

ADVANCED PUBLIC FUNDS INVESTING



WEBINAR 6 | REGULATORY CHANGES & CURRENT TOPICS

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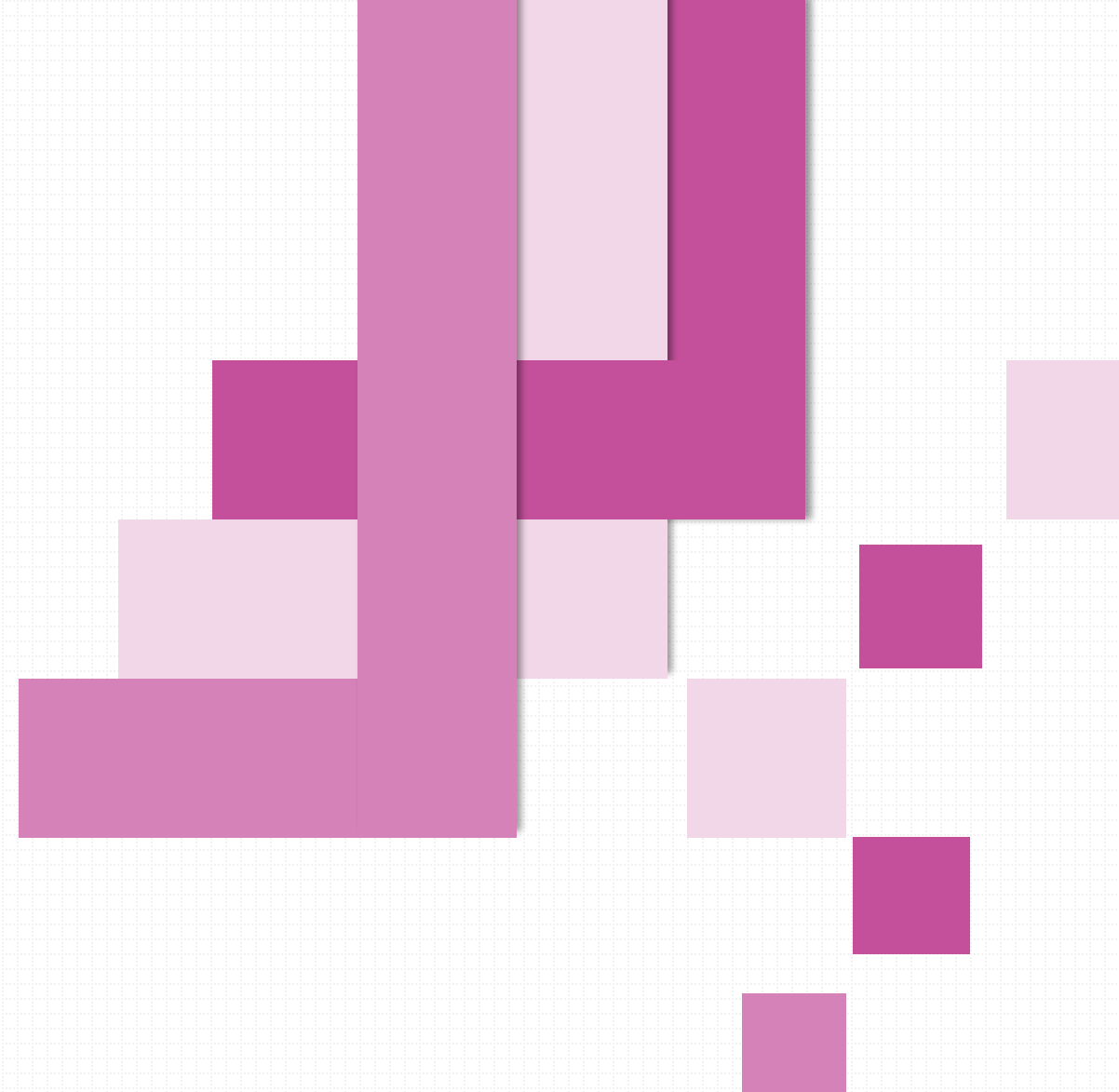


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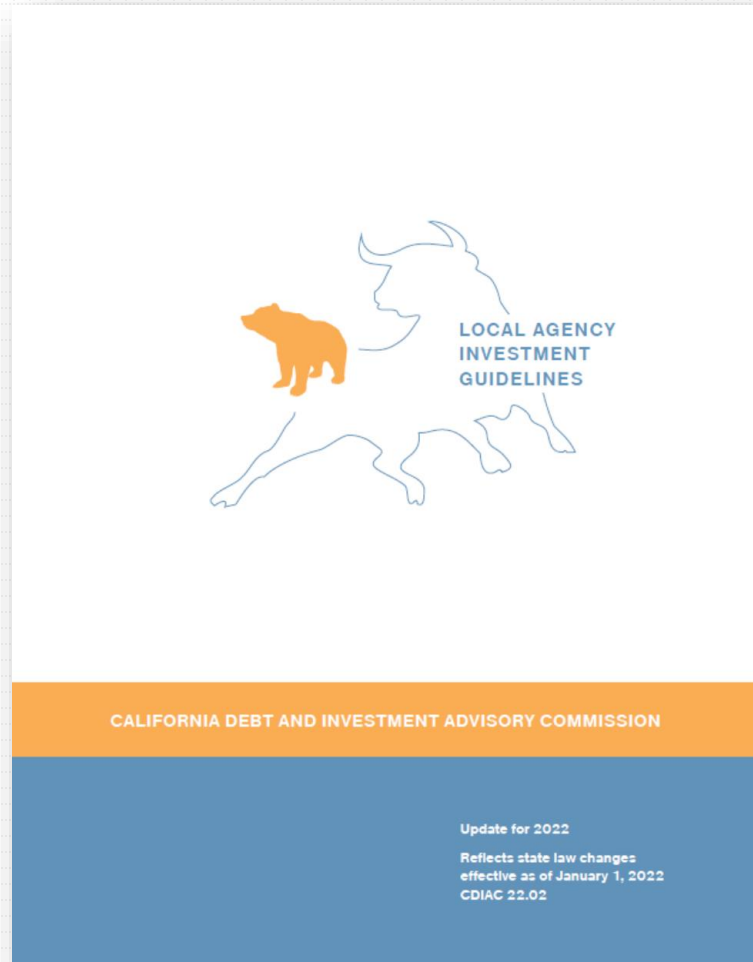
LEGISLATIVE UPDATES

