid securities/"limited liquidity securities"
- At least 50% of the LGIP's securities must be rated A1+; remainder invested in at A1 only
- Weekly reporting to Standard & Poor's

The SBA is currently undergoing a search, through an executive placement company, for a new executive director.

An unofficial LGIP Participant Advisory Committee was created at the outset of the situation and currently consists of 17 members with various affiliations.

At the direction of Speaker Rubio, the House undertook an investigation of the Pool. The team hired for this role issued its report on March 24, 2008, and listed 16 recommendations. Speaker Rubio further directed the House to consider legislation that could effectively provide control measures and ensure accountability and return investor trust in the Pool.

### **Statutes Governing Local Government Investment Pool**

The Pool was created by s. 218.405, F.S., and this section also provided the board with rulemaking powers. Section 218.407, F.S., provides the criteria for local governments to invest in the Pool. The local government must pass a resolution that it is in the interest of the unit of local government to deposit surplus funds in the trust fund, which is then filed with the SBA and authorizes investment of its surplus funds in the trust fund. The SBA may invest those moneys in the trust fund in the same manner and subject to the same restrictions as are set forth in s. 215.47, F.S. Normally, the local governments will have surplus funds deposited into a pooled investment account. This section does not impair the power of a unit of local government to hold funds in deposit accounts with banking or savings institutions or to invest funds as otherwise authorized by law.

The provisions for the administration of the trust fund are set out in s. 218.409, F.S.:

(1) Upon receipt of the resolution from the local governing body, the State Board of Administration shall accept all wire transfers of funds into the trust fund. The State Board of Administration shall also wire-transfer invested local government funds to the local government upon request of the local government official named in the resolution.

(2) The State Board of Administration shall administer the investment trust funds on behalf of the participants and shall have the power to invest such funds. A fee may be charged on any transaction that is not in accord with the close of business as set by the board.

(3) The State Board of Administration may purchase such surety or other bonds as may be necessary for its officials in order to protect the fund. A reserve fund may be established to fulfill this purpose.

(4) All investments may be purchased jointly for the participants in the trust fund. The board may also purchase investments for a pooled investment account in which all participants may share pro rata, as determined by rule of the board, in the capital gain, income, or losses, subject to any penalties for early withdrawal. The board shall determine the rate of return for the pooled investment account. A system may be developed by the board to keep current account balance information and to apportion pooled investment earnings back to individual accounts.

(5) The State Board of Administration shall keep a separate account, designated by name and number of each participating local government. A maximum number of accounts allowed for each participant may be established by the board. Individual transactions and totals of all investments, or the share belonging to each participant, shall be recorded in the accounts.

(6) The State Board of Administration shall report semiannually or upon request to every participant having a beneficial interest in the trust fund. The report shall show the changes in investments made during the preceding period. The report shall delineate, in a manner which is in accordance with generally accepted governmental accounting procedures, those funds on deposit, the manner in which the funds are invested, and the interest earnings thereon. The State Board of Administration shall furnish upon request the details of an investment transaction to any participant. Additional reporting may be made to pool participants.

(7) Costs incurred in carrying out the provisions of this part shall be deducted from the interest earnings accruing to the trust fund. Such deductions shall be prorated among the participant local governments in the percentage that each participant's deposits bear to the total trust fund.

(8)(a) The principal, and any part thereof, of each and every account constituting the trust fund shall be subject to payment at any time from the moneys in the fund or as otherwise provided by agreement between the State Board of Administration and the investing unit.

(b) An order or warrant may not be issued upon any account for a larger amount than the share of the particular account to which it applies; and if such order or warrant is issued, the responsible official shall be personally liable under his or her bond for the entire overdraft resulting from the payment if made.

