

California Legislature

Board of Advisors
to
Senate Special Committee
on Local Government Investments

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PRELIMINARY REPORT

from the

BOARD OF ADVISORS
TO THE
SENATE SPECIAL COMMITTEE
ON LOCAL GOVERNMENT INVESTMENTS

February 16, 1995

Background

Orange County's financial collapse and ultimate bankruptcy filing resulted from nothing short of a reckless abuse of the public trust. The enormous losses suffered by the county would not have occurred if parties having responsibility to maintain the public trust had acted in a proper and sensible manner. There is ample blame to be apportioned. The County Treasurer had a responsibility to limit risks to those which would not undermine the value of the investment portfolio entrusted to his care. He abdicated that responsibility. The Board of Supervisors had an oversight responsibility. They abdicated that responsibility. Members of the securities industry had a responsibility to look after the interests of their client, and not merely their own. They abdicated that responsibility. There was a total lack of an effective system of checks and balances. This basic principle of American government was ignored. The County Treasurer had absolute power, and unlike pension funds, banks, mutual funds and insurance companies, was totally unregulated.

The Senate Hearings have revealed, among other things, that:

1. \$13 billion of securities were purchased for speculative purposes using the County's \$7 billion investment fund as security.
2. There was no public disclosure of the County Treasurer's activities.
3. The County had no written investment plan that could be applied against performance for purposes of an audit.
4. The County had no contingency plan to cut losses if rates went up.
5. All advisors, underwriters, brokers and lawyers had a financial incentive to create transactions (since they were only compensated on the basis of those transactions).
6. Bonds were issued for the sole purpose of investing in securities.

Process

We recommend that the Senate Committee discuss recommendations of the Board of Advisors in an open hearing and adopt the principles which are incorporated in this Preliminary Report. The Senate staff and the Board of Advisors, working together, should then draft an omnibus Local Government Investment Code which would supersede existing statutes.

Focus of Advisory Board

The members of the Board of Advisors are unanimous in their view that there is a need for legislation to prevent future financial debacles of this kind. The Board of Advisors did not focus on the short-term financial problems of Orange County, or the issue of bankruptcy filings by local units of government.

Need for Legislation

It has become clear that current law and practices are insufficient to prevent a similar debacle from occurring.

Purpose of Legislation

The legislation would be to: (a) provide law and an environment that will significantly reduce the likelihood of future losses with regard to local agency funds; (b) restore public and financial market confidence in local agencies and their finances; and (c) enhance the attractiveness of California and local agency obligations in the financial markets. It is our recommendation that the legislation apply to all funds invested by any local agency, and all funds in the hands of county treasurers.

Proposed Legislation

It is suggested that the entire code dealing with Local Government Investments be rewritten. There are too many statutes on the books currently, and many of those statutes are confusing and difficult to find and reconcile. The new Code should include the following:

1. All local agencies should be required to annually adopt written policy guidelines that will apply to their financial management. The guidelines must be sufficiently specific so as to facilitate compliance audits. The guidelines should protect principal first, then provide required liquidity, and lastly, focus on enhancement of income.
2. Local agencies should be prohibited from borrowing for any purpose other than a purpose directly related to their principal activity. There should be a specific prohibition against borrowing for investment purposes.
3. Local agencies should be required to closely match the duration of and projected cash flows of all fund assets and liabilities.
4. Except as to primary finance through ordinary bond issuance, local agencies should be prohibited from borrowing: (a) amounts in excess of 10% of the mark-to-market value of fund assets; and (b) for any purpose other than to provide needed short-term liquidity. "Borrowing" for these purposes would be defined to include reverse repos and all other transactions which are substitutes for or in the nature of loan transactions. Local agencies would be permitted to borrow up to an additional 10% of the mark-to-market value

of fund assets (for a total borrowing of up to 20% of the mark-to-market value of fund assets), provided: (a) this additional borrowing was necessary to provide liquidity; and (b) the local agency received specific prior approval for that borrowing from its investment advisory review committee and the local government's governing body.

5. Local agencies should be prohibited from purchasing financial derivatives for any purpose other than to reduce risk. There should be a specific prohibition against the purchase of financial derivatives for speculative purposes.

6. Immediately prior to all votes or decisions by officials of a local agency on fund investments or any other transactions with underwriters, broker-dealers, investment advisors or financial advisors, all elected officials of the local agency and all appointed officials having any involvement with the decision being made should be required to make public, written disclosure of all gifts and political contributions they have received during the past two years from underwriters, broker-dealers, investment advisors and financial advisors involved in the proposed transaction.

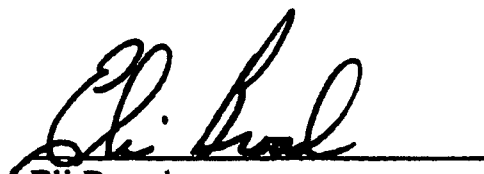
7. Each local agency should be required to have an investment advisory review committee consisting of no fewer than three members. The committee would be comprised of independent experts appointed by the local agency. The committee members could serve without pay, or be paid for their work, provided that if they were paid, payment could only be on the basis of their time devoted to committee work. Payments tied to the dollar amount of the whole or any part of the investment would be prohibited. The committee members should be unaffiliated with persons responsible for making local

agency investments. The committee would publish written reports on a quarterly basis with regard to: (a) compliance on the part of the local agency with its written policy guidelines; (b) compliance on the part of the local agency with laws applicable to fund assets and liabilities; and (c) such other matters pertaining to the local agency's investments as the committee would deem appropriate. The committee members should be conclusively presumed to have fiduciary obligations to the local agency they serve.

8. All local agencies would be required to have annual independent written audit reports of their invested funds. The audit reports would be published and presented to the governing body of the local agency for approval within 90 days following the end of each annual accounting period. Each audit report would include a certificate of compliance with state law and the local agency's written policy guidelines.

9. All local agencies should be conclusively presumed to be unsophisticated investors for purposes of all dealings with broker-dealers. Suitability requirements comparable to those imposed upon broker-dealers when selling to individual unsophisticated investors should be imposed. Local agencies should have an absolute right to rescission of all transactions found through a judicial determination to have been unsuitable. The only exception would be if a broker-dealer could prove that the transaction was approved by the public agency and its financial advisory review committee, following a full and complete discussion with the governing body of the public agency and with the committee of matters pertaining to the suitability of the transaction.

10. All broker-dealers and investment advisors dealing with local agency funds should be conclusively presumed to have fiduciary obligations to the local agency with respect to those funds.
11. Consideration should be given to enactment of legislation parallel to provisions contained in the Investment Company Act of 1940 and ERISA legislation. The Board of Advisors believes that these federal laws have served individual investors well for over 50 years and that the enactment of parallel legislation would assist in restoring public confidence in local agency finance.
12. Violation of any part of the Code dealing with local investment procedures should be subject to criminal penalties.



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