Angelica Hernandez

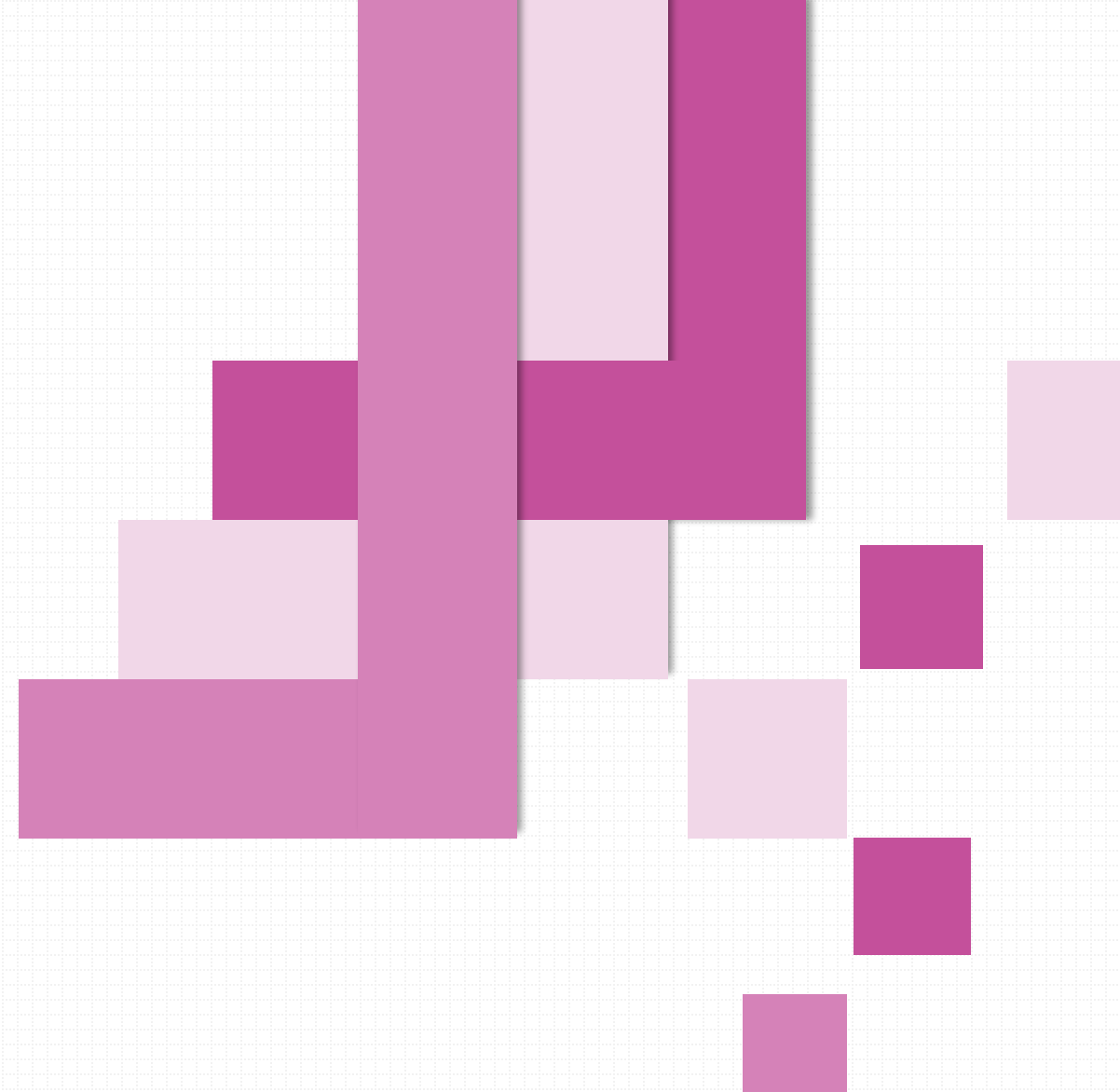
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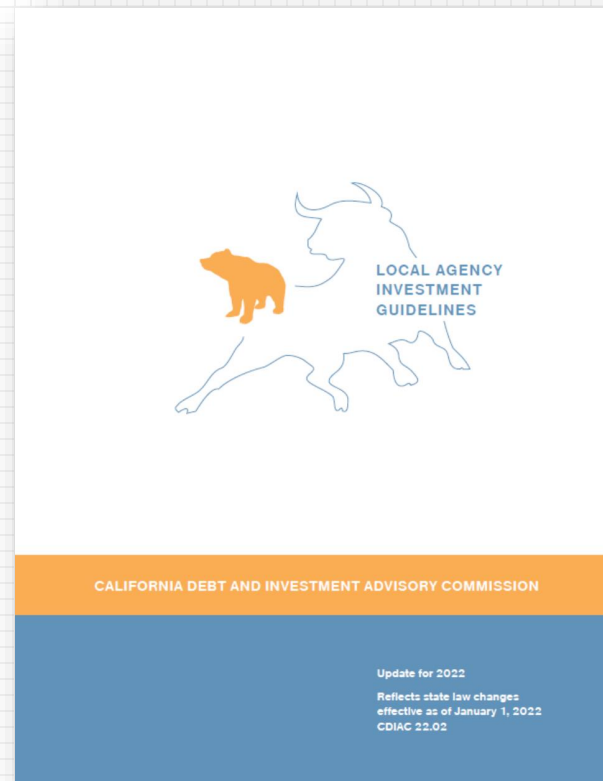
What's New in 2022?



<https://tinyurl.com/CDIACLAIG>



Local Agency Investment Guidelines (LAIG)



What is LAIG?

- Provides references and recommendations for interpreting and applying California statute to common public fund investment topics related to local agencies.
- Provides information on recent changes in state law.
- Updated annually.

LAIG: Question and Answer Format

LAIG Table of Contents:

Chapter 1: The Investment Policy

Chapter 2: Fund Management

Chapter 3: Reporting Requirements

Chapter 4: Treasury Oversight Committees

California Government Code (excerpt of related statutes)

Glossary (Investment related terms)

Index of Statutory Changes

Index

Figures

II. J Are bonds Issued by departments and financing authorities of the State of California permissible investments for local agencies?[Section 53601(c)]

Securities issued by the State of California are permissible investments for local agencies under Section 53601(c). However, questions arise when considering whether bonds issued by departments or financing authorities of the State are also permissible under this section.

MINIMUM LEGAL REQUIREMENTS:

Section 53601(c) permits a local agency to invest in registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state.

CONSENSUS RECOMMENDATION:

There are two conditions that a bond could meet to be a permissible investment under Section 53601(c). The first part of Section 53601(c), "state warrants, treasury notes and bonds of this state", refers to bonds issued by the State of California, for instance, general obligation bonds. This was the operative code section prior to the state's issuance of revenue bonds.

The last part of the code section broadens the definition of permissible investments to include, "bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or a department, board, agency, or authority of the state". This describes state-issued revenue bonds. Issuance by a state authority or instrumentality alone is inadequate to meet the conditions in Section 53601(c) as the source of revenue for repayment must meet the qualifier included in the code section. For a security issued by a state authority or department, are the underlying agreements considered property owned/controlled/operated by the state? In general, if a public agency intends to purchase bonds issued by a state authority or department that are not clearly revenue bonds, an agency should consult counsel on the permissibility of such an investment.

LAI: Figure 1

- Summarizes local agency permissible investments per the Government Code.
- Figure 1 includes a Table of Notes for Figure 1.

FIGURE 1

ALLOWABLE INVESTMENT INSTRUMENTS PER STATE GOVERNMENT CODE (AS OF JANUARY 1, 2022)^A APPLICABLE TO ALL LOCAL AGENCIES^B

See "Table of Notes for Figure 1" on the next page for footnotes related to this figure.

INVESTMENT TYPE	MAXIMUM MATURITY ^C	MAXIMUM SPECIFIED % OF PORTFOLIO ^D	MINIMUM QUALITY REQUIREMENTS	GOVT CODE SECTIONS
Local Agency Bonds	5 years	None	None	53601(a)
U.S. Treasury Obligations	5 years	None	None	53601(b)
State Obligations—CA And Others	5 years	None	None	53601(c) 53601(d)
CA Local Agency Obligations	5 years	None	None	53601(e)
U.S Agency Obligations	5 years	None	None	53601(f)
Bankers' Acceptances	180 days	40% ^F	None	53601(g)
Commercial Paper—Non-Pooled Funds ^F (under \$100,000,000 of investments)	270 days or less	25% of the agency's money ^A	Highest letter and number rating by an NRSRO ^H	53601(h)(2)(c)
Commercial Paper—Non-Pooled Funds (min. \$100,000,000 of investments)	270 days or less	40% of the agency's money ^A	Highest letter and number rating by an NRSRO ^H	53601(h)(2)(c)
Commercial Paper—Pooled Funds ^I	270 days or less	40% of the agency's money ^A	Highest letter and number rating by an NRSRO ^H	53635(a)(1)
Negotiable Certificates of Deposit	5 years	30% ^J	None	53601(i)
Non-negotiable Certificates of Deposit	5 years	None	None	53630 et seq.
Placement Service Deposits	5 years	50% ^K	None	53601.8 and 53635.8
Placement Service Certificates of Deposit	5 years	50% ^K	None	53601.8 and 53635.8

LAI: Index of Statutory Changes

- Index currently starts in 1995.
- Index was added a few years ago.
- Knowing when a change was made, can help understand legislative intent.

Index of Statutory Changes Effective 1996 to Present

1995

[SB 564](#) AUTHOR: JOHNSTON SECTION(S): 53646

Summary of Changes: Requires treasurers to produce an annual investment policy and provide detailed quarterly investment reports.

[SB 866](#) AUTHOR: CRAVEN SECTION(S): 53601, 53635
AND 53859.02

Summary of Changes: Authorizes the County Board of Supervisors to delegate investment authority to the County Treasurer and requires board to establish a treasury oversight committee (with specific membership requirements). Requires delivery of securities by book entry, physical delivery or third-party custodial agreement. Specifies funds invested for repayment of notes cannot exceed the term of the notes. Lastly, sets requirements for those elected or appointed to county auditor, director of finance and county treasurer.