## **Government Finance Officers Association (GFOA) Guidance**

The GFOA has issued a sample investment policy as a model to help investing entities customize a policy to fit their particular needs, constraints and capabilities. The sample policy covers 11 areas including general objectives (safety, liquidity, yield), standards of care (prudence, ethics and conflicts of interest, delegation of authority), safekeeping and custody (internal controls), reporting, and approval of investment policies.<sup>2</sup>

The GFOA has also issued guidance on mark-to-market practices:

**Background.** Market risk is significant in public investment portfolios. Due to price volatility, valuing investments at their current price is necessary to provide a realistic measure of a portfolio's true liquidation value. Over time, reporting standards for state and local government investment portfolios have been enhanced so that investors, governing bodies, and the public remain informed of the current market value of the portfolio. Regular disclosure of the value of a governmental entity's investments is an important step to furthering taxpayer and market confidence in state and local government investment practices. The Governmental Accounting Standards Board (GASB) has also recognized the need to report investments at fair value at fiscal year end.

Government officials should be aware of state, local, accounting, and rating agency requirements regarding mark-to-market practices.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local government officials responsible for investment portfolio reporting determine the market value of all securities in the portfolio on at least a quarterly basis. These values should be obtained from a reputable and independent source and disclosed to the governing body or other oversight body at least quarterly in a written report. The independent source of pricing should not be one of the parties to the transaction being valued and could include:

- 1) a broker or other financial institution who was not a counterparty to the transaction,
- 2) the custodial bank if the bank was not a counterparty to the transaction,
- 3) publicly available publications such as the Wall Street Journal, or
- 4) other pricing services for which a separate fee would be paid.

It is recommended that the written report include the market value, book value, and unrealized gain or loss of the securities in the portfolio.

If there is a significant event in the local or national economy that might affect the value of the portfolio, then a mid-term valuation of the portfolio should be conducted. Governments that employ a more active portfolio management style should consider more frequent marking to market and reporting.<sup>3</sup>

### **Governmental Accounting Standards Board (GASB) Guidance**

The GASB has issued a "Statement No. 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools"<sup>4</sup> which establishes accounting and financial reporting standards for all investments held by governmental external investment pools. LGIPs that are 2a7-like pools are

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<sup>2</sup> GFOA Sample Investment Policy, located at <http://www.gfoa.org/downloads/SampleInvestmentPolicy.pdf>, last viewed March 25, 2008.

<sup>3</sup> GFOA Mark-to-Market Reporting Practices for State and Local Government Investment Portfolios (1995, 2000, 2003, 2005, and 2008) (CASH), located at <http://www.gfoa.org/downloads/MarktmarketFINAL.pdf>, last viewed March 25, 2008.

<sup>4</sup> GASB Summary of Statement No. 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools (Issued 3/97), located at <http://www.gasb.org/st/index.html>, last viewed March 24, 2008.

allowed to report their investments at amortized cost. Rule 2a7 allows money market mutual funds to use amortized cost to report net assets. This Statement establishes, among other things:

- that governments should report investments at fair value in the balance sheet (or other statement of financial position).
- that investment income, including changes in the fair value of investments, should be reported as revenue in the operating statement (or other statement of activities).
- minimum requirements for the financial statements to be presented and the disclosures to be made in the separate financial reports of governmental external investment pools.

### **Advantages and Disadvantages of Pools to Local Governments**

Local government investment pools (“pools”) have existed for more than 100 years. Today, 45 of the fifty states have such pools and the funds run by these pools exceed \$200 billion.<sup>5</sup> There are significant tangible and intangible public service benefits related to these pools. Tangible benefits typically are lower fees, diversification and access to professional management. Fees paid by participants to the Fund averaged a very favorable 1.5 basis points from the Pool’s inception in 1982 through June, 2007, a savings of over 73% relative to the average fees paid. Intangible benefits include the ability of a State’s Auditor General and other oversight and control functions to perform reviews of a single entity, the Pool, to enhance protection of participants, rather than reviews of numerous entities.

