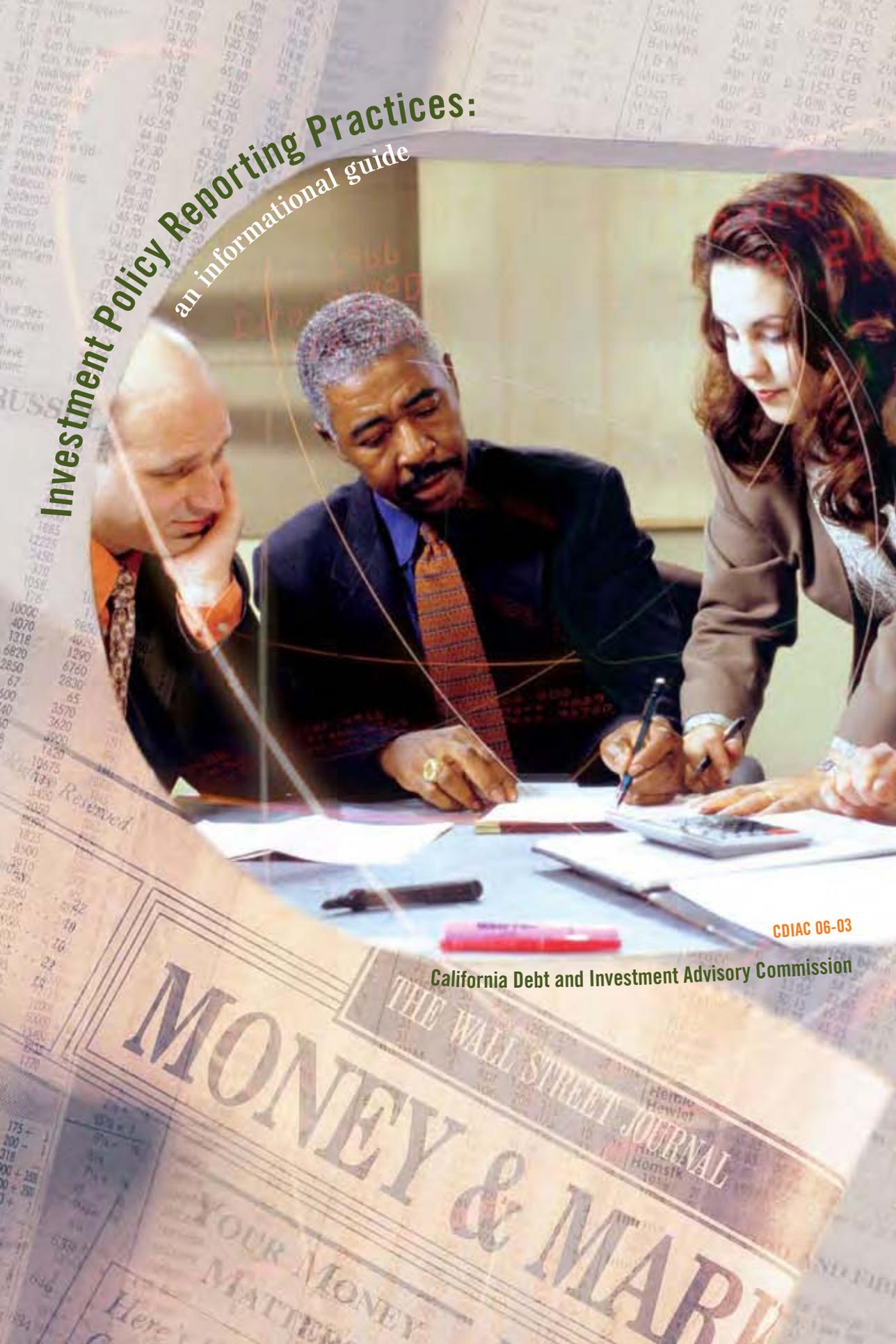


# Investment Policy Reporting Practices: an informational guide



CDIAC 06-03

California Debt and Investment Advisory Commission

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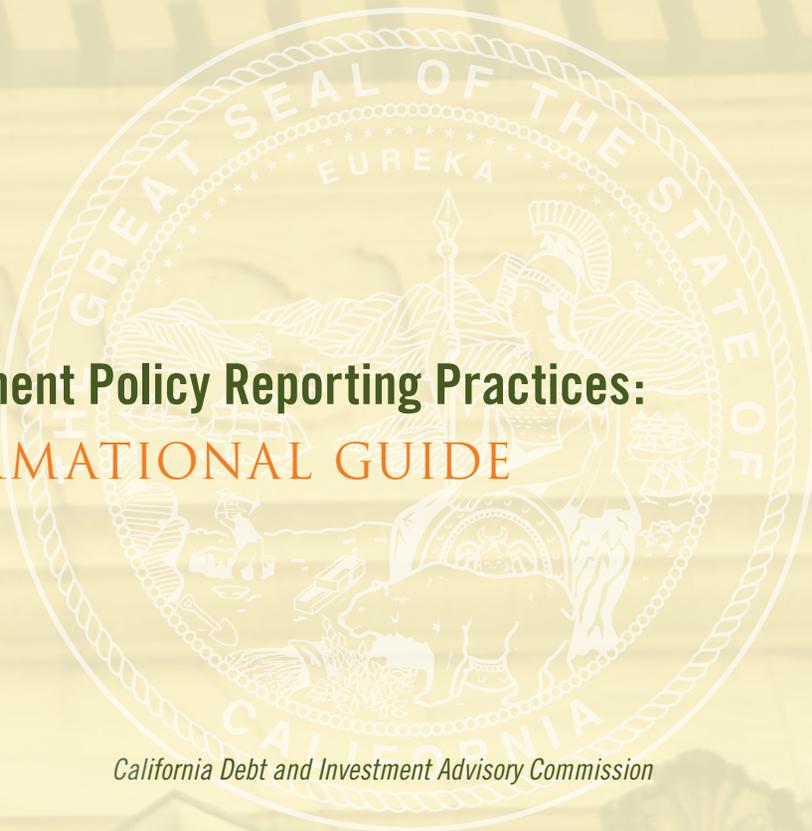
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**Investment Policy Reporting Practices:**  
**AN INFORMATIONAL GUIDE**

*California Debt and Investment Advisory Commission*





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# I. INTRODUCTION

**A**n investment policy serves as the foundation of a local agency's investment goals and priorities. California Government Code Section 53600.3 (hereafter referred to as the "Code") states that all local agency governing bodies that invest public funds (or those persons who are delegated the power to invest) are trustees and therefore fiduciaries subject to the prudent investor standard. The Code goes on to state that when managing public funds, a trustee should act with care, skill, prudence, and diligence under the circumstances then prevailing. The trustee is required to take into consideration, among other things, "... the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency."