1996

[SB 864](#) AUTHOR: CRAVEN
AND KILLEA SECTION(S): 27000.7,
27131, 27132.1, 27132.2,
27132.3, 27136, 53601,
53601.6, 53635 AND
53646

LAIG: Summary of Changes for 2022

- **Statutory Changes: No change.**
 - No state or federal legislation was passed that impacted the local government investment related code sections.
- **Regulatory Changes: No change.**
 - No changes in federal regulations that impacted public fund investing.
- **Recommended Best Practices:**
 - Changes made to the Local Agency Investment Guidelines (LAIG) for 2022.

LAIG: Update for 2022

Addition of discussion and consensus recommendation regarding securities issued by departments or authorities of the State of California, Government Code Section 53601(c).

*53601(c) **Registered state warrants or treasury notes or bonds of this state**, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state.*

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LAI: Update for 2022

- Removal of a paragraph related to a 2020 temporary federal rule change (IRS Notice 2020-25) that extended the holding period for variable rate debt subject to a qualified tender purchased by the issuing agency was deleted. The time-limited authority of the temporary rule change expired.



HOW TO STAY UPDATE - TO - DATE THROUGHOUT THE YEAR?

On an ongoing basis CDIAC tracks legislation at both the state and federal level and follows federal regulatory efforts. This information is available on CDIAC's website.

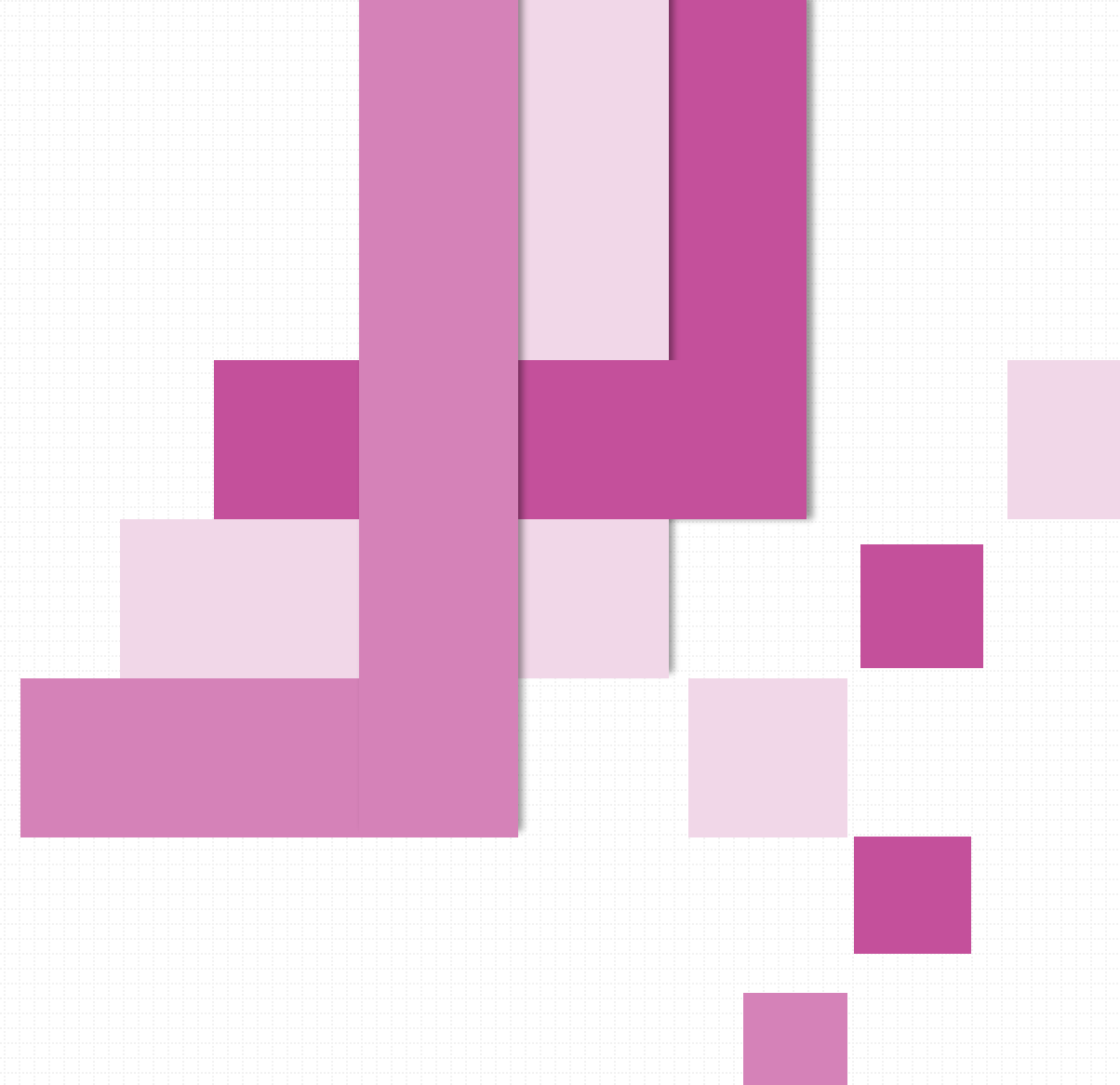
For 2022 CDIAC is Following:

- State legislation: Legislative Update published as part of Debt Line.
- Federal Regulations: Regulatory Activity Calendar is published month with Debt Line.
 - The SEC proposed amendments to Money Market Fund Rules.
- CDIAC's Regulatory Resources for Municipal Issuers (MMRA) webpage:
www.treasurer.ca.gov/cdiac/mmra/index.asp

CURRENT TOPIC

Monique Spyke

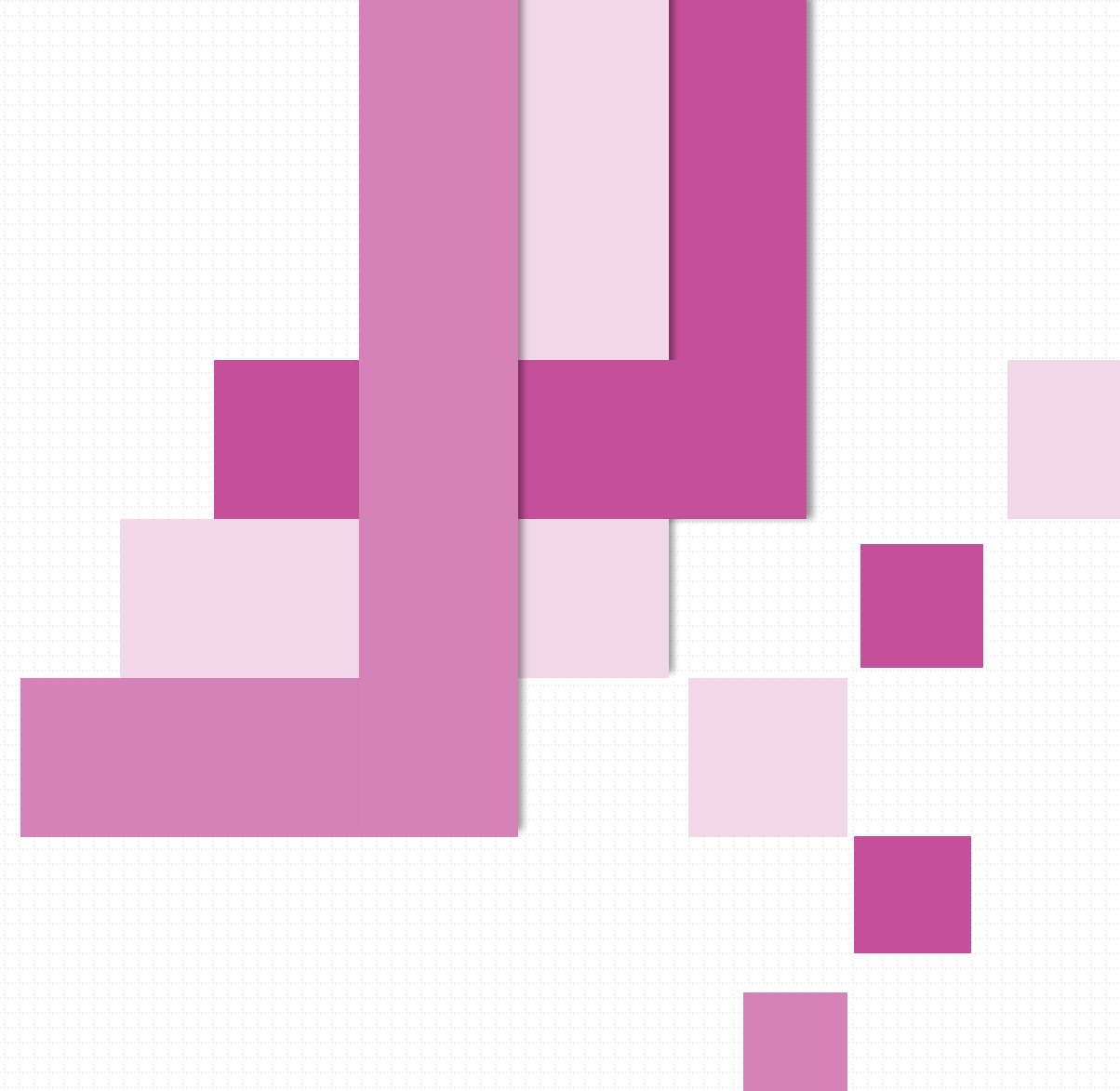
Managing Director | PFMAM



Session Overview

This year's current topic is sophisticated approaches to investment management, such as **structured agreements** and other innovative, yet often complex, strategies that may require internal deliberation and legal counsel.

