



## City of Lexington Investment Policy

### I. Governing Authority

#### *Legality*

The investment program shall be operated in conformance with federal, state and other legal requirements, including North Carolina General Statute 159-30. (See Attachment A)

### II. Purpose

The purpose of this investment policy is to set forth the investment and operational guidelines for the management of the public funds of the City of Lexington. This policy is designed to ensure the prudent management of public funds, the availability of operating and capital funds when needed, and a competitive return on investments.

A copy of this policy will be provided to all investment broker/dealers and investment managers doing business with the City, and also will be provided to other interested parties upon request. Receipt of this policy, including confirmation that persons dealing directly with the City's account have reviewed it, will be received prior to any organization providing investment services to the City.

### III. Scope

This policy applies to activities of the City with regard to investing the financial assets of all City funds. Except for cash in certain restricted and special funds, the City will consolidate cash balances from all funds to maximize investment earnings and to increase efficiencies with regard to investment pricing, safekeeping and administration. Investment income will be allocated to the various funds based on their respective average cash balances on a monthly basis in accordance with generally accepted accounting principles.

### IV. General Objectives

The primary objectives, in priority order, of investment activities are as follows:

#### *(1) Safety*

Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall investment portfolio. The objective will be to mitigate credit risk and interest rate risk.

a) Credit Risk

The City will minimize credit risk, which is the risk of loss due to the failure of the security issuer or backer, by:

- \* Limiting investments to the types of securities in accordance with North Carolina General Statute 159-30
- \* Pre-qualifying the financial institutions and broker/dealers with which the City will do business in accordance with Section VI
- \* Diversifying the investment portfolio so that the impact of potential losses from any one type of security or from any one individual issuer will be minimized.

b) Interest Rate Risk

The City will minimize interest rate risk, which is the risk that the market value of securities in the portfolio will fall due to changes in market interest rates, by:

- \* Structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity
- \* Investing operating funds primarily in shorter-term securities, the investment pool established by the State Treasurer, or similar investments and limiting the average maturity of the portfolio in accordance with this policy (see Section IX).

*(2) Liquidity*

The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands (static liquidity). Furthermore, since all possible cash demands cannot be anticipated, the portfolio should consist largely of securities with active secondary or resale markets (dynamic liquidity). Alternatively, a portion of the portfolio may be placed in money market mutual funds or local government investment pools, which offer same-day liquidity for short-term funds.

*(3) Yield*

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments is limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

- \* A security with declining credit may be sold early to minimize loss of principal
- \* Liquidity needs of the portfolio require that the security be sold
- \* In the event of a credit risk or default by a specific issuer, the investment officer shall review and, if appropriate, proceed to liquidate securities with comparable credit risks.

**V. Standards of Care**

*A) Prudence*

The standard of prudence to be used by City investment officials shall be the “prudent person” standard and shall be applied in the context of managing an overall portfolio. Investment officers acting in accordance with established procedures and this investment

policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and the liquidity and the sale of securities are carried out in accordance with the terms of this policy.

The "prudent person" standard states that, "Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of the capital as well as the probable income to be derived."

*B) Ethics and Conflicts of Interest*

Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with the proper execution and management of the investment program, or that could impair their ability to make impartial decisions. Investment officials shall disclose any material interests in financial institutions with which they conduct business. They shall further disclose any personal financial/investment positions that could be related to the performance of the portfolio. This disclosure need not include normal banking or brokerage relationships that are at normal market rates and conditions available to the general public. Investment officials shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the City.

*C) Delegation of Authority*

Authority to manage the investment program is granted to the Director of Finance, hereinafter referred to as the investment officer and derived from G.S. 159-25 (a)(6). (See Attachment B) Responsibility for the operation of the investment program is hereby delegated to the investment officer, who shall act in accordance with established procedures and internal controls for the operation of the investment program consistent with this policy. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the investment officer. The investment officer may designate one or more members of the staff to assist in the performance of functions of cash management and investing. Such delegation will not relieve the investment officer of responsibility for all transactions and executions performed by the designated individuals. The investment officer shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials.

## **VI. Authorized Financial Institutions, Depositories and Broker/Dealers**

A list will be maintained of financial institutions authorized to provide investment services. Securities dealers not affiliated with a bank shall be classified as "primary" dealers and qualify under Securities and Exchange Commission (SEC) Rule 15C3-1 (uniform net capital rule). (See Attachment C)

All financial institutions and broker/dealers that conduct investment transactions with the City will have on file with the City a Broker/Dealer Questionnaire and Agreement. In the selection and review of the financial condition of broker/dealers and as applicable, the

investment officer will incorporate the GFOA Recommended Practice on “Government Relationships with Securities Dealers.” (See Attachment D)

## **VII. Safekeeping and Custody**

### *A. Safekeeping*

Securities, where applicable, will be held by a third-party custodian as evidenced by safekeeping receipts.