Based on a careful examination of a local agency's short- and long-term cash flow needs, tolerance for risk, the likely return from the investments that fit these parameters, and any specific investment concerns confronting the organization, an investment policy sets the local agency's guidelines for its investment portfolio. If the investment policy is carefully researched, effectively drafted, and revised regularly to assure that it meets the agency's goals/priorities for its portfolio, it can help protect the assets of the organization.

Prior to Chapter 889, Statutes of 2004 (AB 2853, Laird), California Government Code Section 53646 required county treasurers to annually render to their legislative bodies and oversight committees, a statement of investment policy, which was required to be reviewed and approved at a public meeting. In the case of other local agencies<sup>1</sup> (including cities), a treasurer or chief fiscal officer was required to annually render an investment policy to be *considered* at a public meeting. Changes to investment policies were required to be approved by county boards of supervisors and to be considered by the legislative bodies of other local agencies. The investment policy reporting requirement generally was intended to provide the legislative body the ability to meet its fiduciary obligations as a trustee and to increase the exposure of the agency's

<sup>1</sup> Government Code Section 53630 defines a "local agency" as a county, city, city and county, including a chartered city or county, a community college district, or other public agency or corporation in this state.

## I. INTRODUCTION

investment activities to those interested parties outside the agency. With the advent of AB 2853, the requirement to submit investment policies was made optional, although the Legislature still encourages the submittal of investment policies because of the public interest served.

If the local agency still renders an investment policy at a public meeting to its legislative body for consideration or approval, Chapter 687, Statutes of 2000 (AB 943, Dutra), requires that cities and counties submit a copy of investment policies to the California Debt and Investment Advisory Commission (CDIAC) within sixty days of the close of the second quarter of each calendar year and within 60 days of any subsequent amendments.<sup>2</sup> Since receiving the first investment policies submitted by local agencies under AB 943 in 2000, CDIAC has improved its understanding of the investment reporting activities of California cities and counties. For example, an analysis of the latest submittal of investment policies has shown that a large majority of both counties and cities have policies that are more restrictive than the Government Code requirements. In addition, a significant percentage of counties and cities have some weighted average maturity (WAM) restriction in their policy.

The goal of this report is to provide local agencies with examples of common reporting practices that may add to the readability of their investment policies and assist those with fiduciary responsibilities in assessing the benefits and risks of the agency's investment goals/priorities. Using information gathered from investment policies filed, this report summarizes the different methods and formats used by cities and counties in California to document their investing goals and restrictions. It identifies alternative practices that effectively and efficiently communicate the agency's investment practices to fiduciaries and the public. This report provides examples and describes approaches to reporting investment policies that have been successfully used by other local agencies to report their practices to their legislative bodies. It encourages local governments to be complete and deliberate in identifying the information that fiduciaries need to fulfill their duties. This report goes on to recommend a California local agency model investment policy, thus setting standards which local agencies may con-

<sup>2</sup> Similar requirements exist for investment portfolio reports. See CDIAC's report entitled *Investment Portfolio Reporting Practices: An Informational Guide* (CDIAC #04-5).

## I. INTRODUCTION

sider. Local agencies can then use the resources that this report provides to identify the investment policy sections that make the most sense for their given circumstances.

The report addresses the following questions:

- What is the purpose behind developing investment policies?
- Are local agencies required to submit and amend investment policies?
- What information should cities and counties report to their legislative bodies in their policies?
- What formats are commonly used to summarize the agency's investment policies in an effective manner?
- Is there a California model local agency investment policy?

The report includes an Appendix at the end of the document that gives definitions and recommendations on various investment policy terms and concepts.

Readers are encouraged to consult previously published sample investment policies including the policies put forth by the Government Finance Officers Association (GFOA) and the Association of Public Treasurers of the United States & Canada (APT US&C) for good examples of investment policies. Copies of the GFOA model policy can be found on the Internet at [www.gfoa.org/services/documents/sampleinvestmentpolicy.htm](http://www.gfoa.org/services/documents/sampleinvestmentpolicy.htm). Copies of the APT US&C model policy can be found at [www.aptusc.org/common/certification/model\\_investment\\_policy.php](http://www.aptusc.org/common/certification/model_investment_policy.php). These policies will be examined in Section V of this report.



## II. STATE INVESTMENT POLICY REQUIREMENTS

## General Requirements

California Government Code Section 53646 states that local agency treasurers or chief fiscal officers<sup>3</sup> may annually render an investment policy to their legislative bodies and oversight committees. If rendered, these policies are required to be reviewed and approved by county boards of supervisors and considered by all other legislative bodies at a public meeting. The Code goes on to say that, in recognition of the state and local interests served by the now optional policies, the Legislature encourages local agency officials to continue rendering investment policies to their legislative bodies and oversight committees. However, no liability is imposed on local agencies that do not continue to review and update their investment policies.

## County Requirements

If a county government chooses to render an investment policy to its legislative body and oversight committee, California Government Code Section 27133 requires the policy to include certain items (see text box). These items include the list of securities in which the county treasurer may invest according to state law and the maximum percentage and term allowed by type of security. The county investment policy is also required to list the criteria used for selecting security brokers and dealers from whom the county treasurer may purchase

### Investment Policy Required Contents for Counties Pursuant to California Government Code Section 27133

1. List of securities in which it may invest
2. Maximum allowable percentage of each security
3. Maximum allowable term of each security
4. Criteria for selecting brokers and dealers
5. Limits on the receipt of honoraria, gifts, and gratuities from persons with whom the treasurer conducts business
6. Requirement that the treasurer provide the oversight committee with an investment report as required by the board of supervisors
7. The manner of calculating and apportioning costs of investing, depositing, banking, auditing, reporting, handling, or managing funds
8. The terms and conditions under which local agencies may deposit funds for investment in county pool
9. Criteria for considering requests to withdraw fund from the county treasury

<sup>3</sup> In the case of counties, the treasurer may render a policy.

## II. STATE INVESTMENT POLICY REQUIREMENTS

or sell securities or other obligations. These criteria are required to prohibit the selection of a broker/dealer that has made a political contribution in excess of the limits contained in Municipal Securities Rulemaking Board Rule G-37<sup>4</sup> to the local treasurer, any member of the governing board of the local agency, or any candidate for those offices. Government Code Section 27133 also requires the investment policy to place a limit on the receipt of honoraria, gifts, and gratuities to members of the county oversight committee from advisors, brokers, dealers, bankers, or other persons with whom the county treasury conducts business<sup>5</sup>.

The investment policy must require that the county treasurer provide the county oversight committee with an investment report (as required by the board of supervisors). The calculation and apportionment of the costs of investing, depositing, banking, auditing, reporting, handling, or managing funds is required to be set forth in the policy. Government Code Section 27013 allows the treasurer to deduct administrative costs before distributing interest or income dividends to shareholders in county treasury pools. Such cost reimbursement shall be paid into the county general fund. In addition, the policy is required to define the terms and conditions under which entities can deposit funds with the treasury for investment. Lastly, the Code requires investment policies to clearly specify the criteria that must be considered when pool members submit requests to withdraw funds from the treasury. These criteria should take into account the effect of a proposed withdrawal on the stability and predictability of the investment in the county treasury.