The discussion may include the use of California Government Code in a more sophisticated manner, such as leveraging opportunities afforded by the updated accredited investor and **qualified institutional buyer (QIB)** rules, as well as the use of technology to manage investment operations and an exploration of grey areas in Code that pose challenges to local agencies.



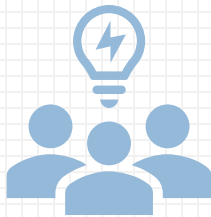


Updated QIB Rules

Why did the SEC enact these changes?



- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2013
 - Harmonize private/public market approaches
 - Simplify capital raising



- Input from issuers, investors and the general public

What are the highlights of the new rule?

Expands access for local governments to private market securities

- Commercial paper
- Negotiable bank deposits
- Corporate bonds

Qualification based on sophistication or size rather than type of entity

Investors must meet an asset test

Accredited investor: Control at least \$5 million in assets
QIB: Own at least \$100 million of securities

Why are these changes important?

- Issuers have increasingly resorted to private market securities
- Government investors were not able to participate in these markets
- Access to private market securities means:
 - ✓ Expanded investment options for government investors
 - ✓ Potential for greater diversification
 - ✓ Enhanced market liquidity

What is the downside or risk to these rule changes?

Private market securities tend to be:

- Less liquid
- More complex
- Less credit-worthy issuers may favor private market issuances

These securities necessitate an extra



layer of due diligence

What should I consider about commercial paper?

GFOA cautions investors to carefully consider:

Does our policy permit it?

Do we have the internal resources?

There are different structures:

Corporate promissory notes

Asset-backed commercial paper

Develop **policies and procedures** to manage the associated risks.

Risk Management is Important

The new rule does **not** alleviate the need for best practices, including:

- Develop policies and procedures
- Diversify by issuer, sector and maturity
- Perform credit research and monitoring
- Stay disciplined to an investment strategy

POLLING QUESTION

Was your investment program impacted by the recent QIB changes?



What other opportunities
are we missing?

Investment Universe vs. California Government Code

Securities	1 Day	180 Days	270 Days	1 Year	5 Years	Over 5 Years
U.S. Treasuries	✓ Permitted					Requires Approval
Federal Agencies	✓ Permitted					Requires Approval
Municipal Securities	✓ Permitted					Requires Approval
Negotiable Certificates of Deposit	✓ Permitted					Requires Approval
Commercial Paper	✓ Permitted			X Prohibited		
Bankers' Acceptances	✓ Permitted		X Prohibited			
Medium-Term Corporate Notes	✓ Permitted					X Prohibited
Asset-Backed Securities (ABS)	✓ Permitted					X Prohibited
Supranationals	✓ Permitted					X Prohibited
Repurchase Agreements	✓ Permitted				X Prohibited	
Money Market Funds/Bond Mutual Funds	✓ Permitted	X Prohibited				
Local Government Investment Pools	✓ Permitted	X Prohibited				
Foreign Sovereign						X Prohibited
Fixed-Income ETFs						X Prohibited
High-Yield Bonds						X Prohibited
Private Placements						X Prohibited
Convertibles						X Prohibited
Non-U.S. Dollar Investment Grade						X Prohibited
Emerging Markets Debt						X Prohibited
Bank Loans						X Prohibited
Domestic Equities (Large, Mid, Small Cap)						X Prohibited
International Equities (Large, Mid, Small Cap)						X Prohibited
Emerging Markets						X Prohibited
Preferred Stock						X Prohibited
Equity Mutual Funds and ETFs						X Prohibited
Commodities						X Prohibited
Real Estate						X Prohibited
Hedge Funds						X Prohibited
Private Equity						X Prohibited
Venture Capital						X Prohibited
Tangible Assets						X Prohibited
Complex Derivatives						X Prohibited

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What Does the Government Code Expressly Prohibit?

- Inverse floaters
- Range notes
- Mortgage-derived, interest-only strips

What are our concerns?

Inflation



Rising Costs



Volatility and Market Risk



Future Return Expectation



First, A Structured Products Advisor Perspective

- Structured and customizable products are a potential avenue for sophisticated investors
- Employing structured products in an investment portfolio requires specialized knowledge and swift market access
- Given the complexity of structured products, PFMAM maintains a dedicated group of four strategists, including three CFA charterholders
- Strategies should be highly customized

Active Management

Manage & adjust portfolios over time based on cash flow needs and market conditions

Passive Strategies

One-time procurements to meet cash flow requirements without ongoing management

Considerations for Structured Investments

Benefits

- ▶ Fully customizable
- ▶ Agreements can be structured to include downgrade triggers and collateralization requirements
- ▶ May provide exposure to infrequent issuers
- ▶ Potential to utilize different coupon structures
- ▶ Typically valued at par, which may limit interest rate risk

Risks

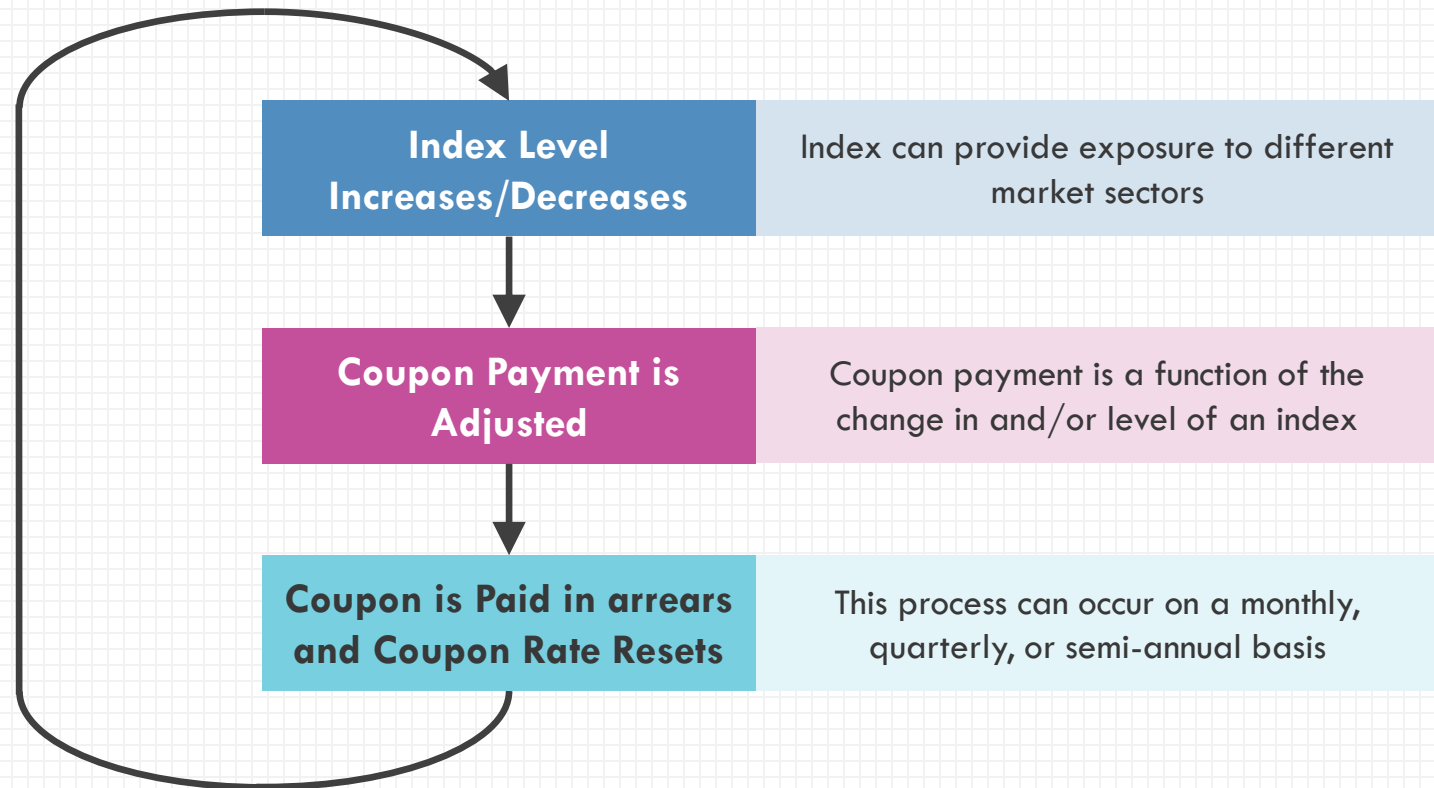
- ▶ Credit and bankruptcy risk
- ▶ Lack of pricing transparency and limited liquidity due to reduced provider participation and lack of secondary market
- ▶ Customization premium reduces return, particularly for secured structures
- ▶ Two-way collateralization may be required based on creditworthiness of investor
- ▶ Requires extensive analysis to determine relative value versus other alternatives and in-depth conversations with counsel