### *B. Internal Controls*

The investment officer is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that:

- (1) The cost of a control should not exceed the benefits likely to be derived; and
- (2) The valuation of costs and benefits requires estimates and judgments by management.

### *C. Delivery vs. Payment*

All trades, where applicable, will be executed by delivery vs. payment to ensure that securities are deposited in an eligible financial institution prior to the release of funds.

## **VIII. Guidelines**

### *A. Authorized Investments*

Investments may be made in any type of security allowed pursuant to N.C. General Statute 159-30. (See Attachment A)

### *B. Collateralization*

In accordance with N.C. General Statute 159-31, (See Attachment E) the investment officer will require that sufficient collateral be pledged for public funds. As applicable, the investment officer will incorporate the GFOA Recommended Practice on “Collateralization of Public Deposits.” (See Attachment F)

### *C. Performance Standards*

The investment portfolio will be managed in accordance with the parameters specified within this policy. A series of appropriate benchmarks shall be established against which portfolio performance shall be compared on a regular basis.

### *D. Marking to Market*

The market value of the portfolio shall be calculated and reviewed a minimum of quarterly by the investment officer, and disclosed semi-annually (or as requested) to City Council. This will ensure that review of the investment portfolio, in terms of value and price volatility, has been performed consistent as applicable with the GFOA Recommended Practice on “Mark-to-Market Reporting Practices for State and Local Government Investment Portfolios.” (See Attachment G)

## **IX. Investment Portfolio Parameters**

### *A. Diversification*

The investment portfolio shall be diversified by:

- Limiting investments to avoid over concentration in securities from a specific issuer or business sector (excluding US Treasuries and the local government investment pool)
- Allowing no more than 25% of the City's portfolio to be placed with a single financial institution
- Allowing no more than 20% of the portfolio to be placed with a single issuer of commercial paper (CP)
- Allowing no more than 30% of the portfolio to be invested in CP
- Allowing no more than 25% of the portfolio to be placed with a single issuer of government agency paper (AP)
- Allowing no more than 50% of the portfolio to be invested in AP
- Allowing no more than 30% of the portfolio to be invested in qualified banker's acceptances
- Allowing no more than 20% of the portfolio to be invested with maturity over 1 year
- Limiting the maximum term for long-term investments to 3 years
- Investing in securities with varying maturities
- Continuously investing a portion of the portfolio in readily available funds such as local government investment pools (LGIPs), money market funds or overnight repurchase agreements to ensure that appropriate liquidity is maintained in order to meet ongoing obligations.

Deviation from the above statements should be no more than 5% without disclosure to City Council. As applicable, diversification will incorporate the GFOA Recommended Practice on "Diversification of Investments in a Portfolio." (See Attachment H)

### *B. Maximum Maturities*

To the extent possible, the City shall attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, the City will not directly invest in securities maturing more than three (3) years from the date of purchase or in accordance with state and local statutes and ordinances.

Reserve funds and other funds with longer-term investment horizons may be invested in securities exceeding three (3) years, if the maturity of such investments is made to coincide as nearly as practicable with the expected use of funds.

Because of inherent difficulties in accurately forecasting cash flow requirements, a portion (up to 100%) of the portfolio should be continuously invested in the local government investment pool established by the State Treasurer, to ensure that appropriate liquidity is maintained to meet ongoing obligations.

### *C. Competitive Bids*

Subject to diversification, maturity and cash flow considerations, the investment officer shall obtain competitive bids for investment instruments.

## X. Policy Considerations and Reporting Requirements

This policy shall be adopted by City Council and shall be reviewed on a regular basis by investment officials. Investment officials (and City Council if significant to the scope) must approve any changes to the policy.

The investment officer shall generate monthly reports of investment activity for management purposes. These reports as well as other summary information regarding key details of the investment portfolio shall be reviewed monthly by the Director of Finance; and will be made available for the City Manager, City Council and/or other parties as desired.