### Other Local Government Agency Requirements

Unlike for counties, the Government Code does not require other local agencies (including cities) to include specific contents in their investment policies. Absent such a requirement, other local agencies may use the county requirements as a starting point for developing or modifying their investment

<sup>4</sup> As of this writing, the limit is set at \$250.

<sup>5</sup> These limits would be in addition to any limits set by the agency, state law, or by the State Fair Political Practices Commission (FPPC). California Government Code Section 89502 prohibits state and local officials, with some exceptions, from receiving honoraria payments. Government Code Section 89503 originally established a limit of \$250 to the value of gifts received by local government agency elected officials from any single source in any calendar year. The FPPC is allowed to adjust this limit every other year by inflation. As of this writing, the limit is set at \$360.

## II. STATE INVESTMENT POLICY REQUIREMENTS

policies. External industry groups also may offer model investment policies for local agencies to consider. Model policies set forth by the Government Finance Officers Association (GFOA) and the Association of Public Treasurers of the United States & Canada (APT US&C) are compared in Section IV of this report. Finally, local agencies (including counties) may find it helpful to review the criteria used in other local agency policies. Section IV of this report also examines a sample of investment policies that CDIAC has collected from cities and counties that have been submitted in fulfillment of the AB 943 requirement. Section V presents a California model local agency investment policy developed by CDIAC based upon its review of statutes and various investment policies.





### III. ANNUAL REVIEW AND REPORTING SCHEDULE

The annual review of the contents of an investment policy should be an integral part of the general operations of a treasury department. A local agency investment policy should be updated regularly in the following areas:

- Investment goals and overall investment strategies
  - Enunciate the current mission statement or purpose
  - Describe the existing portfolio management strategy (i.e., passive or active)
- Reflect current local government philosophy and risk tolerance
- Reflect current state law (e.g., allowable investments, prohibited investments, prudent investor practices/standards, reporting conventions, etc.)
- Reflect current practices (e.g., safekeeping, internal controls, criteria for selection of financial dealers and institutions, etc.)

Figures 1 and 2 provide illustrations of hypothetical annual investment policy reporting schedules. These schedules are for illustrative purposes only because AB 2853 permanently suspended this requirement and because Government Code Section 53646 specifies annual review but does not state at what time during the year this review should occur. Figure 1 assumes the investment policy review process is conducted on a July 1 through June 30 fiscal year basis. It also assumes that cities and counties submit their policies to their legislative bodies before their fiscal years begin. Figure 2 assumes the investment policy review process is completed on a calendar year basis.

However, for the purposes of the CDIAC AB 943 filing requirement, if a city or county treasurer renders an investment policy to his/her legislative body for approval or consideration at a public meeting, then he/she is required to submit his/her investment policy to CDIAC within 60 days of the close of the second quarter of the *calendar year*. In addition, changes to an investment policy are required to be submitted to CDIAC within 60 days of any subsequent amendments.

### III. ANNUAL REVIEW AND REPORTING SCHEDULE



### III. ANNUAL REVIEW AND REPORTING SCHEDULE

**FIGURE 1**  
**Hypothetical Reporting Schedule\***  
**Investment Policies Reviewed on a Fiscal Year Basis (July 1 - June 30)**

200X											
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
January 1, beginning of <i>1st Quarter</i>			April 1, beginning of <i>2nd Quarter</i>			July 1, beginning of <i>3rd Quarter</i>			October 1, beginning of <i>4th Quarter</i>		
* Investment policies are also due to CDIAC within 60 days of any subsequent amendments.						July 1, investment policy due to <i>legislative body</i> by start of the fiscal year			September 1, copy of annual investment policy due to <i>California Debt and Investment Advisory Commission</i>		

**FIGURE 2**  
**Hypothetical Reporting Schedule\*\***  
**Investment Policies Reviewed on a Calendar Year Basis (January 1 - December 31)**

200X											
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
January 1, beginning of <i>1st Quarter</i>			April 1, beginning of <i>2nd Quarter</i>			July 1, beginning of <i>3rd Quarter</i>			October 1, beginning of <i>4th Quarter</i>		
January 1, investment policy due to <i>legislative body</i> by start of the calendar year		March 1, copy of annual investment policy due to <i>California Debt and Investment Advisory Commission</i>									
** Investment policies are also due to CDIAC within 60 days of any subsequent amendments.											



#### IV. EXAMINATION OF SAMPLE AND ACTUAL INVESTMENT POLICIES

This section will look at a number of different ways investment policies are represented. It will compare how two national local government associations—the GFOA and APT US&C—present their model investment policies and review a sample of California county and city investment policies.

## National Local Government Associations

The GFOA and APT US&C have both published model investment policies for the municipal investment industry. These two model policies are referenced often in California local agency investment policies as the basis for their policies. Figure 3 provides an outline of the organizational structure of both the GFOA and APT US&C model policies.

In general, both model investment policies are very similar. They both contain sections that deal with:

- scope
- prudent investor standard
- safety, liquidity, and yield
- ethics and conflicts of interest
- authorized financial dealers and institutions
- authorized and suitable investments
- master repurchase agreements
- collateralization
- safekeeping and custody
- diversification
- maximum maturities
- internal controls
- benchmarking
- investment reporting
- investment policy adoption
- repurchase agreements
- glossaries

The GFOA model investment policy also includes sections that cover local considerations, minority and community financial institutions, the governing authority, competitive bids, marking to market, policy considerations (such as exempted investments), and suggests a number of attachments (including a broker/dealer questionnaire). The APT US&C model investment policy, on the other hand, includes a few suggested components that the GFOA model investment policy does not, including a general policy statement, investment procedures, and investment pools/mutual funds.

#### IV. EXAMINATION OF SAMPLE & ACTUAL INVESTMENT POLICIES

**FIGURE 3**  
**Content of Model Investment Policies**

	GFOA	APTUS&C
Policy Statement		X
Governing Authority: Legality	X	
Scope: Pooling of Funds	X	X
General Objectives: Safety, Liquidity, and Yield	X	X
General Objectives: Local Considerations	X	
Standards of Care: Prudence	X	X
Standards of Care: Ethics and Conflict of Interest	X	X
Standards of Care: Delegation of Authority	X	X
Investment Procedures		X
Authorized Financial Institutions, Depositories, and Broker/Dealers	X	X
Authorized Financial Institutions (Minority and Community)	X	
Safekeeping and Custody: Delivery vs. Payment	X	X
Safekeeping and Custody: Third-party Custodian	X	X
Safekeeping and Custody: Internal Controls	X	X
Suitable & Authorized Investments: Types	X	X
Suitable & Authorized Investments: Collateralization	X	X
Suitable & Authorized Investments: Repurchase Agreements	X	
Suitable & Authorized Investments: Master Repurchase Agreements	X (in other documentation)	X
Investment Parameters: Diversification	X	X
Investment Parameters: Maximum Maturities	X	X
Investment Parameters: Competitive Bids	X	
Investment Pools/Mutual Funds		X
Reporting: Methods	X	X
Reporting: Performance Standards	X	X
Reporting: Marking to Market	X	
Policy Considerations: Exemption	X	
Policy Considerations: Amendments	X	
Approval of Investment Policy	X	X
Attachments	X	
Other Documentation	X	