Applications

- ▶ Lock in rate of return on future cash flows and/or deposits
- ▶ Achieve exposure to an area of the yield curve potentially without taking on interest rate risk
- ▶ Use of floating- or variable-rate coupons, including potential exposure to different indices
- ▶ More complex coupon structures and/or underlying indices will have less provider participation

What a Variable Rate Coupon Looks Like

Deposit agreement with floating coupon



POLLING QUESTION

Does your agency currently use structured investments?

Potential Implementations of Variable Rate Coupons

Repurchase Agreements

Deposit Agreements

Forward Delivery Agreements

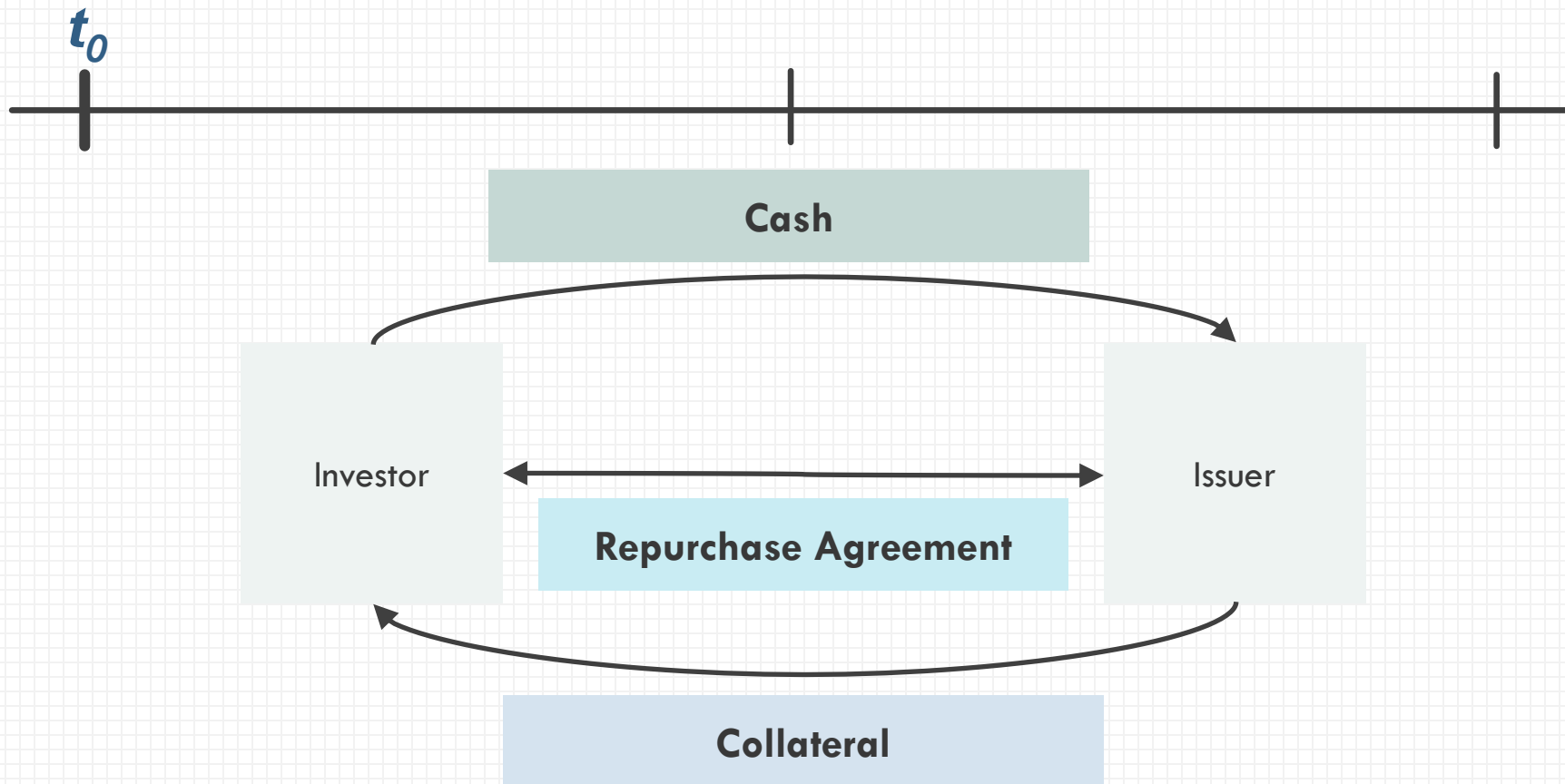
REPURCHASE AGREEMENTS

California Government Code Section 53601 (j)

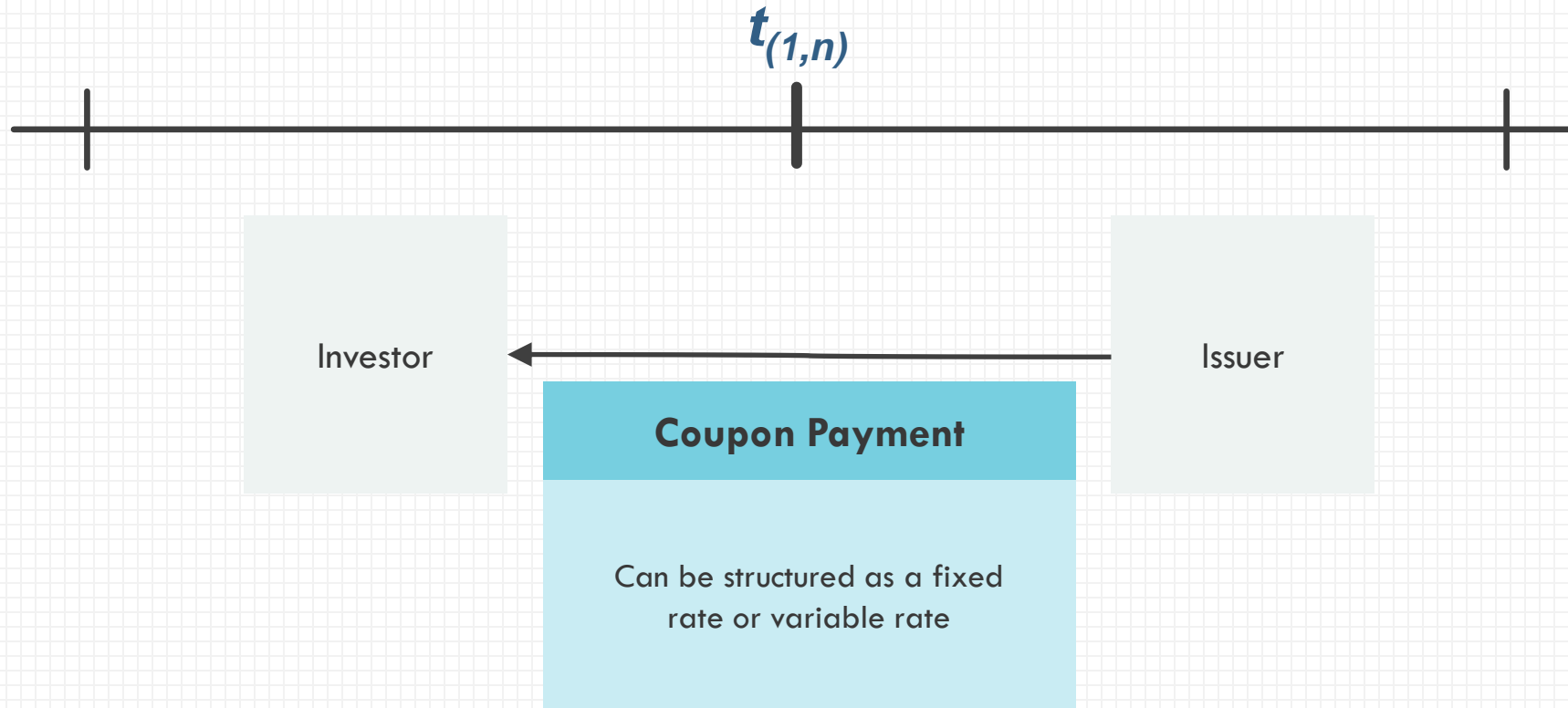
California
Government Code
53601

(j) Investments in repurchase agreements or reverse repurchase agreements or securities lending agreements of securities. . .