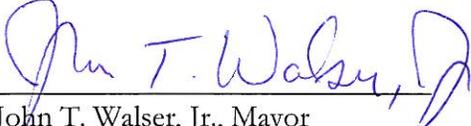
## XI. List of Attachments

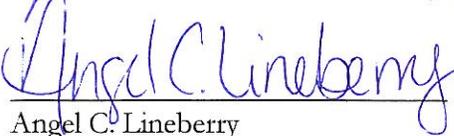
- \* Attachment A – North Carolina General Statute 159-30
- \* Attachment B – North Carolina General Statute 159-25
- \* Attachment C – Securities and Exchange Commission (SEC) Rule 15C3-1
- \* Attachment D – GFOA Recommended Practice “Government Relationships with Securities Dealers”
- \* Attachment E – North Carolina General Statute 159-31
- \* Attachment F – GFOA Recommended Practice “Collateralization of Public Deposits”
- \* Attachment G – GFOA Recommended Practice “Mark-to-Market Reporting Practices for State and Local Government Investment Portfolios”
- \* Attachment H – GFOA Recommended Practice “Diversification of Investments in a Portfolio”

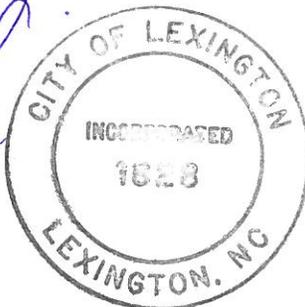
## XII. Other Documentation

- \* Investment Trading Relationship Agreement
  - \* Exhibit A – Broker / Dealer Questionnaire
  - \* Exhibit B – Settlement Information

ADOPTED this the 12th day of January, 2011.

  
John T. Walser, Jr., Mayor

  
Angel C. Lineberry  
Deputy City Clerk



North Carolina General Statute 159-30**§ 159-30. Investment of idle funds.**

(a) A local government or public authority may deposit at interest or invest all or part of the cash balance of any fund. The finance officer shall manage investments subject to whatever restrictions and directions the governing board may impose. The finance officer shall have the power to purchase, sell, and exchange securities on behalf of the governing board. The investment program shall be so managed that investments and deposits can be converted into cash when needed.

(b) Moneys may be deposited at interest in any bank, savings and loan association, or trust company in this State in the form of certificates of deposit or such other forms of time deposit as the Commission may approve. Investment deposits, including investment deposits of a mutual fund for local government investment established under subdivision (c)(8) of this section, shall be secured as provided in G.S. 159-31(b).

(b1) In addition to deposits authorized by subsection (b) of this section, the finance officer may deposit any portion of idle funds in accordance with all of the following conditions:

- (1) The funds are initially deposited through a bank or savings and loan association that is an official depository and that is selected by the finance officer.
  - (2) The selected bank or savings and loan association arranges for the deposit of funds in certificates of deposit for the account of the local government or public authority in one or more federally insured banks or savings and loan associations wherever located, provided that no funds shall be deposited in a bank or savings and loan association that at the time holds other deposits from the local government or public authority.
  - (3) The full amount of principal and any accrued interest of each certificate of deposit are covered by federal deposit insurance.
  - (4) The selected bank or savings and loan association acts as custodian for the local government or public authority with respect to the certificates of deposit issued for the local government's or public authority's account.
  - (5) At the same time that the local government or public authority funds are deposited and the certificates of deposit are issued, the selected bank or savings and loan association receives an amount of deposits from customers of other federally insured financial institutions wherever located equal to or greater than the amount of the funds invested by the local government or public authority through the selected bank or savings and loan association.
- (c) Moneys may be invested in the following classes of securities, and no others:
- (1) Obligations of the United States or obligations fully guaranteed both as to principal and interest by the United States.
  - (2) Obligations of the Federal Financing Bank, the Federal Farm Credit Bank, the Bank for Cooperatives, the Federal Intermediate Credit

Bank, the Federal Land Banks, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, Fannie Mae, the Government National Mortgage Association, the Federal Housing Administration, the Farmers Home Administration, the United States Postal Service.