### Local Agencies

#### *City Investment Policies*

CDIAC reviewed a random sample of investment policies from 30 of California's 478 incorporated cities. These policies were contrasted against the GFOA and APT US&C model investment policies (see Figure 4 below). The city investment policies surveyed included a discussion of most of the areas recommended in the GFOA and APT US&C policies. The exceptions (those areas that were contained in less than 2/3 of the cities surveyed) included legality, local considerations, minority and community institutions, collateralization, repurchase agreements, master repurchase agreements, competitive bids, reporting methods, marking to market, and exemption and amendments to the policy. In addition, the two industry standard investment policies recommend the inclusion of certain attachments and other documentation, which most cities do not include.

City investment policies do contain information not covered in the two model policies. The most common differences are listed in Figure 5 below. One-half of the city investment policies surveyed contained reference to prohibited investments. The model policies recommend language on what investment instruments are allowed. This language found in these city policies, in contrast, highlights those instruments that are specifically prohibited by law, ordinance, or policy. Other commonly included topics in city investment policies include developing a cash flow analysis and determining the availability of cash flows, developing a minimum credit requirement for institutions that are used to purchase or hold investments (as opposed to minimum credit requirements for the investments themselves), developing investment oversight committees, developing swap policies, maintaining a buy and hold philosophy as opposed to actively investing, prohibiting speculative investing, and requiring the treasurer to determine the social and political impact of investment options. Most cities also include a statement in their general objective of the goal of maintaining the public trust, which was not included in the model policies.

#### IV. EXAMINATION OF SAMPLE & ACTUAL INVESTMENT POLICIES

In addition to these commonly included topics, there are other, less common topics that may be of interest to some cities. These include information on calculation of earnings (a requirement in county investment policies), addressing GASB 31 (which concerns the reporting of investment assets and income for all investment portfolios held by governmental entities), requiring the investment policy to be certified by the APT US&C, and addressing Community Revitalization Act (CRA) compliance.



IV. EXAMINATION OF SAMPLE & ACTUAL INVESTMENT POLICIES

**FIGURE 4**  
**Comparison of GFOA/APT US&C Policies to City and County Samples\***

	City		County		
	Incidence	Percentage	Incidence	Percentage	
<b>Policy Statement</b>	29	96.7%	7	70.0%	
<b>Governing Authority</b> Legality	8	26.7%	7	70.0%	
<b>Scope</b> Pooling of Funds	27	90.0%	8	80.0%	
<b>General Objectives</b>	Safety	30	100.0%	9	90.0%
	Liquidity	30	100.0%	9	90.0%
	Yield	30	100.0%	9	90.0%
	Local Considerations	2	6.7%	0	0.0%
<b>Standards of Care</b>	Prudence	29	96.7%	7	70.0%
	<i>Ethics and Conflicts of Interest</i>	20	66.7%	10	100.0%
	Delegation of Authority	25	83.3%	7	70.0%
<b>Investment Procedures</b>	8	26.7%	2	20.0%	
<b>Authorized Financial Institutions, Depositories, and Broker/Dealers</b>	<i>Provide Information and Annual Review</i>	24	80.0%	9	90.0%
	Minority and Community	4	13.3%	1	10.0%
<b>Safekeeping and Custody</b>	Delivery vs. Payment	20	66.7%	7	70.0%
	Third-party Custodian	24	80.0%	9	90.0%
	Internal Controls	22	73.3%	6	60.0%
<b>Suitable and Authorized Instruments</b>	<i>Types</i>	30	100.0%	8	80.0%
	Collateralization	13	43.3%	3	30.0%
	Repurchase Agreements	3	10.0%	2	20.0%
	Master Repurchase Agreements	1	3.3%	1	10.0%
<b>Investment Parameters</b>	<i>Diversification</i>	24	80.0%	6	60.0%
	<i>Maximum Maturities</i>	22	73.3%	7	70.0%
	Competitive Bids	7	23.3%	2	20.0%
<b>Investment Pools/Mutual Funds</b>	3	10.0%	0	0.0%	
<b>Reporting</b>	<i>Methods</i>	9	30.0%	2	20.0%
	Performance Standards	28	93.3%	10	100.0%
	Marking to Market	5	16.7%	0	0.0%
<b>Policy Considerations</b>	Exemption	3	10.0%	0	0.0%
	Amendments	5	16.7%	2	20.0%
<b>Approval of Investment Policy</b>	22	73.3%	7	70.0%	
<b>Attachments</b>	12	40.0%	4	40.0%	
<b>Other Documentation</b>	0	0.0%	0	0.0%	
<i>Calculation and Apportionment of Costs</i>			9	90.0%	
<i>Terms and Conditions of Deposit for Voluntary Depositors</i>			9	90.0%	
<i>Criteria for Consideration of Requests to Withdraw</i>			9	90.0%	

\* Italicized categories are statutorily required for counties only.

## IV. EXAMINATION OF SAMPLE & ACTUAL INVESTMENT POLICIES

FIGURE 5

### Most Common Sections in City Policies

	Incidence	Percentage
Prohibited investments	15	50.0%
Public trust	5	16.7%
Cash flow and availability	4	13.3%
Credit requirements for institutions	4	13.3%
Investment oversight committee	3	10.0%
Swaps	3	10.0%
Buy and hold philosophy	2	6.7%
No speculative investments	2	6.7%
Social and political impact of investments	2	6.7%

### *County Investment Policies*

CDIAC reviewed a random sample of investment policies from ten of California's 58 counties. These policies were contrasted against the standard of the GFOA and APT US&C model investment policies (see Figure 4). Like cities, county investment policies surveyed included a discussion of most of the areas recommended in the GFOA and APT US&C model policies. The exceptions (those areas that were contained in less than two-thirds of the counties surveyed) mimicked the cities almost exactly and included local considerations, minority and community institutions, internal controls, collateralization, repurchase agreements, master repurchase agreements, competitive bids, reporting methods, marking to market, and exemption and amendments to the policy. In addition, like cities, the inclusion of certain attachments and other documents was not included in most county investment policies.

Counties, unlike cities in California, are able to establish investment pools that some local agencies (e.g., school districts) must statutorily use. Other local agencies voluntarily use these pools. State law requires that the county investment policies contain certain information regarding investment pools. Figure 4 highlights this mandated information in italics. Such required information includes topics above and beyond what is included in the GFOA and

#### IV. EXAMINATION OF SAMPLE & ACTUAL INVESTMENT POLICIES

APT US&C model policies, such as the calculation and apportionment of costs, terms and conditions of deposit for voluntary depositors, and criteria for consideration of requests to withdraw.