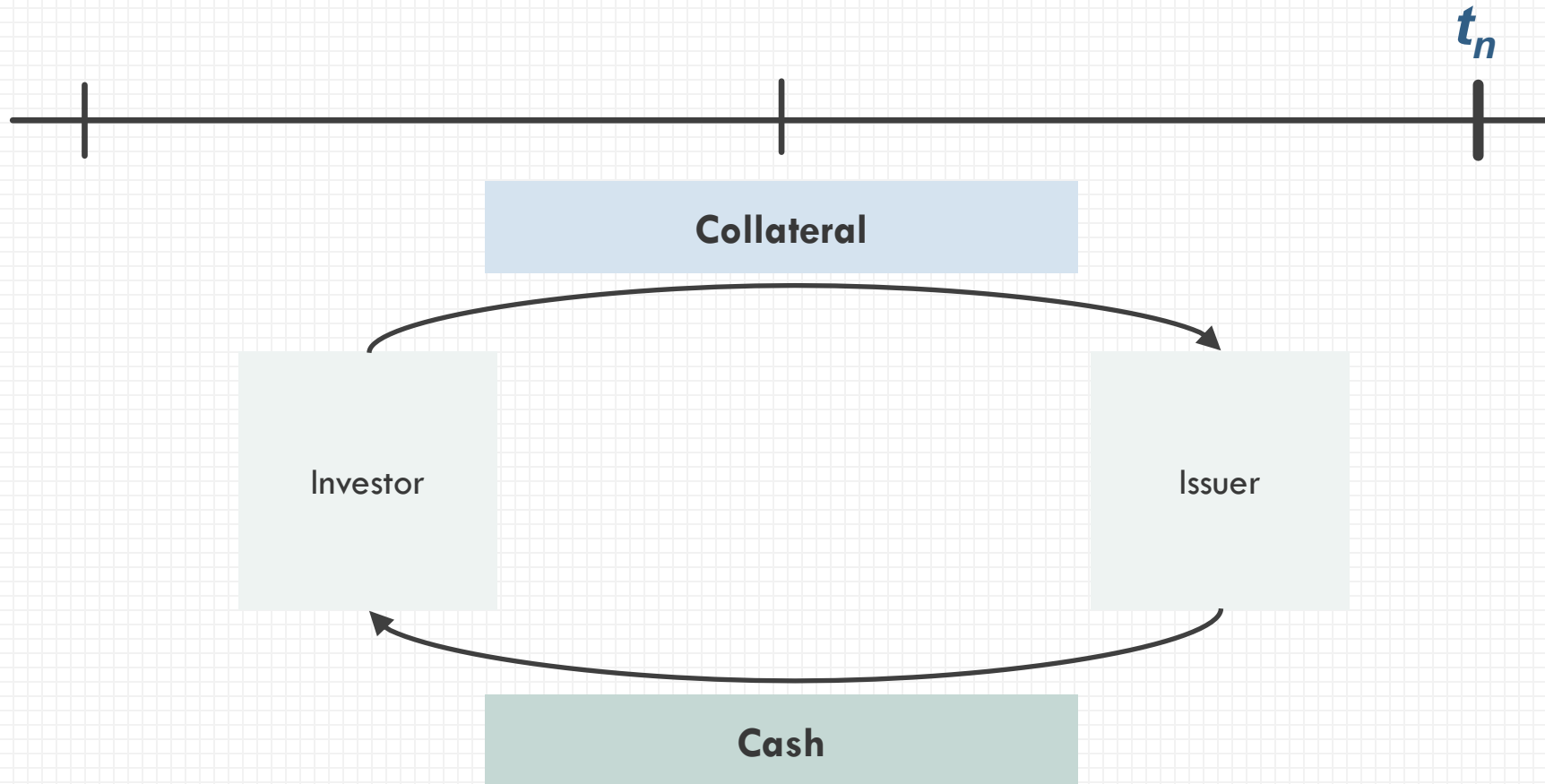
Repurchase Agreement Illustration



Repurchase Agreement Illustration



Repurchase Agreement Illustration



Additional Thoughts & Considerations

Repurchase Agreements

- 1** Cost of funding collateral is prohibitive in current interest rate environment
- 2** Limited provider universe and no secondary market – complex coupon structures may have limited or no providers
- 3** Extensive negotiation of agreement documentation required
- 4** Collateralization by investor of negative mark-to-market values in between payment and/or coupon reset dates may be required
- 5** Agreements maturing beyond one year are treated differently than shorter-maturing/overnight repurchase agreements in the event of an issuer bankruptcy

DEPOSIT AGREEMENTS

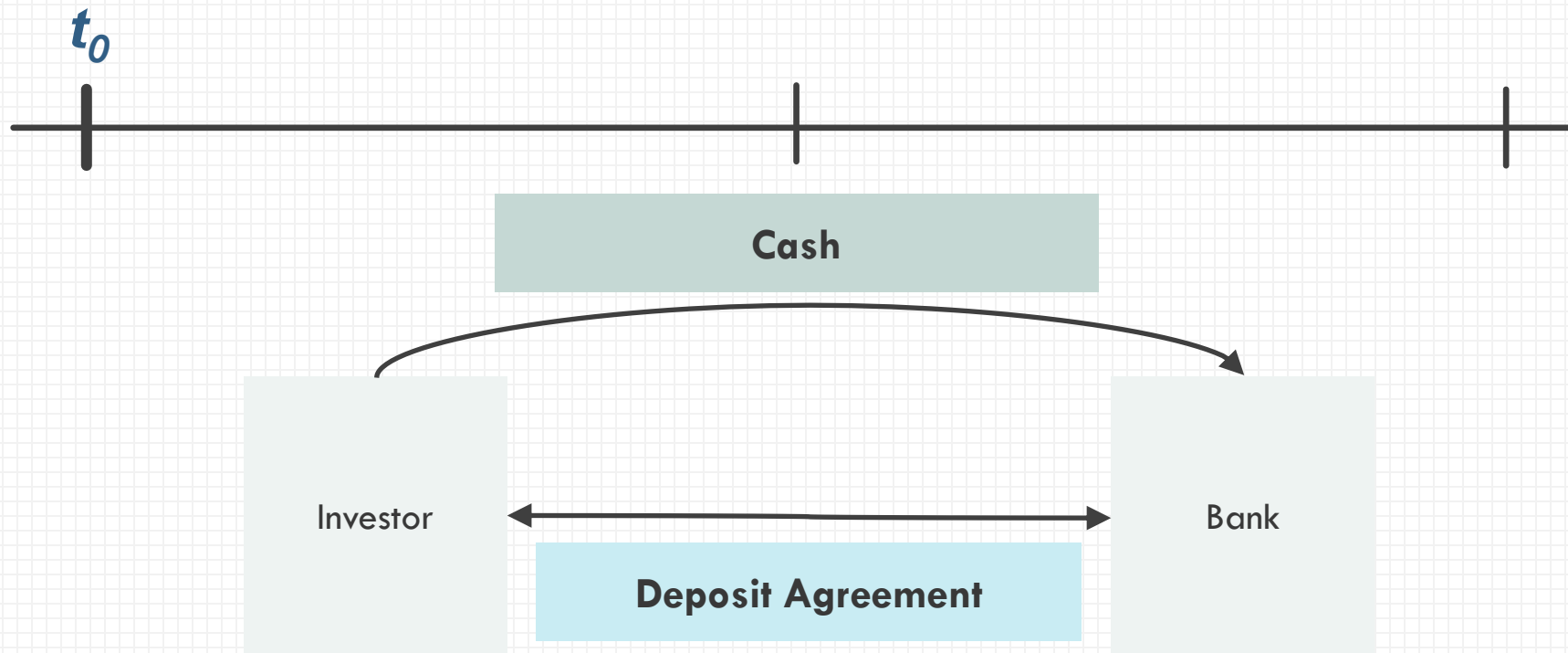
California Government Code Sections 53601 (i) and (k)