- (3) Obligations of the State of North Carolina.
- (4) Bonds and notes of any North Carolina local government or public authority, subject to such restrictions as the secretary may impose.
- (5) Savings certificates issued by any savings and loan association organized under the laws of the State of North Carolina or by any federal savings and loan association having its principal office in North Carolina; provided that any principal amount of such certificate in excess of the amount insured by the federal government or any agency thereof, or by a mutual deposit guaranty association authorized by the Commissioner of Banks of the Department of Commerce of the State of North Carolina, be fully collateralized.
- (6) Prime quality commercial paper bearing the highest rating of at least one nationally recognized rating service and not bearing a rating below the highest by any nationally recognized rating service which rates the particular obligation.
- (7) Bills of exchange or time drafts drawn on and accepted by a commercial bank and eligible for use as collateral by member banks in borrowing from a federal reserve bank, provided that the accepting bank or its holding company is either (i) incorporated in the State of North Carolina or (ii) has outstanding publicly held obligations bearing the highest rating of at least one nationally recognized rating service and not bearing a rating below the highest by any nationally recognized rating service which rates the particular obligations.
- (8) Participating shares in a mutual fund for local government investment; provided that the investments of the fund are limited to those qualifying for investment under this subsection (c) and that said fund is certified by the Local Government Commission. The Local Government Commission shall have the authority to issue rules and regulations concerning the establishment and qualifications of any mutual fund for local government investment.
- (9) A commingled investment pool established and administered by the State Treasurer pursuant to G.S. 147-69.3.
- (10) A commingled investment pool established by interlocal agreement by two or more units of local government pursuant to G.S. 160A-460 through G.S. 160A-464, if the investments of the pool are limited to those qualifying for investment under this subsection (c).
- (11) Evidences of ownership of, or fractional undivided interests in, future interest and principal payments on either direct obligations of the United States government or obligations the principal of and the

interest on which are guaranteed by the United States, which obligations are held by a bank or trust company organized and existing under the laws of the United States or any state in the capacity of custodian.

- (12) Repurchase agreements with respect to either direct obligations of the United States or obligations the principal of and the interest on which are guaranteed by the United States if entered into with a broker or dealer, as defined by the Securities Exchange Act of 1934, which is a dealer recognized as a primary dealer by a Federal Reserve Bank, or any commercial bank, trust company or national banking association, the deposits of which are insured by the Federal Deposit Insurance Corporation or any successor thereof if:
- a. Such obligations that are subject to such repurchase agreement are delivered (in physical or in book entry form) to the local government or public authority, or any financial institution serving either as trustee for the local government or public authority or as fiscal agent for the local government or public authority or are supported by a safekeeping receipt issued by a depository satisfactory to the local government or public authority, provided that such repurchase agreement must provide that the value of the underlying obligations shall be maintained at a current market value, calculated at least daily, of not less than one hundred percent (100%) of the repurchase price, and, provided further, that the financial institution serving either as trustee or as fiscal agent for the local government or public authority holding the obligations subject to the repurchase agreement hereunder or the depository issuing the safekeeping receipt shall not be the provider of the repurchase agreement;
  - b. A valid and perfected first security interest in the obligations which are the subject of such repurchase agreement has been granted to the local government or public authority or its assignee or book entry procedures, conforming, to the extent practicable, with federal regulations and satisfactory to the local government or public authority have been established for the benefit of the local government or public authority or its assignee;
  - c. Such securities are free and clear of any adverse third party claims; and
  - d. Such repurchase agreement is in a form satisfactory to the local government or public authority.
- (13) In connection with funds held by or on behalf of a local government or public authority, which funds are subject to the arbitrage and rebate provisions of the Internal Revenue Code of 1986, as amended,

participating shares in tax-exempt mutual funds, to the extent such participation, in whole or in part, is not subject to such rebate provisions, and taxable mutual funds, to the extent such fund provides services in connection with the calculation of arbitrage rebate requirements under federal income tax law; provided, the investments of any such fund are limited to those bearing one of the two highest ratings of at least one nationally recognized rating service and not bearing a rating below one of the two highest ratings by any nationally recognized rating service which rates the particular fund.

(d) Investment securities may be bought, sold, and traded by private negotiation, and local governments and public authorities may pay all incidental costs thereof and all reasonable costs of administering the investment and deposit program. Securities and deposit certificates shall be in the custody of the finance officer who shall be responsible for their safekeeping and for keeping accurate investment accounts and records.

(e) Interest earned on deposits and investments shall be credited to the fund whose cash is deposited or invested. Cash of several funds may be combined for deposit or investment if not otherwise prohibited by law; and when such joint deposits or investments are made, interest earned shall be prorated and credited to the various funds on the basis of the amounts thereof invested, figured according to an average periodic balance or some other sound accounting principle. Interest earned on the deposit or investment of bond funds shall be deemed a part of the bond proceeds.

(f) Registered securities acquired for investment may be released from registration and transferred by signature of the finance officer.

(g) A local government, public authority, an entity eligible to participate in the Local Government Employee's Retirement System, or a local school administrative unit may make contributions to the Local Government Other Post-Employment Benefits Fund established in G.S. 147-69.4.