Like cities, counties investment policies also contained information not listed in the model policies. The most common ones are contained in Figure 6 below and include listing prohibited investments (90 percent), providing for a county treasury oversight committee (70 percent), and stating the desire to maintain the public trust (30 percent). These three topics were also commonly found in city investment policies sampled (see Figure 5). In addition to these common topics, there are other, less common ones that may be of interest to some counties. These include: disclosure of significant activities (bringing specific events to the attention of the legislative body or oversight committee if a specific threshold is met), methods for mitigating reinvestment risk (through duration and maturity diversification and limiting investment in mortgage-backed and callable securities), and specifically describing how the county should respond in the event of credit rating downgrades on investment instruments.

**FIGURE 6**  
**Most Common Sections in County Policies**

	Incidence	Percentage
Prohibited investments	9	90.0%
County treasury oversight committee	7	70.0%
Public trust	3	30.0%



V. CALIFORNIA MODEL LOCAL AGENCY  
INVESTMENT POLICY

**A**fter reviewing the investment policies submitted by California cities and counties, CDIAC has developed a separate model investment policy for California local governments. This model policy is “all-inclusive;” that is, it contains all of the elements of policies that CDIAC reviewed and determined would benefit local agencies in meeting their fiduciary requirements. Therefore, local agencies should review it and determine what elements best suit their needs and fiduciary responsibilities. Some may not be reflective of a local agency’s current investment strategy (e.g., a local agency that follows a passive investment strategy, investing solely in the State Local Agency Investment Fund, may not see a need for a section on “Competitive Bidding”). However, the model can still serve these agencies to help them in their annual review, providing them with areas to consider if their goals or practices are changing or may change in the near future.

The General Model Investment Policy may be used by all local agencies, in particular cities because they have no minimum legal requirements for the contents of their investment policies. CDIAC includes a section following the General Model Investment Policy entitled “Additional Investment Policy Issues for Counties” that highlights those sections required of counties under state law if they render an investment policy to their legislative bodies.

### General Model Investment Policy

- MISSION STATEMENT OR PURPOSE
- SCOPE OF POLICY
  - **Scope:** The policy should state that it governs the investment of money in a sinking fund or money in its treasury not required for the immediate needs of the local agency.
  - **Bond Proceeds:** The policy should specify how to invest bond proceeds. The policy should either defer how bond proceeds are invested to the bond documents, such as the bond indenture, or it should state, in a separate section, how bond funds should be invested.

- **LEGAL AUTHORITY**

- **Government Code Sections:** In general, the California Government Code (including Sections 16429.1 and 53601 et seq.) governs investment of most local agency funds. The policy should state the specific sections applicable to the local agency's investments.
- **Legislative Changes:** Legislative changes should be incorporated into the policy at least annually, specifying the California Government Code sections that have been added, deleted, or amended.

- **OBJECTIVES**

- **Safety:** The policy should state that the fund's primary objective is the preservation of principal. Capital losses should be avoided, whether from default or erosion of market value. There are two primary types of risks that should be minimized – credit risk (the risk that an issuer or other counterparty to an investment will not fulfill its obligations) and interest rate or market risk (the risk that changes in interest rates will adversely affect the fair value of an investment).
- **Liquidity:** The policy should state that the treasurer's objective also should be liquidity of the portfolio. The portfolio should remain sufficiently flexible to enable the treasurer to meet operating requirements that are reasonably anticipated. In order to ensure liquidity, an investment policy should recognize that calculating cash flows are the basis of any good investment strategy. Meeting the daily cash flow demand goes hand-in-hand with meeting the local agency's liquidity needs.
- **Yield:** The policy should state that the third objective (behind safety and liquidity) is attaining a market rate of return throughout budgetary and economic cycles.
- **Public Trust:** The policy should state that, while managing the portfolio, the treasurer and his staff will avoid any transactions that might impair public confidence in the local agency.

## V. CALIFORNIA MODEL LOCAL AGENCY INVESTMENT POLICY

- **Social and Policy Considerations:** The investment policy may incorporate language that takes into account any social and policy considerations that have been established by the governing body. For example, some cities have ordinances banning the investment of public funds in tobacco firms, nuclear energy, etc. These requirements may be explicitly spelled out in the policy.
- **GENERAL STRATEGY**
  - **Hold to Maturity:** The investment policy should document whether the treasurer will follow a passive or active investment strategy. Passive investment policies should adhere to the investment goal of holding investments to maturity. This is opposite the active investment strategy of buying and selling investments to achieve a certain benchmark objective. Great care (and perhaps a contract with a fiscal agent) should be followed with an active investment policy. In practice, many local agencies follow a combination of both types of investment strategies.
- **STANDARDS OF CARE**
  - **Prudent Investor Standard:** The investment policy should state that the treasurer and his/her staff will follow the Prudent Investor Standard as applied in the context of managing an overall portfolio.
  - **Ethics and Conflict of Interest:** The investment policy should set ethics and conflict of interest standards for officers and employees involved in the investment process. These parties should refrain from personal business activities that could conflict with proper execution of the investment program or which could impair their ability to make impartial decisions.
  - **Delegation of Authority:** The investment policy should explicitly describe the positions to which power to invest is delegated and also specify the time-frame for which such a delegation is valid. Such a delegatee is still required to adhere to the requirements set forth in the investment policy.

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- **Investment Oversight Committee:** The investment policy may contain a section on the investment oversight committee. Such a sections should specify the membership and responsibilities of this committee. The oversight committee's role is to notify the treasurer if changes to the policy are required and also when irregularities are seen in the investment report.

- **SAFEKEEPING AND CUSTODY**

- **Third-party Safekeeping:** The investment policy should contain a section dealing with the safekeeping of securities by a third-party and evidenced by safekeeping receipts. A third-party trustee should keep most, if not all, securities. Certain exceptions, such as for certificates of deposit, money market funds, or investment pools, may exist, and should be explained in the policy.

- **Internal Controls:** The investment policy should contain a section on the fund's internal controls. Internal controls are designed to ensure that the assets of the local agency are protected from theft, loss, or misuse. Such controls that should be considered include: control of collusion, separation of duties, safekeeping of securities, and written confirmation of telephone transactions and wire transfers.

- **Delivery vs. Payment:** The investment policy should contain a section requiring delivery vs. payment on investment transactions. All investment transactions should be conducted using standard delivery vs. payment procedures. In delivery vs. payment, the purchaser pays for the securities when they are delivered either to the purchaser or his/her custodian, and ensures that securities are deposited in an eligible financial institution prior to the release of funds.