Local Government Investment Pools “are not registered with the Securities and Exchange Commission (SEC) and are exempt from SEC regulatory requirements because they fall under a governmental exclusion clause. While this exemption allows pools greater flexibility, it also reduces investor protection. Investments in these pools are not insured or guaranteed and substantial losses have occurred in the past. Some rating agencies rate LGIPs using the same criteria as money market mutual funds. These ratings are based on safety of principal and ability to maintain a NAV of \$1. Pool ratings can provide an additional method of due diligence.”<sup>6</sup>

### **Effect of Proposed Changes**

The bill is designed to address a number of issues related to the overall management of the Local Government Investment Pool (Pool) such as governance, investor protection, and mandated transparency. The bill addresses the governance by the Trustees of the Pool by:

- Increasing their accountability to participants and the Legislature for the management of the Pool; and
- Increasing their role in review and approval of a number of critical management documents.

The bill addresses investor protection by increasing the transparency of the State Board of Administration (SBA) or professional money management firm’s operations of the Pool to participants or prospective investors by fully disclosing or reporting:

- Enrollment materials to prospective participants;
- A written investment policy;
- How the fund is operated;
- How the fund may be restricted in a crisis;
- What fees and charges may be imposed;
- How reserves are established;

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<sup>5</sup> Source: iMoneyNet, “Government Investment Pools: 2007 Update of Investment Strategies, Facts, Figures and Trends”.

<sup>6</sup> GFOA Use of Local Government Investment Pools (LGIPs) (2007) (CASH), located at <http://www.gfoa.org/downloads/cashlgip.pdf>, last viewed March 24, 2008.

- How interest may be used;
- Monthly management reports (more frequently if needed) based on best investment practices; and
- Market value calculations of the portfolio.

Further, the bill requires employees and management to abide by the “prudent person” standard as referenced in s. 215.47(9), F.S., follow certain ethical standards, establish internal controls for escalation reporting purposes, and immediately disclose material impacts to the Pool or its operations to participants as well as other groups like the Investment Advisory Council. The bill also deletes the authority of the SBA to set the rate of return for participants contrary to a rate dictated by market conditions. This will prevent a rate of return being set at zero as it was in November 2007 when the November interest was transferred to the Fund B Pool.

The bill also establishes a procedure to deal with material impacts to the Pool or its operations and how the executive director may respond by limiting or restricting the Pool for a maximum of 48 hours. The Trustees must convene a meeting and vote to continue the action up to a maximum of 15 days, and thereafter must reconvene to vote to continue any action up to a maximum 15 days at a time.

The bill also increases the role of the Investment Advisory Council in reviewing critical management documents. Further, the bill creates a Participant Local Government Advisory Council, composed of a majority of trust fund participants, which is also closely involved in reviewing critical documents and providing input to the SBA or a professional money management firm regarding the operation of the trust fund. Both Councils receive immediate notification of any actions taken by the executive director to address material impacts on the fund.

The bill also requires the distribution of the November 2007 interest to the participants owed that interest.

## **Section By Section Analysis**

### Purpose

Section 1 amends the purpose of the “Investment of Local Government Surplus Funds Act” presently in statute by requiring the investment of the funds to be based on the principles of investor protection, mandated transparency, and proper governance.

### Definitions

Section 2 adds definitions for, among other things, the Governmental Accounting Standards Board and the Government Finance Officers Association.

### Administration and Certification

Section 3 provides authority for the SBA to contract with a professional money management firm to administer the trust fund. This section sets out the objectives of the fund which are safety, liquidity, and competitive returns with minimization of risks, in that order. Additionally, this section requires the Trustees to annually certify to the Joint Legislative Auditing Committee (JLAC) that the trust fund is in compliance with the statutes governing the fund and that the Trustees have reviewed the fund and determined that the management of the fund is in accord with best investment practices. Further, after the bill creating the Fund B Surplus Funds Trust Fund becomes law, HB 7095 requires the distribution to plan participants of the funds from the securities that composed part of the November 2007 interest when those securities either mature, are sold, or are worked out.