(h) A unit of local government employing local law enforcement officers may make contributions to the Local Government Law Enforcement Special Separation Allowance Fund established in G.S. 147-69.5. (1957, c. 864, s. 1; 1967, c. 798, ss. 1, 2; 1969, c. 862; 1971, c. 780, s. 1; 1973, c. 474, ss. 24, 25; 1975, c. 481; 1977, c. 575; 1979, c. 717, s. 2; 1981, c. 445, ss. 1-3; 1983, c. 158, ss. 1, 2; 1987, c. 672, s. 1; 1989, c. 76, s. 31; c. 751, s. 7(46); 1991 (Reg. Sess., 1992), c. 959, s. 77; c. 1007, s. 40; 1993, c. 553, s. 55; 2001-193, s. 16; 2001-487, s. 14(o); 2005-394, s. 2; 2007-384, ss. 4, 9.)

North Carolina General Statute 159-25**§ 159-25. Duties of finance officer; dual signatures on checks; internal control procedures subject to Commission regulation.**

- (a) The finance officer shall have the following powers and duties:
- (1) He shall keep the accounts of the local government or public authority in accordance with generally accepted principles of governmental accounting and the rules and regulations of the Commission.
  - (2) He shall disburse all funds of the local government or public authority in strict compliance with this Chapter, the budget ordinance, and each project ordinance and shall preaudit obligations and disbursements as required by this Chapter.
  - (3) As often as may be requested by the governing board or the manager, he shall prepare and file with the board a statement of the financial condition of the local government or public authority.
  - (4) He shall receive and deposit all moneys accruing to the local government or public authority, or supervise the receipt and deposit of money by other duly authorized officers or employees.
  - (5) He shall maintain all records concerning the bonded debt and other obligations of the local government or public authority, determine the amount of money that will be required for debt service or the payment of other obligations during each fiscal year, and maintain all sinking funds.
  - (6) He shall supervise the investment of idle funds of the local government or public authority.
  - (7) He shall perform such other duties as may be assigned to him by law, by the manager, budget officer, or governing board, or by rules and regulations of the Commission.

All references in other portions of the General Statutes, local acts, or city charters to county, city, special district, or public authority accountants, treasurers, or other officials performing any of the duties conferred by this section on the finance officer shall be deemed to refer to the finance officer.

(b) Except as otherwise provided by law, all checks or drafts on an official depository shall be signed by the finance officer or a properly designated deputy finance officer and countersigned by another official of the local government or public authority designated for this purpose by the governing board. If the board makes no other designation, the chairman of the board or chief executive officer of the local government or public authority shall countersign these checks and drafts. The governing board of a unit or authority may waive the requirements of this subsection if the board determines that the internal control procedures of the unit or authority will be satisfactory in the absence of dual signatures.

(c) The Local Government Commission has authority to issue rules and regulations having the force of law governing procedures for the receipt, deposit, investment, transfer, and disbursement of money and other assets by units of local government and public authorities, may inquire into and investigate the internal control

procedures of a local government or public authority, and may require any modifications in internal control procedures which, in the opinion of the Commission, are necessary or desirable to prevent embezzlements or mishandling of public moneys. (1971, c. 780, s. 1; 1973, c. 474, ss. 18-20; 1975, c. 514, s. 10; 1987, c. 796, s. 3(5).)

## Securities and Exchange Commission (SEC) Rule 15C3-1

### VI. FINANCIAL RESPONSIBILITY OF BROKER-DEALERS

Broker-dealers must meet certain financial responsibility requirements, including:

- maintaining minimum amounts of liquid assets, or net capital;
- taking certain steps to safeguard the customer funds and securities; and
- making and preserving accurate books and records.

#### **A. Net Capital Rule (*Rule 15c3-1*)**

The purpose of this rule is to require a broker-dealer to have at all times enough liquid assets to promptly satisfy the claims of customers if the broker-dealer goes out of business. Under this rule, broker-dealers must maintain minimum net capital levels based upon the type of securities activities they conduct and based on certain financial ratios. For example, broker-dealers that clear and carry customer accounts generally must maintain net capital equal to the greater of \$250,000 or two percent of aggregate debit items. Broker-dealers that do not clear and carry customer accounts can operate with lower levels of net capital.



**Government Finance Officers Association**

**Recommended Practice**

**Government Relationships with Securities Dealers (1986, 1988, 2003, and 2006) (CASH)**

**Background.** Finance officers, treasurers and investment officers (hereafter referred to as government investors) who manage and invest public funds place billions of dollars in the fixed-income and money markets on a daily basis. They have a fiduciary responsibility to protect public funds, to always act in the best interest of their entity, to maintain safety and an appropriate level of liquidity and to attain a competitive return on their portfolio.