- **AUTHORIZED FINANCIAL DEALERS AND INSTITUTIONS**

- **Authorized Financial Dealers and Institutions:** The investment policy should contain a section detailing the requirements for authorized financial dealers and institutions. The local agency should only conduct business with approved banks, savings and loans, credit unions, and securities dealers.



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To this end, a list of authorized financial dealers and institutions should be maintained. Broker/dealers and institutions should meet all requirements established by federal and state law.

- **SUITABLE AND AUTHORIZED INVESTMENTS**

- **Authorized Investment Types:** The investment policy should contain a list of authorized investment types. The local agency should look at its goals, objectives, and standards of care to establish a list of authorized investment types that also meet statutory requirements. Instead of referring to the California Government Code sections that specify legal investment instruments, local agencies should specify each instrument in which it can invest.
- **Prohibited Investment Types:** In addition to a listing of authorized investments, the investment policy should also contain a list of prohibited investments. California Government Code Section 53601.6 prohibits local agencies from investing in inverse floaters, range notes, or mortgage-derived, interest-only strips, and any security which could result in zero interest accrual if held to maturity. There may be additional investment instruments in which the legislative body does not want the treasurer to invest. To eliminate any ambiguity, the local agency should state that investments not specifically approved by the policy are prohibited.

- **INVESTMENT PARAMETERS**

- **Diversification of Investments:** The investment policy should contain a list of the maximum percentage of a portfolio that can be invested in each instrument. State law sets the maximum percentage in the case of some investment instruments. Local agencies may want to consider more stringent restrictions or further restrictions on other investment instruments, depending on their investment goals and risk tolerances.
- **Diversification of Issuers:** The investment policy should contain a list of the maximum percentage of an investment that can be invested in a specific issuer. State law sets the maximum percentage in the case of some

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investment instruments. Local agencies may want to consider more stringent restrictions or further restrictions on other investment instruments.

- ***Diversification of Institutions:*** The investment policy should contain a list of the maximum percentage of an investment that can be invested in a specific depository institution. State law sets the maximum percentage in the case of some investment instruments. For instance, state law restricts agencies from investing more than 30 percent of their funds in the bankers' acceptances of any one commercial bank. Local agencies may want to consider more stringent restrictions or further restrictions on other investment instruments.
- ***Maximum Maturity:*** The investment policy should list the maximum maturity of each investment instrument. State law sets the maximum maturity for certain investment instruments. If the law is silent, California Government Code Section 53601 states that the maximum maturity is five years, unless express authority is granted by the legislative body for the specific investment or is included as part of the investment program. Local agencies may want to consider more stringent restrictions on these instruments.
- ***Minimum Credit Requirements:*** The investment policy should list the minimum credit rating required for each investment. State law sets the minimum credit rating required for certain investment instruments. Local agencies may want to consider more stringent restrictions or further restrictions on other investment instruments.
- ***Maximum Weighted Average Maturity of a Portfolio:*** The investment policy should list the maximum weighted average maturity (WAM) or similar alternatives (such as duration) of a portfolio.<sup>6</sup> There are no requirements under state law for maximum WAM of a portfolio. CDIAC's Local Agency Investment Guidelines suggests that local agencies consider whether their investment policies should provide guidance on an acceptable range for these WAMs.
- ***Collateralization:*** In order to anticipate market changes and provide a level of security for all funds, the investment policy should contain collater-

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alization levels for certain investments. For example, state law requires securities underlying repurchase agreements to be valued at 102 percent or greater of the funds borrowed against those securities.

- **PORTFOLIO MANAGEMENT ACTIVITY**

- **Active or Passive Portfolio Management:** The investment policy should specify whether the treasurer follows an active or a passive portfolio management strategy (or a combination of the two). In active portfolio management, treasurers buy and sell securities based on how to maximize portfolio values over a given timeframe. In passive portfolio management, the goal is to match a market rate of return (usually a benchmark). Local agencies should consider their weigh the pros and cons of each strategy in light of their staff resources and investment goals.
- **Competitive Bidding:** The investment policy should ensure that investments are purchased in the most cost effective and efficient manner by using a competitive bidding process for the purchase of securities. Usually, competitive bidding is required from a pre-approved list of approved broker/ dealers on all investment transactions except for new issue securities.
- **Reviewing and Monitoring of the Portfolio:** The investment report should establish a reviewing and monitoring timeline to ensure that the investments are kept track of in a timely manner. In order to report the results of the portfolio investments, the treasurer needs to look at his or her investment practices and to monitor the results of such investments.
- **Portfolio Adjustments:** The investment policy should specify what actions should be taken when the portfolio goes out of alignment. For instance, should a concentration limitation be exceeded due to an incident such as a fluctuation in portfolio size, the affected securities may be held to maturity to avoid losses; however, the treasurer may choose to rebalance the portfolio earlier to bring it back into compliance if the portfolio will not suffer any losses for selling the investment prior to maturity.

<sup>6</sup> Duration is a measure of the price volatility of a portfolio and reflects an estimate of the projected increase or decrease in the value of that portfolio based upon an increase or decrease in interest rates.

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- **Performance Standards:** The investment policy should describe the investment objectives, usually to obtain a rate of return throughout budgetary and economic cycles, commensurate with investment risk constraints and cash flow needs. In addition, the policy should indicate a benchmark against which to compare the portfolio yield. There are a number of indices that could serve as a benchmark. They have various maturities (e.g., 1-3 year, 1-5 year, etc.) and asset allocations (e.g., Treasury only, Government only, Government/Corporate A-rated, etc.). They can be found in several families of indices such as Merrill Lynch, Lehman Brothers, Salomon Smith Barney, among others.

- **REPORTING**

- **Reporting Methods:** The investment policy should list a method of reporting investments that conforms to Government Code Section 53646 (b). California law sets minimum investment reporting standards, including listing the types of investment, issuer names, dates of maturity, par amounts, dollar amounts, market values, descriptions of programs under the management of contracted parties, a statement of compliance with the investment policy, and a statement of the ability to meet cash flow needs for six months.
- **GASB Statement 31 - Marking to Market:** The investment policy should state that the portfolio is to be marked to market on a timely basis and should specify how frequently it is market to market. GFOA recommends, in its report entitled “Mark-to-Market Practices for State and Local Government Investment Portfolios and Investment Pools,” that market values 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.<sup>7</sup> This is also consistent with GASB Statement 31, which requires that governmental entities report investments at fair value, and with the California Governmental Code, which also requires market values of investments be reported.