California
Government Code
53601

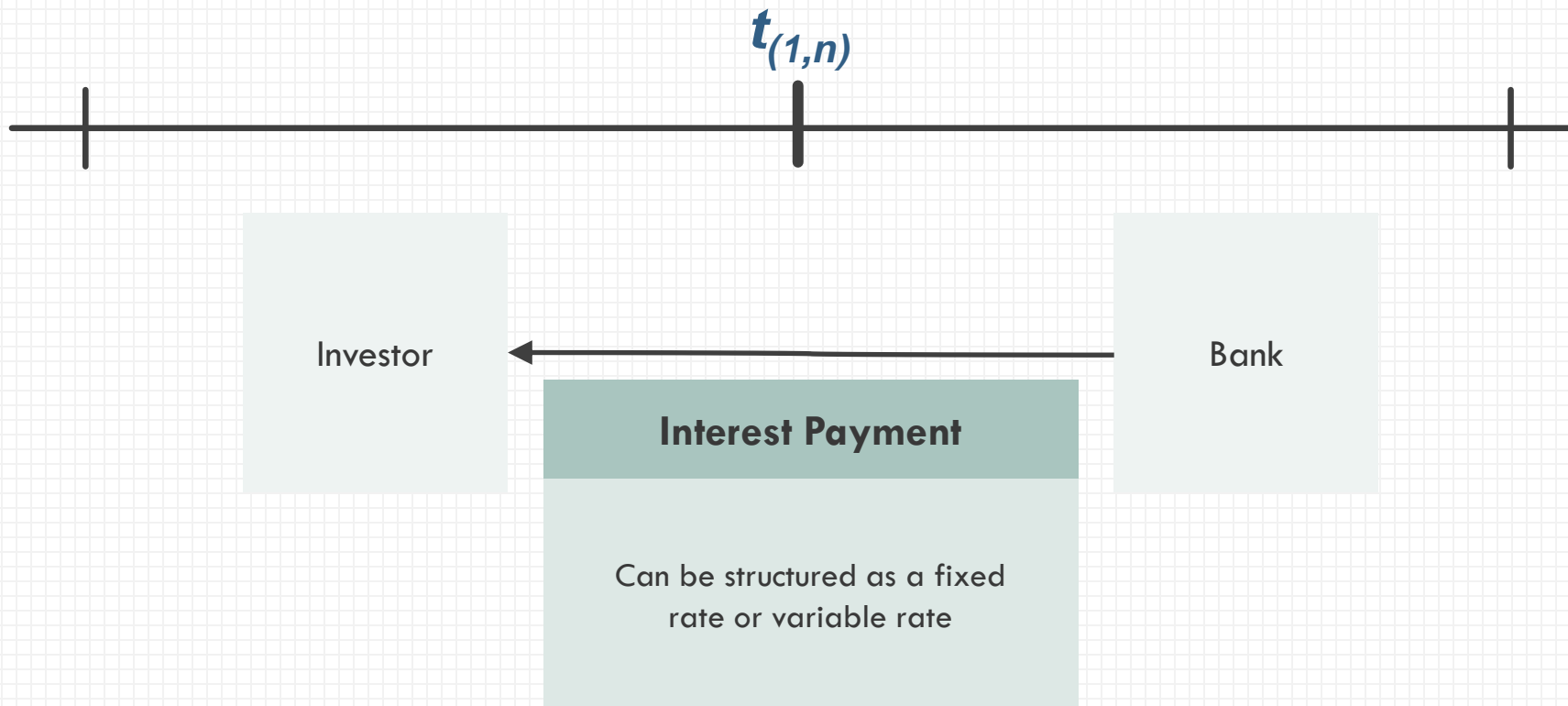
(i) Negotiable certificates of deposit issued by a nationally or state-chartered bank, a savings association or a federal association (as defined by Section 5102 of the Financial Code), a state or federal credit union, or by a federally licensed or state-licensed branch of a foreign bank.

(k) Medium-term notes, defined as all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States.

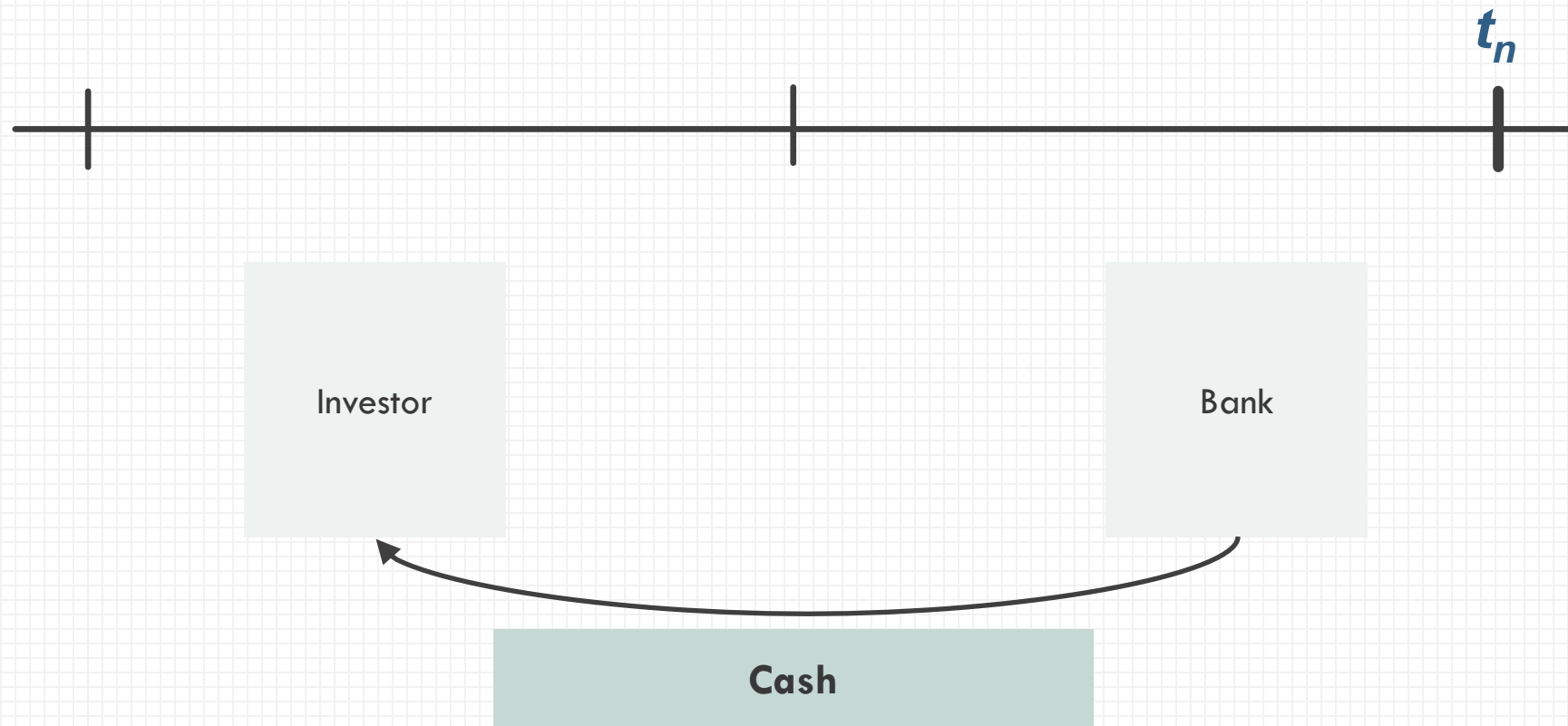
Deposit Agreement Illustration



Deposit Agreement Illustration



Deposit Agreement Illustration



Additional Thoughts & Considerations

Deposit Agreements

- 1** Credit risk and initially unsecured nature underscores importance of diversification and reducing concentration risk
- 2** Complex coupon structures may have limited or no providers
- 3** Determination of permissibility will require extensive conversations with counsel and supplemental legal opinions may be required by providers
- 4** Collateralization by investor of negative mark-to-market values in between payment and/or coupon reset dates may be required