### Enrollment in Fund

Section 4 creates a process for the board or a professional money management firm to provide enrollment materials with such things as:

- A profile with information regarding the administration and investment policy of the trust fund;

- Rights and conditions of participation, including potential restrictions on withdrawals;
- Historical performance, investment holdings, credit quality and average maturity of the trust fund investments;
- Applicable administrative rules;
- Rate determination processes for any deposit or withdrawal;
- Any fees, charges, penalties, and deductions that apply to the account;
- Most recently published financial statements or independent audit, if available, prepared under generally accepted accounting principles; and a
- Disclosure statement for signature by the appropriate local government official.

A local government official must sign the disclosure accepting the terms of investment and return it with the resolution in order to invest funds. This section also requires funds to be invested in a pooled investment account.

### Standard of Care

Section 5 establishes the standards of care that must be followed by the board or a professional money management firm. The Trustees are required to insure that the fund is administered on behalf of the participants. Further, the bill requires that the power to invest funds must be based on a written investment policy which must be updated annually to conform to best investment practices. The bill then references s. 215.47(9), F.S., which references the Federal Employee Retirement Income Security Program (ERISA) to include the “prudent person” standard in the bill. This section also addresses ethics and conflicts of interests and sets out a policy for all employees to observe including disclosures of certain actions related to personal investments. In addition, this section creates a framework for internal controls to be established. At the outset it creates an affirmative duty for all employees to immediately disclose any material impact to the trust fund to participants. The internal controls cover a number of circumstances such as fraud or employee error and must be set out in writing as part of the investment policy. The internal controls also include formal escalation procedures to address material impacts that require reporting and action.

### Approval of Investment Policy

The bill also requires review and approval of the investment policy by the Trustees at least annually or as market conditions dictate. The investment policy is also reviewed at those times as well by the Investment Advisory Council and the Participant Local Government Advisory Council created later in this section.

### Reserves

Further, this section establishes the policy for reserves which must be a portion of the management fee and must be fully disclosed to participants with an opportunity to withdraw from the fund if the participant does not agree to a change in the reserve fee.

### Penalties & Rate of Return

This section amends the provisions related to penalties for early withdrawal by requiring that information regarding penalties must be disclosed to participants and an opportunity to withdraw from the fund be available if the participant does not agree to a change in the penalty fee. Also, the SBA’s authority to set the rate of return is deleted so that the rate is based on market conditions. This will prevent a rate of return being set at zero as it was in November 2007 when the interest was transferred to the Fund B Pool.

In addition, this section requires that a system be developed, approved by the Trustees, and disclosed to keep current account balances and to apportion pooled investment earnings to individual accounts.

### Reports

The bill establishes a reporting program for the board or a professional money management firm. A report must be provided, at least monthly, or upon the occurrence of a material event, to all

participants, the board's executive director, the Trustees, the JLAC, the Investment Advisory Council, and the Participant Local Government Advisory Council. The report includes:

- Reports of any material impacts on the trust fund, and any actions or escalations taken by staff to address such impacts. The Trustees shall provide quarterly a report to the Joint legislative Auditing Committee that the Trustees have reviewed and approved the monthly reports and actions taken, if any, to address any impacts.
- A management summary that provides an analysis of the status of the current investment portfolio and the individual transactions executed over the last month. This management summary will be prepared in a manner which will allow anyone to ascertain whether investment activities during the reporting period have conformed to investment policies. Such reporting shall be in conformance with best market practices.

The details of any particular transaction are available upon request.

#### Marking to Market

The bill provides that the market value of the portfolio must be calculated on a daily basis. A transparent process must be created to prevent an advantage or disadvantage to parties making deposits or withdrawals on any particular day. A statement of the market value and amortized cost of the portfolio must be issued in conjunction with deposits and withdrawals which must also be reported monthly with the management report. The review of the portfolio must be in conformance with GFOA and GASB statements. Procedures for additional reporting are also created.

#### Interest

This section provides that administrative costs may be deducted from the interest earned by participants, but that the remaining interest must be distributed and may not be used for any other purpose including making up investment losses.