Generally, access to the securities markets is made through securities dealers who are registered broker/dealers and through financial institutions (banks) with broker/dealer subsidiaries. The fiduciary responsibilities of a government investor include ensuring that:

- reasonable comparisons are made to judge the appropriateness of all investments
- all security transactions are made at the best price through a competitive process;
- the counterparty to the transaction will fulfill all of their obligations; and,
- the securities are properly safe-kept and ownership perfected through registration in the name of the entity.

Communication with a broker for the purposes of discussing market conditions, reviewing investment strategies and transacting a trade often occur by phone, e-mail, or fax. Regardless of the method of communicating with a broker, a government investor needs to perform due diligence on all securities dealers prior to adding them to their list of approved brokers/dealers for transacting trades.

**Recommendation.** The Government Finance Officers Association (GFOA) makes the following specific recommendations to government investors in selecting securities dealers for their approved list, managing the relationships with the broker/dealers, and conducting investment transactions with them:

- I. Utilize a defined internal process to select, qualify, renew or terminate brokers and dealers.
  - a. Use a questionnaire and/or peer references to help determine that the broker understands the public entity's needs/objectives.
  - b. Determine that the broker is actively involved in the market sectors utilized by the government entity.
  - c. Select a number of brokers suitable to the entity, allowing for appropriate competition/service on all transactions; while limiting it to a manageable number.
  - d. Require security brokers and dealers to comply with the Federal Reserve Bank of New York's capital adequacy guidelines<sup>1</sup> or SEC Net Capital Rule as a condition of doing business. Obtain annual financial reports of the securities firm.

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<sup>1</sup> Primary dealers in U.S. government securities adhere to stringent capital adequacy guidelines as prescribed by the Federal Reserve Bank of New York. A current listing of primary dealers can be located [www.ny.frb.org](http://www.ny.frb.org).

- e. Require that brokers certify to a review of the government entity's investment policy to assure compliance with its objectives, portfolio risk constraints, and investment trading requirements.
  - f. Record and retain pertinent information on the firm and the individual broker including an annual review of the Central Registration Depository (CRD®) information for both maintained by the National Association of Security Dealers.
    - Violations or sanctions imposed by a regulatory agency or government should be carefully reviewed for termination of relationship.
  - g. Establish parameters that guide periodic review and potential termination of a broker dealer relationship.
2. Due diligence on Broker/Dealers should include obtaining information on:
    - a. a security dealer's experience and knowledge of public funds investing;
    - b. all contact information for the primary contact, backup and operations staff;
    - c. a broker's manager and supervisor;
    - d. the financial strength of the firm;
    - e. areas of expertise and trading activity;
    - f. registration with NASD and any citations;
    - g. the names and contact information for references similar to the entity; and
    - h. potential conflicts of interest.
  3. Establish a competitive procedure for attaining reasonable market rates:
    - a. Require that all security sales be made through a competitive bid process. If possible, use a competitive offer process on purchases as well.
    - b. Securities sold through a selling group at a set price (usually par) or available for specific bidding should be compared to comparable maturity securities as part of the competitive process to determine the best relative value.
  4. Require that all security transactions be settled on a delivery versus payment basis at the entity's custodian bank to perfect ownership under a written custodial agreement.
  5. Retain complete documentation for audit trail purposes including trade tickets, confirmations and safekeeping receipts.

#### **References.**

- *An Introduction to Broker/Dealer Relations for State and Local Governments*, M. Corinne Larson, GFOA, 1994.
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- Federal Reserve Bank of New York, [www.frb.ny.gov](http://www.frb.ny.gov), [http://www.newyorkfed.org/markets/pridealers\\_listing.html](http://www.newyorkfed.org/markets/pridealers_listing.html)
- NASD Central Registration Depository (CRD®), [www.nasd.com](http://www.nasd.com), [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=370](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=370)
- Securities and Exchange Commission, [www.sec.gov](http://www.sec.gov), VI. Financial Responsibility of Broker Dealers A. Net Capital Rule 15c3-1 (17 CFR 240.15c3-1) <http://www.sec.gov/divisions/marketreg/bdguide.htm#VI>

Approved by the GFOA's Executive Board, October 6, 2006.

