Senate
California Legislature

TOM HAYDEN
SENATOR
TWENTY-THIRD DISTRICT

March 1, 1995

Board of Advisors
Senate Special Committee on Local Investment

Dear Members of the Board of Advisors:

We want to thank you for your insightful and comprehensive legislative recommendations to the members on our Senate Special Committee on Local Investment. We greatly appreciate the time and energy you have expended in preparing your preliminary report and in assisting the committee in its efforts to investigate the Orange County financial crisis.

We strongly agree with your assessment that Orange County's financial collapse resulted from "reckless abuse of the public trust" and from numerous public officials abdicating their responsibility for protecting public funds. We also support many of your legislative proposals. This letter is intended to focus on the priorities ahead, as we see them, and invite your response.

Let us not be distracted from the root causes of the Orange County financial crisis by the debates over tax increases versus cuts in government programs that may dominate the rhetoric of the special legislative session. Those debates, however important, involve allocating the burden of responsibility for the bankruptcy without prosecuting the real causes and culprits. It is ridiculous to entertain a bailout for Wall Street lenders without reforming the culture of special interests which caused the county to file for bankruptcy in the first place. We have no quarrel with the obligation to pay one's debts. But the Wall Street practices which sucked Orange County into the black hole of bankruptcy must be addressed as well.

There appear to be four root causes of the Orange County crisis which need to be addressed:

(1) Investment of taxpayer money in risky derivatives and reverse repurchase agreements. Your proposal moves in the right direction, although we would appreciate knowing any exceptions you contemplate. This is a key issue because special interests seek to protect their habit of investing taxpayer money in risky investments. The head of the Federal Reserve Board and others have been promoting what we call a "derivatives protection program." We will hear increasingly that the Orange County crisis is essentially that of the "one bad apple" in the Treasurer's office, not derivatives. On this issue we are unmistakeably fiscal conservatives. It is one matter for private investors seeking quick profits to invest in derivatives, but gambling with taxpayer dollars is another matter.

(2) Insufficient disclosure. Your proposals require quarterly reports to an investment advisory review committee and annual audit reports to the governing body of the local agency charged with investing taxpayer money. Your recommendations, however, do not require disclosure to investors in the fund. After learning that many institutional and individual investors in the Orange County pool had little or no understanding of the county's investment policies, we are concerned that reports which disclose the pool's investment policy and the status of the investments must be made to pool investors.

(3) Lack of independent oversight mechanisms. Your proposals require the formation of an independent advisory review committee composed of at least three members, all independent experts appointed by the local agency in charge of local investments. Your definition of "independent", however, needs clarification. For example, by banning or limiting any association between committee members and bond and securities firms, we can be assured that committee members do not have direct ties with the industry they are charged with overseeing. We agree that the committee members should have fiduciary obligations to the local agency they serve.

(4) The influence of campaign contributions by bond and securities firms to local officials who approve investment decisions. We do not think your report contains a strong enough solution to the problematic pattern of bond and securities firms making large campaign contributions to local elected officials in Orange County. In your preliminary report, you propose legislation to require public, written disclosure of all gifts and political contributions received by local officials from underwriters, broker-dealers, and investment and financial advisors. In our view, this type of legislation will not by itself curb the excessive and unacceptable amount of campaign contributions made by those parties to local elected officials responsible for investing taxpayer funds.

Senator Hayden's staff has examined campaign reports since 1979 and found that at least $185,000 in campaign contributions flowed from bond and securities houses to Orange County supervisors and Robert Citron during the time period studied. Of course, this is only a minimum estimate since it cannot include contributions from individuals who failed to disclose such professional affiliations. The figure also does not include those contributions made to state elected officials representing Orange County. Nevertheless, the numbers clearly illustrate that bond and securities firms played a substantial role in financing Orange County political campaigns in the last decade.

In our view, there should be an outright ban on political contributions from bond and securities firms to supervisors and other local officials responsible for investing taxpayer monies. Although the Securities and Exchange Commission (SEC) recently imposed restrictions on campaign contributions from bond houses to elected officials responsible for investment policy, the SEC rules contain numerous loopholes that we must close through state legislation. For example, the SEC ban does not cover investment brokers, bond lawyers or financial advisers who are not registered as bond dealers. The SEC restrictions also currently allow members of underwriting firms to contribute to local officials in charge of investment policy if the contributor is not considered a municipal finance professional under the SEC rules. That loophole permitted Merrill Lynch's Michael Stamenson to contribute $1,000 to Robert Citron the day before the Board of Supervisors approved the $600 million bond which Merrill Lynch underwrote.

Another significant advantage to enacting a strong state ban on campaign contributions is that such a law would allow local and state law enforcement agencies to levy penalties on illegal contributions if the SEC fails to act.

The issue is clear: to end the influence of special interests on local investment policy, the state must completely ban all contributions from bond dealers, investment brokers, underwriters and financial advisers.

We realize that your report to the members of the Senate committee is only preliminary, so we hope that you reconsider your proposals regarding increased disclosure and the restriction of campaign contributions in preparation for your final report. Again, we thank you for your assistance in helping the Senate to formulate effective policy changes to prevent the Orange County debacle from occurring again. We look forward to seeing you at our next hearing in Orange County.

Sincerely,

Tom Hayden

TOM HAYDEN

Sincerely,

Quentin L. Kopp

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cc: **Members of the Senate Special Committee on Local Investment**