#### Material Impacts on Fund

This section of the bill provides that the executive director may, in good faith, on the occurrence of an event that has a material impact on liquidity or operations of the fund, for 48 hours limit contributions to or withdrawals from the trust fund to ensure that the board can invest monies entrusted to it. Such action must be immediately disclosed to all participants, the Trustees, the Joint Legislative Auditing Committee, the Investment Advisory Council, and the Local Government Advisory Council. The Trustees must then convene an emergency meeting as soon as practicable from the time the executive director has instituted such measures and review the necessity of those measures. If the Trustees agree with them, the Trustees must vote to continue the measures for up to an additional 15 days. The Trustees must convene and vote to continue any such measures prior to the expiration of the time limit set, but in no case may the time limit set by the Trustees exceed 15 days.

#### Annual Financial Audit

The bill also provides that an annual financial audit must be conducted by the Auditor General which must include testing for compliance with the investment policy. The audit is provided to all participants, the board, the Trustees, the Joint Legislative Auditing Committee, the Investment Advisory Council, and the Local Government Advisory Council. The Trustees must certify to JLAC that they have reviewed the audit and that any necessary items are being addressed by a corrective action plan which includes target completion dates.

#### Participant Local Government Advisory Council

The final portion of this section creates a 16 member Participant Local Government Advisory Council. Thirteen members of the Council must be current participants in the fund and three must have significant investment experience. The Governor, Attorney General, and Chief Financial Officer each make four appointments, three from the participants and one with investment experience, and the President of the Senate and the Speaker of the House of Representatives each make two appointments both from current participants. In choosing participants, the appointing body must attempt

to choose participants with differing levels of participation. The appointees serve staggered two year terms and are limited to three consecutive terms. The Council meets quarterly or upon the call of the chair, who is selected by the Council members. An appointee may only be removed for cause. If the entity represented by an appointee ceases to be a participant in the fund, then the appointment is vacated to be filled by the original appointing entity. The Council may choose a volunteer executive director.

The Council may:

- Provide the board with input regarding proposed investment policies, internal controls, investment classes, competitively-bid contracts, and programs that may affect trust fund participants;
- Consider requests from trust fund participants to review the board's investment policies, internal controls, investment classes, competitively-bid contracts, and programs that may affect trust fund participants; and
- Review rules promulgated by the board. The Council may provide input on any rule and offer alternatives that the Council believes reduce the impact on trust fund participants while meeting the stated objectives of the proposed rule.

The Council may not:

- Interfere with, modify, prevent or delay board action or investment activities;
- Intervene in legal actions; or
- Subpoena witnesses to testify or to produce documents, but it may request witnesses to voluntarily testify or produce documents.

The Council shall prepare and submit a written biennial report to the board, Trustees, the Investment Advisory Council, and the Joint Legislative Auditing Committee that describes the activities and recommendations of the Council.

#### Effective Date

Section 6 provides that the bill is effective upon becoming a law.

#### C. SECTION DIRECTORY:

Section 1: Amends s. 218.401, F.S., to provide for investment principles.

Section 2: Amends s. 218.403, F.S., adding additional definitions.

Section 3: Amends s. 218.405, F.S., relating to Trustee certification and objectives of the trust fund.

Section 4: Amends s. 218.407, F.S., relating to local government investment authority.

Section 5: Amends s. 218.409, F.S., relating to administration of the trust fund and the creation of a Participant Advisory Council.

Section 6: Provides that the bill is effective upon becoming a law.

## **II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT**

### A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

A successfully managed local government investment pool may create an environment in which local government participants may benefit from lower costs and a higher rate of return, which in turn may lower the necessity for other revenue sources to fund local government.

### III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable because this bill does not appear to: require cities or counties to spend funds or take an action requiring expenditure of funds; reduce the authority that cities or counties have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with cities or counties.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

None.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

D. STATEMENT OF THE SPONSOR

Not applicable.

### IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES

None.