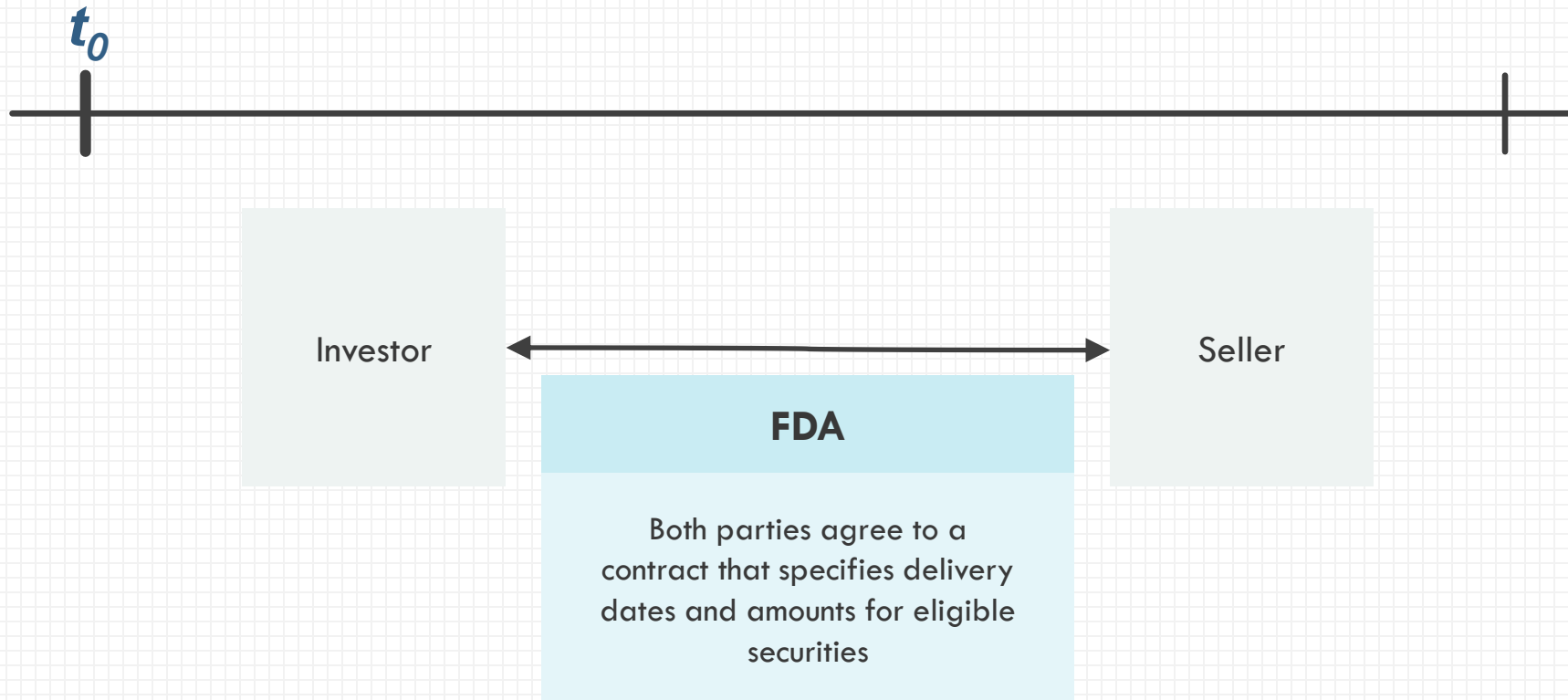
POLLING QUESTION

When do you believe it's appropriate to use structured investments?

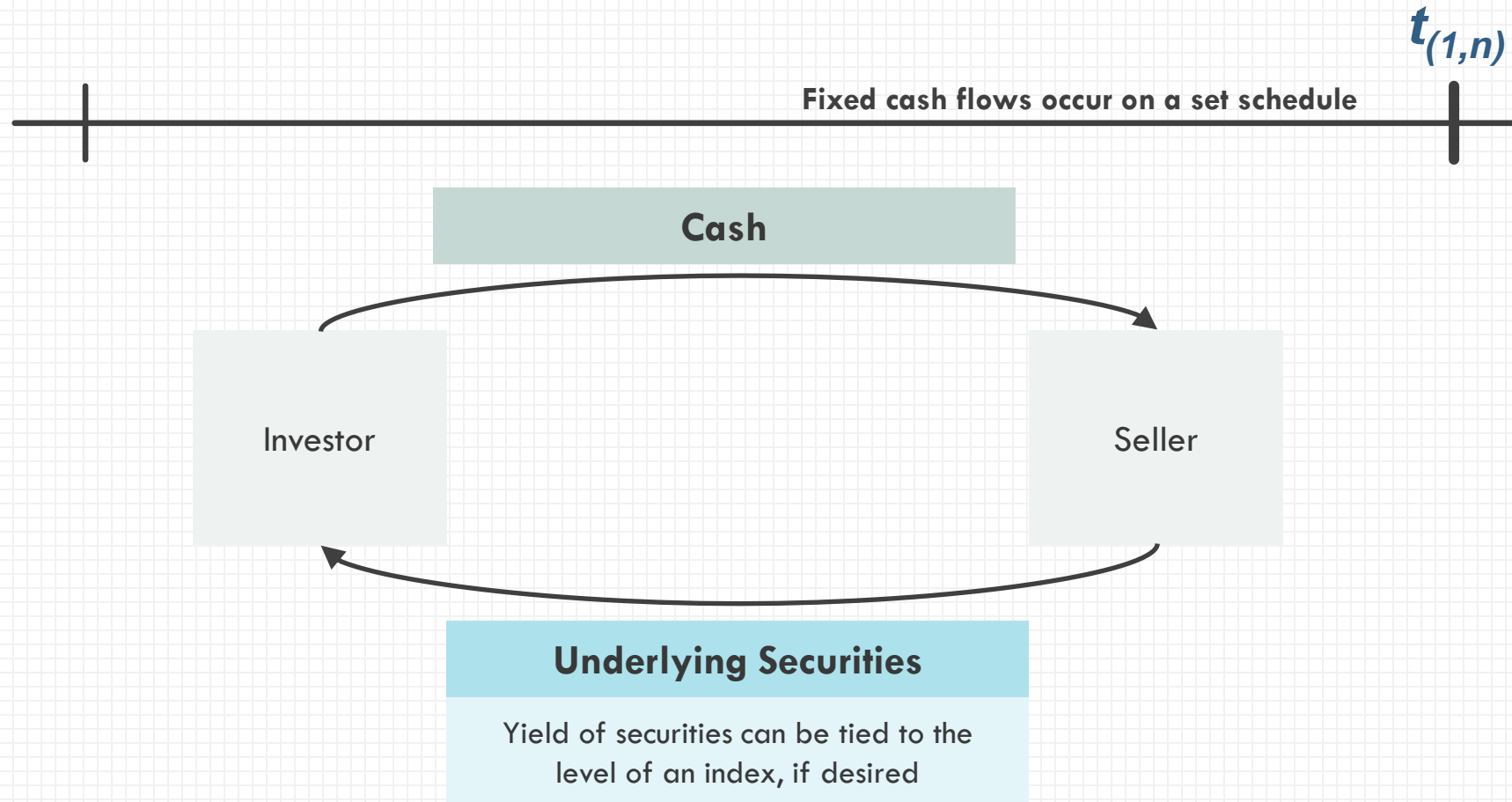
FORWARD DELIVERY AGREEMENTS

California Government Code Section 53600 et seq.

Forward Delivery Agreement Illustration



Forward Delivery Agreement Illustration



Additional Thoughts & Considerations

Forward Delivery Agreements

- 1** Highly structured agreement requires fixed cash flows with any deviations subject to potential breakage fees
- 2** Cost to provider of hedging exposure of underlying deliverables is extensive and passed along to investor in form of lower contract yield
- 3** Limited provider universe and no secondary market – complex coupon structures may have limited or no providers
- 4** Collateralization by investor of negative mark-to-market values in between payment and/or coupon reset dates may be required

POLLING QUESTION

Which of the following is not a trait of structured investments?

Questions?



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THANK YOU

We look forward to your participation in the next webinar in this series:

Advanced Investment Analysis



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