North Carolina General Statute 159-31**§ 159-31. Selection of depository; deposits to be secured.**

(a) The governing board of each local government and public authority shall designate as its official depositories one or more banks, savings and loan associations, or trust companies in this State or, with the written permission of the secretary, a national bank located in another state. In addition, a unit or public authority, with the written permission of the secretary, may designate a state bank or trust company located in another state as an official depository for the purpose of acting as fiscal agent for the unit or public authority. The names and addresses of the depositories shall be reported to the secretary. It shall be unlawful for any public moneys to be deposited in any place, bank, or trust company other than an official depository, except as permitted by G.S. 159-30(b); however, public moneys may be deposited in official depositories in Negotiable Order of Withdrawal (NOW) accounts.

(b) The amount of funds on deposit in an official depository or deposited at interest pursuant to G.S. 159-30(b) shall be secured by deposit insurance, surety bonds, letters of credit issued by a Federal Home Loan Bank, or investment securities of such nature, in a sufficient amount to protect the local government or public authority on account of deposit of funds made therein, and in such manner, as may be prescribed by rule or regulation of the Local Government Commission. When deposits are secured in accordance with this subsection, no public officer or employee may be held liable for any losses sustained by a local government or public authority because of the default or insolvency of the depository. No security is required for the protection of funds remitted to and received by a bank, savings and loan association, or trust company acting as fiscal agent for the payment of principal and interest on bonds or notes, when the funds are remitted no more than 60 days prior to the maturity date. (1927, c. 146, s. 19; 1929, c. 37; 1931, c. 60, s. 32; c. 296, s. 7; 1935, c. 375, s. 1; 1939, c. 129, s. 1; c. 134; 1953, c. 675, s. 28; 1955, cc. 698, 724; 1971, c. 780, s. 1; 1973, c. 474, s. 26; 1979, c. 637, s. 1; 1981, c. 447, s. 2; 1983, c. 158, s. 3; 1999-74, s. 1.)



## GFOA Recommended Practice

### Collateralization of Public Deposits (1984, 1987, 1993, 2000, and 2007) (CASH)

**Background.** The safety of public funds should be the foremost objective in public fund management. Collateralization of public deposits through the pledging of appropriate securities or other instruments (i.e. surety bonds or letters of credit) by depositories is an important safeguard for such deposits. The amount of pledged collateral is determined by a public entity's deposit level. Some states have established programs for the pooling of collateral for deposit of public funds.

Federal law imposes certain limitations on collateral agreements between financial institutions and public entities in order to secure public entity deposits. Under certain circumstances, the Federal Deposit Insurance Corporation (FDIC) may void a perfected security interest and leave the public depositor with only the right to share with other creditors in the pro rata distribution of the assets of a failed institution.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends the use of pledging requirements as protection for state or local government's deposits. GFOA encourages state and local governments to establish adequate and efficient administrative systems to maintain such pledged collateral, including state or locally administered collateral pledging or collateral pools. To accomplish these goals, GFOA recommends the following:

1. Public entities should implement programs of prudent risk control. Such programs could include a formal depository risk policy, credit analysis, and use of fully secured investments. In the absence of a state program for pooling collateral, public entities should establish and implement collateralization procedures, including procedures to monitor their collateral positions. Monitoring informs a public entity of undercollateralization, which may threaten the safety of an entity's deposits, and overcollateralization, which may increase the cost of banking services.
2. State and local government depositors should take all possible actions to comply with federal requirements in order to ensure that their security interests in collateral pledged to secure deposits are enforceable against the receiver of a failed financial institution. Federal law provides that a depositor's security agreement, which tends to diminish or defeat the interest of the FDIC in an asset acquired by it as receiver of an insured depository, shall not be valid against the FDIC unless the agreement:
  - is in writing;
  - was approved by the board of directors of the depository or its loan committee; and
  - has been, continuously, from the time of its execution, an official record of the depository institution.
3. Public entities should have all pledged collateral held at an independent third-party institution, and evidenced by a written agreement in an effort to satisfy the Uniform Commercial Code (UCC) requirement for control. The UCC states that the depositor does not have a perfected interest in a security unless the depositor controls it. Control means that swaps, sales, and transfers cannot occur without the depositor's written approval.

- The value of the pledged collateral should be marked to market monthly, or more frequently depending on the volatility of the collateral pledged. If state statute does not dictate a minimum margin level for collateral based on deposit levels (e.g., Georgia and Minnesota statutes require 110 percent), the margin levels should be at least 102 percent, depending on the liquidity and volatility of the collateral pledged. State statutes also govern whether minimum margin levels apply to principal only or to accrued interest as well. Public entities should review applicable state statutes and confirm compliance.
  - Substitutions of collateral should meet the requirements of the collateral agreement, be approved in writing prior to release, and the collateral should not be released until the replacement collateral has been received.
4. The pledge of collateral should comply with the investment policy or state statute, whichever is more restrictive.
  5. Public entities that use surety bonds in lieu of collateral should limit the insurers to those of the highest credit quality as determined by a nationally recognized insurance rating agency.
  6. The public entity should review the terms and conditions of any letters of credit, including those issued by a federal agency or government sponsored enterprise.

