



## FULL ANALYSIS

### I. SUBSTANTIVE ANALYSIS

#### A. HOUSE PRINCIPLES ANALYSIS:

**Lower taxes:** A successfully administered investment pool for local governments may mean a higher rate of return and more revenue available 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 into withdrawing \$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 Securities with a then-par value of approximately \$867 million together with additional securities with a

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

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.

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.

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

#### LGIP B

- Daily assessment of liquidity
- Daily assessment of market value of all securities
- All cash invested in overnight securities only
- Countrywide maturity: \$200 million will move to LGIP A 3/17/08
- Ongoing assessment of impaired assets

#### **LGIP B Securities**

By July 31, 2007, the Pool had invested in 28 collateralized debt obligations and structured investment vehicles and seven extendable asset-backed commercial paper (ABCP) issued by seven ABCP programs that chose to extend. The Pool's investment guidelines effective July 1, 2006, to October 31, 2007, permitted the purchase of first-tier securities, which are, as defined by SEC Rule 2a-7, those receiving the highest short term rating for debt obligations from two of the nationally recognized statistical rating organizations. If only one service rated the security, only one was required.

The first tier rating for the three major agencies are:

- Standard and Poor's A-1+ and A-1
- Moody's P-1
- Fitch F1+ and F1

KKR Pacific and KKR Atlantic, sponsored by KKR Financial Holdings, and Ottimo, sponsored by Aladdin Capital Management, three ABCP issues, extended their maturities and chose to negotiate with their investors to meet a mutually agreed-upon liquidation plan for the assets collateralizing the securities. Axon, a SIV sponsored by Axon Financial Funding, is also in restructuring. All of these Securities were first-tier rated.

The following table sets forth the history and status of the rating of these four Securities with their original par value totaling \$947.8 million.

SECURITIES	PAR (\$MM)	SELLER	PURCHASE DATE	RATING AT PURCHASE	DOWNGRADE DATE & RATING
Ottimo	52.8	Lehman	7/3/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
Ottimo	100	Lehman	7/9/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
KKR Pacific	125.1	Lehman	7/26/2007	A-1+/P-1/F1+	10/29/2007 Fitch B
KKR Pacific	200	Lehman	7/27/2007	A-1+/P-1/F1+	10/29/2007 NP (Moody)
Ottimo	30.7	JP Morgan	7/27/2007	A-1+/P-1	NA
Axon	175	JP Morgan	7/27/2007	A-1/P-1/F1+	10/29/2007 F3 (Fitch)
KKR Pacific	64.3	Lehman	8/1/2007	A-1/P-1/F1+	8/15/2007 B (Fitch)
KKR Pacific	200	Lehman	8/1/2007	A-1/P-1/F1+	10/24/2007 A-2 (S&P)

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>

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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.

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 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).

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<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.

- 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**

### **Purpose**

HB 7099 implements the Fund B Surplus Funds Trust Fund created in HB 7097 in order to legally separate these funds from Fund A in the Local Government Surplus Funds Trust Fund. The purpose stated in the bill is to maximize the payout of principal on invested surplus funds of units of local government formerly in Fund B of the Local Government Surplus Funds Trust Fund through a prudent workout of the trust fund with the ultimate goal of self-liquidating the trust fund through maturity and payout of the investments.

### **Administration and Certification**

The fund may be administered by the SBA or a professional money management firm based on a written investment policy. The investment policy must be reviewed and approved by the Trustees. The Trustees must certify to the Joint Legislative Auditing Committee that the fund is being operated in accordance with the statutes implementing the trust fund. The bill provides for the accounting mechanisms for the trust fund participants and establishment of accounts. Any accrued funds must be paid out monthly as long as \$100,000 is in the fund at the end of that month. Once the fund self-liquidates, a final distribution shall be made to the participants in the trust fund. Participants may not conduct transactions in the fund.

### **Internal Controls**

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.

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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.

The bill also requires review and approval of the investment policy by the Trustees 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.

#### Costs and Interest

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

#### Reserves

Once the pool self-liquidates, any remaining reserve shall be distributed on a pro rata basis in the percentage that each participant's deposits bear to the total trust fund.

#### Reporting

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.

#### Trustee Review

The Trustees are required to review the progress of the fund at each meeting of the State Board of Administration until the fund self-liquidates. The bill also provides for an Auditor general report to be issued prior to the 2013 Legislative session.

#### Sunset of Provisions

The bill also provides that the sections of the bill will expire upon the self-liquidation of the Fund B Surplus Funds Trust Fund as announced by the executive director of the SBA.

The bill has a contingent effective date.

### C. SECTION DIRECTORY:

Section 1: Creates s. 218.418, F.S., to provide definitions.

Section 2: Creates s. 218.420, F.S.; relating to the trust funds purpose, rulemaking authority, administration, and reporting.

Section 3: Creates s. 218.423, F.S. providing for an Auditor General review of the trust fund.

Section 4: Provides that the bill has a contingent effective date.

## 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:

Although the bill implements a new trust fund, the funds come from the Fund B of the Local Government Surplus Funds Trust Fund already being managed by Federated Investors Inc.

### 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:

The bill provides rulemaking authority to the State Board of Administration to implement the provisions of the bill.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

D. STATEMENT OF THE SPONSOR

Not applicable.

### IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES

None.