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- **Calculation of Yield and Costs:** The investment policy should specify how yield and costs are calculated. There are a wide variety of ways to measure yields and costs of a portfolio. In order to make an apples-to-apples comparison over time, the treasurer needs to define how yields and costs are calculated. For instance, yield can be yield to maturity, yield to cost, etc. Some examples of calculating the cost of a portfolio are par, market, and book value.
- **INVESTMENT POLICY ADOPTION, REVIEW, AND AMENDMENT:** The investment policy should specify when the policy is to be adopted (for instance, in the beginning of the new fiscal or calendar year), reviewed (recommended at least annually) and amended. The review should ensure that the policy is consistent with the overall objectives of preservation of principal, liquidity, and return, and is in conformance with the law, financial and economic trends, and the cash flow needs of the local agency.
- **DEFINITIONS OR GLOSSARY OF TERMS:** The investment policy should include a definition section because it is important that a common vocabulary be established between the treasurer, the legislative body, and the public. Some important definitions to consider including are investment types, measures of yield and cost, as well as the definitions of the various sections of the policy.

### Additional Investment Policy Issues for Counties

Per the California Government Code, counties should include these sections:

- **Limits on the receipt of honoraria, gifts, and gratuities:** County investment policies should include a section limiting the receipt of honoraria, gifts, and gratuities by the treasurer, his or her staff, and the oversight committee. The GFOA model investment policy includes a section entitled “Ethics and Conflict of Interest.” The requirements under the law for California counties specifically requires that the policy establish limits on the receipt of honoraria, gifts, and gratuities (an award given without service). The

<sup>7</sup> Such an independent source could include a broker or other financial institution that was not a counterparty to the transaction, the custodial bank if the bank was not a counterparty to the transaction, publicly available publications such as *The Wall Street Journal*, or other pricing services for which a separate fee would be paid.

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State Fair Political Practices Commission (FPPC) has currently set this value at \$360, but some local agencies have a lower limit. This section is meant to eliminate conflicts of interest.

- ***Calculating and apportioning costs of investing, depositing, banking, auditing, reporting, handling, or managing funds:*** The county investment policy should include a section detailing how the costs of administering the pool are calculated and apportioned. County pools have many contributors that should share in the cost of running the pool. Therefore, the county investment policy should determine how the costs of investing, depositing, banking, auditing, reporting, handling, or managing funds should be calculated and apportioned among these contributors.
- ***Terms and conditions under which local agencies may deposit funds for investment in county pool:*** The county investment policy should include a section describing the factors that the treasurer should take into consideration when determining whether or not to allow a local agency to invest in the county pool. Some local agencies are required to invest in county pools while others are voluntary contributors. Counties are required to specify the criteria it should follow for determining whether a voluntary contributor should be allowed to invest in the county pool. For instance, many counties require a finding that the inclusion of a voluntary contributor will not adversely affect the interests of the other depositors.
- ***Criteria for considering requests to withdraw funds from the county treasury (voluntary and non-voluntary contributors):*** The county investment policy should include a section describing the factors that the treasurer should take into consideration when determining whether or not to allow a local agency to withdraw funds from the pool. Counties are required to specify under what circumstances depositors should be allowed to withdraw their funds from the county pool. For instance, the policy may require the treasurer to evaluate each proposed withdrawal on a case-by-case basis. The requirements might include, a resolution by the legislative body requesting the withdrawal, a determination that such a withdrawal is consistent with the

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investment policy, and a determination that such a withdrawal will not adversely affect the interests of other depositors.

- **Investment Oversight Committee:** In addition to the information specified in the General Model Investment Policy above, this section of the policy should also contain a statement that the treasurer provide the committee with a copy of the investment report for the appropriate timeframe, as required by California Government Code Section 27130.





## APPENDIX A: INVESTMENT POLICY TERMINOLOGY

The following are examples of terminology commonly found in California city and county investment policies. The inclusion of these sections provides clarity to investment policies and better enables readers to understand important concepts. Most of them include a recommendation for implementation.

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**AUTHORIZED FINANCIAL DEALERS AND INSTITUTIONS:** List of financial institutions authorized to provide investment services. May also include a list of approved security broker/dealers with which the local government can do business can also be maintained. These institutions and broker/dealers are usually selected by their ability to add value to the investment process.

**Recommendation:** Some criteria to consider include creditworthiness, expertise, and the products in which the financial dealer or institution is familiar. GFOA suggests that all entities qualifying for investment transactions provide the local government with audited financial statements; proof of industry group (National Association of Securities Dealers [NASD]) certification; proof of state registration; completed broker/dealer questionnaire; and certification of having read, understood, and agreeing to comply with the investment policy.

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**COLLATERALIZATION:** Process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security. California Government Code Section 53601 requires that all repurchase agreements be secured by eligible securities with a market value of 102 percent or greater of the funds borrowed.

**Recommendation:** GFOA recommends and California Government Code requires that full collateralization be required on non-negotiable certificates of public deposit.

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**DELEGATION OF AUTHORITY:** The granting of authority to manage the investment program to designated officials. Such authority is usually derived from code sections, ordinance, charters, or statutes. Government Code Sec-

tion 53607, for example, allows the legislative body of a local government to delegate, for a one-year period, its authority to invest or reinvest funds or to sell or exchange securities held by the local government. Subject to Section 53607, Government Code Section 27000.1 allows a board of supervisors to delegate investment authority to the county treasurer.

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**DELIVERY VS. PAYMENT:** A type of securities transaction in which the purchaser pays for the securities when they are delivered either to the purchaser or his/her custodian. It ensures that securities are deposited in an eligible financial institution prior to the release of funds. Securities should be held by a third-party custodian as evidenced by safekeeping receipts.

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**DIVERSIFICATION:** A process of investing assets among a range of security types by sector, maturity, credit rating, and call type or structure. This reduces exposure to risk by combining a variety of investments, which are unlikely to all move in the same direction.

**Recommendation:** GFOA suggests diversifying a local agency investment portfolio by limiting investments to avoid exposure to a specific sector, limiting investment in securities with higher credit risks, investing in instruments with varying maturities, and continuously investing a portion of the portfolio in readily available funds such as a local government investment pool, money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained in order to meet ongoing obligations.

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**ETHICS AND CONFLICTS OF INTEREST:** The California Political Reform Act of 1974 requires certain designated public officials at all levels of government to publicly disclose their private economic interests and requires all public officials to disqualify themselves from participating in decisions in which they have a financial interest. As part of this requirement, local agencies are required to adopt and promulgate a Conflict of Interest Code, with certain required sections. To further promulgate this Code, investment policies sometimes include language requiring the ethical conduct of investment officers and statements



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regarding refraining 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.

**Recommendation:** To avoid conflicts, GFOA recommends that investment officers disclose material interests in financial institutions with which they do business, disclose personal financial interests that could be related to the performance of the investment portfolio, and refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the local government.

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**EXEMPTION:** Language that grandfathers prohibited investments into the investment policy because they may have been held in the portfolio prior to the prohibition.

**Recommendation:** When these investments mature or are liquidated, the money should be reinvested as provided by the policy and the exemption language should be removed from the policy.

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**GENERAL OBJECTIVES:** The section of an investment policy that illustrates the three main objectives (safety, liquidity, and yield), in order of priority, of a good investment policy. In addition to these commonly included objectives, there are a myriad of other objectives for which an investment policy can strive. Safety is the preservation of principal. Liquidity is how easily an investment may be redeemed for cash. Yield is the current rate of return on a security generally expressed as a percentage of its current price.