**Note:** As a result of the court case North Arkansas Medical Center v. Barrett, 963 F.2d 780 (8<sup>th</sup> Cir. 1992), the FDIC issued a policy statement in March 1993 indicating that it would not seek to void a security interest of a federal, state, or local government entity solely because the security agreement did not comply with the contemporaneous execution requirement set forth in Section 13(e) of the Federal Deposit Insurance Act 12 U.S.C. 1823(e). The policy statement was officially enacted by Section 317 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law 103-325).

**References:**

- GFOA Sample Security Agreement, 1995.
- GFOA Sample Custodial Trust Agreement, 1995.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, M. Corinne Larson, GFOA, 2006.
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.

Approved by the GFOA's Executive Board, October 23, 2007.



## BEST PRACTICE

### **Mark-to-Market Reporting Practices for State and Local Government Investment Portfolios (1995, 2000, 2003, 2005, and 2008) (TIM)**

**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.

### **References**

- *GASB Statement 31 and Implementation Guide, Accounting and Financial Reporting for Certain Investment and for External Investment Pools*, March, 1997.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- *Investment Procedures and Internal Controls Guideline*, GFOA, May 2003.
- *Elected Official's Guide Investing, Second Edition*, Sofia Anastopoulos, GFOA, 2007.

Approved by the GFOA's Executive Board, February 22, 2008.



## BEST PRACTICE

### **Diversification of Investments in a Portfolio (2002 and 2007) (CASH)**

**Background.** Government investors have a fiduciary responsibility to protect public funds and to prudently manage their investments in order to achieve the investment objectives of safety, liquidity, and return. Generally, greater risk in a portfolio increases the opportunity for higher returns. However, greater risk also increases the volatility of the returns, which is another definition of risk. The effective management of risk in a portfolio is critical for achieving an entity's investment objectives.

A useful strategy for managing risk in a portfolio is through diversification. To this end, a government should establish a target risk profile. In establishing a risk profile, an entity considers its investment objectives and constraints, risk tolerances, liquidity requirements and the current risk/reward characteristics of the market. The profile should be adjusted as needed to changes in any of those considerations. Such a profile provides a framework and discipline for making individual investment decisions that manage the risk and create the structure of a portfolio.

The government entity's risk profile, in turn, helps it determine appropriate levels of diversification. Diversification of investments in a portfolio is based on the different types of risk – primarily interest rate or market risk, liquidity risk and credit risk. Diversification is achieved by investing in a variety of securities with dissimilar risk characteristics that respond differently to changes in the market. Areas where diversification can be achieved include the maturity distribution in a portfolio (market and liquidity risk), sector allocation (credit risk), issuer allocation (credit risk), and the structures (noncallable vs. callable) of securities (market and liquidity risk).

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local governments properly manage the risk in their portfolios to achieve their investment objectives and comply with their investment constraints. GFOA further recommends the use of diversification in a portfolio as an important strategy for managing risk. Diversification strategies can be implemented through the following steps:

- carefully and clearly defining what the objectives safety, liquidity and return mean to the government entity
- preparing a cash flow projection to determine liquidity needs and the level and distribution of risk that is appropriate for the portfolio
- considering political climate, stakeholders' view toward risk, and risk tolerances
- ensuring liquidity to meet ongoing obligations by investing a portion of the portfolio in readily available funds, such as Local Government Investment Pools (LGIPs), money market funds, or overnight repurchase agreements
- establishing limits on positions in specific securities to protect against default risk
- establishing limits on specific business sectors
- developing strategies and guidelines for investments in single class of securities (such as commercial paper or bankers acceptances)
- limiting investments in securities that have higher credit and/or market risks (such as derivatives)
- limiting particular structures (i.e. optionality, amortizing components, coupons, issue sizes)
- defining parameters for maturity/duration ranges
- establishing a targeted risk profile for the portfolio based on investment objectives and constraints, risk tolerances, liquidity requirements and the current risk/reward characteristics of the market.

## **References**

- *Elected Official's Guide Investing, Second Edition*, Sofia Anastopoulos, GFOA, 2007.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- Sample Investment Policy, GFOA, 2003.

Approved by the GFOA's Executive Board, March 2, 2007.