**Recommendation:** As per California Government Code Section 53600.5, safeguarding the principal of the funds under its control should be the primary objective of local agencies. Liquidity also should be a principal objective of a portfolio. The portfolio should maintain sufficient liquidity to meet operating requirements. To accomplish this, a local agency can structure a portfolio so that investments mature when cash is needed and also by investing in liquid securities with an active secondary market. Yield should be the last objective an investment port-

folio should strive for, behind safety and liquidity. Since there are many different ways for yield to be calculated, the investment policy should specify how it is to be calculated.

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**INTERNAL CONTROLS:** The system used to ensure that the local government assets are protected from loss, theft, or misuse. Such a system should provide a reasonable assurance that such loss, theft, or misuse can be prevented. Examples include separation of duties, delegation of authority, and documentation.

**Recommendation:** GFOA suggests that an internal control system address the following points: control of collusion, separation of transaction authority from accounting and recordkeeping, custodial safekeeping, avoidance of physical delivery of securities, clear delegation of authority to subordinate staff, written confirmation of transactions for investments and wire transfers, and development of a wire transfer agreement with the lead bank and third-party custodian.

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**INVESTMENT PARAMETERS:** Specified restrictions on investments to limit the amount of risk in a portfolio. These parameters may be specified in the California Government Code; however, the local agency may choose to further restrict investment options depending on its risk tolerance. Such parameters may include diversification of investments types, percentages, or dollar limits per issuer and setting maximum maturities.

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**INVESTMENT TYPES:** A recitation of the investment types the local agency has been given authority in which to invest. This may be a list of securities allowable under California Government Code Section 53601 et seq., and may be further restricted by the agency itself. For a description of the allowable California local agency investment instruments, please see CDIAC's latest version of its *Local Agency Investment Guidelines*, available on its website at [www.treasurer.ca.gov/cdiac](http://www.treasurer.ca.gov/cdiac).

**Recommendation:** GFOA recommends the investment in the following types of securities: U.S. government securities and agency obligations; highly-rated cer-

## APPENDIX A: INVESTMENT POLICY TERMINOLOGY

tificates of deposit, bankers' acceptances, commercial paper; investment-grade state and local government obligations; repurchase agreements securitized by the previously-mentioned securities; SEC-regulated, dollar-denominated money market mutual funds; and local government investment pools.

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**MARKING-TO-MARKET:** The act of recording the price or value of a security to reflect its current market value rather than its book value.

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**MAXIMUM MATURITIES:** Maturity is the date on which the security or obligation is redeemed by the issuer in exchange for cash. California law states that local governments cannot invest in instruments with terms remaining to maturity in excess of five years unless they receive express authority from their legislative bodies to do so.

**Recommendation:** Local governments should attempt to match investment maturities with anticipated cash flow requirements. There is no requirement under California law for local governments to have a WAM restriction for their portfolio, although CDIA's *Local Agency Investment Guidelines* suggests that local agencies consider adopting a WAM restriction.

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**PERFORMANCE STANDARDS:** The criteria by which a stated goal is measured.

**Recommendation:** An investment portfolio's performance and risk exposure should be evaluated against appropriate benchmarks on a regular basis. One standard that should be strived for should be a market rate of return in a given interest rate environment.

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**POLICY CONSIDERATIONS:** The local ordinances or other requirements that place restrictions on the policy.

**Recommendation:** Local governments should consider what should be exempted from the policy and also when, or under what circumstances, the policy should be amended.

**POOLING OF FUNDS:** A statement in the investment policy that except for certain restricted or special funds, cash balances should be consolidated from all funds to maximize investment earnings.

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**PRUDENT INVESTOR STANDARD:** Legal maxim that all investments should be made with care, skill, prudence and diligence under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the professional management of their business affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

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**REPORTING:** Presentation of evaluation data or other information to communicate processes, roles, and results.

**Recommendation:** Investment policies should include reporting requirements such as methods of reporting investments, the standards against which investments should be reported, and the requirement for calculating market value.

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**REPORTING METHODS:** Ways in which investment outcomes are reported including listing of instrument values, dollar value returns, percentage yields, etc.

**Recommendation:** GFOA suggests that local governments prepare investment reports at least quarterly. In California, investment reports are no longer required to be submitted to legislative bodies. This requirement is now permissive. If a local government chooses to submit an investment report in accordance with California Government Code Section 53646 to their legislative bodies, they are still required to submit copies to CDIAC for the second and fourth quarter of every calendar year until January 1, 2007. GFOA goes on to list some suggested components of investment reports including listing of securities, gains and losses, average weighted yield to maturity as compared to benchmarks, listing of investment by maturity date, and percentage of the total portfolio which each type of investment represents.

## APPENDIX A: INVESTMENT POLICY TERMINOLOGY

**RISK:** Two of the most common risks associated with local government portfolio investing are credit risk and interest rate risk. Credit risk is the risk to an investor that an issuer will default in the timely payment of interest and/or principal on a security. Interest rate risk is the risk that the market value of securities in the portfolio will fall due to changes in general interest rates.

**Recommendation:** Credit risk can be minimized by limiting investment to the safest types of securities, pre-qualifying financial institutions, broker/dealers, and others with which the local agency will do business, and diversifying the number of issuers in an investment portfolio. Interest rate risk can be minimized by structuring the portfolio so that investments mature at the same time that cash is required or investing operating funds in highly liquid, shorter-term securities (e.g., U.S. Treasury bills or notes).

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**SAFEKEEPING AND CUSTODY:** Rules derived to ensure the safety of an investment and within whose control the investment resides. Some examples include third-party safekeeping, developing lists of authorized financial dealers and institutions, developing internal controls, and using a delivery vs. payment standard for transactions.

**Recommendation:** Local agencies should consider requiring securities to be held by third-party custodians, evidenced by timely statements illustrating the balance held by these custodians.

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**SCOPE:** The types of funds that the policy covers (e.g., operating funds, bond proceeds, etc.). In general, investment policies cover short-term operating funds. Longer-term funds such as retirement funds are covered by other policies. The investment of bond funds usually is governed by the bond documents such as the trust indenture.

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**STANDARDS OF CARE:** The degree of care that a reasonably prudent person would exercise in the investment of local agency funds.



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**Frank Moore**, *Senior Research Specialist*, CDIAC Policy Research Unit.

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**Jane W. Thompson**, *CDIAC Executive Director*;

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## California Debt and Investment Advisory Commission

915 Capitol Mall, Room 400  
Sacramento, CA 95814

phone: 916.653.3269

fax: 916.654.7440

e-mail: [cdiac@treasurer.ca.gov](mailto:cdiac@treasurer.ca.gov)

internet: [www.treasurer.ca.gov/cdiac](http://www.treasurer.ca.gov/cdiac)

