



County of Orange
California

Thomas G. Mauk
County Executive Officer

August 25, 2009

James R. Perez, Foreperson
2008-09 Orange County Grand Jury
700 Civic Center Drive West
Santa Ana, CA 92702

Subject: Response to Orange County Grand Jury Report, "Orange
County Investments: The Need for Stronger Oversight"

Dear Mr. Perez:

Per your request, and in accordance with Penal Code 933, please find the County of Orange response to the subject report as approved by the Board of Supervisors. Respondents are: Board of Supervisors and Treasury Oversight Committee. If you have any questions, please contact Kathleen Long at (714) 834-7410 in the County Executive Office who will either assist you or direct you to the appropriate individual.

Sincerely,

Thomas G. Mauk
County Executive Officer

Enclosure

County Executive Office
10 Civic Center Plaza
Third Floor
Santa Ana, California
92701-4062

Tel: (714) 834-2345
Fax: (714) 834-3018
Web: www.oc.ca.gov

2008-09 Grand Jury Report
“Orange County Investments: The Need for Stronger Oversight”
Board of Supervisors/Treasury Oversight Committee
Responses to Findings and Recommendations

Responses to Findings F.2, F.2(a)(b)(c), F.3(a)(b)(c), F.4, F.5, F.7, F.8, F.11 and F.12

F.2. The County investment policy prohibits investments in the commercial paper or medium-term notes of corporations that are not organized and operating within the United States. The policy also prohibits investments in derivatives.

Response: *Agrees with the finding.*

F.2(a) Whistlejacket Capital, a SIV investment held within the County’s investment portfolio, was an investment vehicle incorporated in the state of Delaware. It was established by Standard Chartered Bank, one of the largest banks in the United Kingdom, and wholly-owned by Whistlejacket Capital Ltd, a firm incorporated in one of the Channel Islands under the jurisdiction of the United Kingdom.

Response: *Agrees with the finding.*

F.2(b) Whistlejacket invested in debt instruments all over the world and used, and intended to use, derivative instruments to hedge against currency and interest rate risk.

Response: *Agrees with the finding.*

Limited investing in derivative instruments to hedge against currency and interest rate risk is generally accepted as a prudent investment practice.

F.2(c) The County’s investment in SIV’s (specifically Whistlejacket), did not directly violate the language of the IPS or Government Code because each SIV was incorporated in the U. S. and the County was not directly investing in derivatives. However, the intent of the policies and laws governing prohibited investments should have been considered before making these investments. And, the Treasury Oversight Committee (TOC) should have been more actively involved in scrutinizing these investments.

Response: *Disagrees partially with the finding.*

We agree with the first sentence to F.2(c). However, we disagree that the intent of the policies and laws governing prohibited investments were not considered. We are advised that all investment decisions are made with due consideration of the prudent investor rule and the statutory objectives of public funds investment.

In addition, given the rapid deterioration of SIVs, especially Whistlejacket, as a class of investments, we disagree that the TOC could have reasonably had a more active role with respect to those investments.

F.3 Findings pertaining to the revised December, 2008, IPS are:

F.3(a) The language used in Section III reads: "...the standard of prudence to be used by County investment officers shall be the prudent investor standard and shall be applied in the context of managing an overall portfolio." This suggests that the standard for measuring prudence is the performance of the entire portfolio, rather than risks associated with individual investments.

Response: Disagrees partially with the finding.

Although it is correct that one measure of prudence is with reference to the entire portfolio, we believe that the standards of prudence apply more broadly. Government Code Section 27000.3(c) says in part:

When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the county treasurer or board of supervisors, as applicable, shall act with care, skill prudence, and diligence under the circumstances then prevailing, specifically including, but not limited to, the general economic conditions and anticipated needs of the county and other depositors, 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 county and other depositors. Within the limitations of this section and **considering individual investments as part of an overall investment strategy**, investments may be acquired as authorized by law. (Emphasis added.)

Under 27000.3(c) and 53600.3, for example, the Treasurer has to consider the prudence of each investment decision, taking into account the prudence of such investment in context of the entire fund or portfolio. In addition, we are concerned that the Grand Jury's use of "performance" as a modifier to "entire portfolio" may be misapplied to relate to yield, instead of the numerous benchmarks of successful investment of public funds, including, but not limited to safety, liquidity and the short and long term cash flow needs of investors.

F.3(b) The language used in Section III describing how the Treasurer should invest with care and prudence includes: "...specifically including, but not limited to, the general economic conditions and the anticipated needs of the County and other depositors..." This phrase suggests that the County's budgetary requirements are dependent on yield to an extent that could adversely influence the degree of care and prudence required.

Response: Disagrees wholly with the finding.

As noted in the body of the Grand Jury Report, the language in Section III comes directly from sections 27000.3(c) and 53600.3 of the Government Code. The TOC's interpretation is that the phrase deals not with attempting to target a specific yield but with liquidity. One of the primary failures noted in the County bankruptcy was the inappropriate mismatch of asset maturities to pool liabilities. The timing of the cash flow needs of the pool participants is an important consideration.

- F.3(c)** The language used in Section II describing investments in the Extended Fund reads: "It will be invested primarily in high grade securities commensurate with achieving a higher yield, while also considering preservation of capital." This places an emphasis on yield before safety of principal. Also, the use of the word "primarily" permits investments in less than "high grade securities".

Response: Agrees with the finding.

However, it should be noted that "higher yield" is in comparison to the Money Market Fund and should not be viewed in a vacuum. In all cases, the statutory requirements of placing security and liquidity ahead of yield apply.

- F.4** The TOC is not functioning as an oversight committee as it was originally intended and as set forth in its bylaws, and as a consequence, is not as effective as it should be.

Response: Disagrees wholly with the finding.

The TOC is functioning *exactly* as it was originally intended and as set forth in its bylaws. The bylaws refer to the committee's authority as contained in Government Code sections 27130 through 27137. It is important to note that there is a direct, one-for-one correspondence between the Government Codes and the bylaws. The general purpose of the TOC is contained in section 27130: "The Legislature further finds and declares that the creation of county treasury oversight committees will promote the public interest by involving depositors in the management of their funds." This has been accomplished as individually delineated by various Government Code sections. As validated by annual independent audits, the TOC has been in compliance with these sections since its origination:

§27131 (TOC Bylaw Rules 4 & 5) Outlines establishment and determinations of size and membership.

§27132 (TOC Bylaw Rules 6 – 10) Outlines membership and the pool of candidates.

§27132.1 (TOC Bylaw Rule 11) Prohibition against members employment by campaign contributors.

§27132.2 (TOC Bylaw Rule 12) Prohibition against fundraising by a member for

a treasurer.

§27132.3 (TOC Bylaw Rule 13) Prohibition against members' employment in the financial services industry.

§27132.4 (TOC Bylaw Rule 2) Adherence to open meeting laws.

§27133 (TOC Bylaw Rule 27) Review and monitoring of the investment policy prepared by the treasurer. Note that independent *daily* monitoring of the investment pool had been accomplished for nearly one year by the Auditor-Controller's Internal Audit Section. This was subsequently reduced to ten times monthly on a random basis.

§27134 (TOC Bylaw Rule 28) Periodic audits for compliance with the bylaws.

§27137 (TOC Bylaw Rule 29) No committee interference with the day-to-day operations and decisions of the treasurer.

Thirteen audits of the TOC have been conducted since its inception. None have found the committee to be out of compliance with the Government Code, and by association, none have found it to be out of compliance with its bylaws.

- F.5** The Treasury Oversight Committee (TOC) has been operating, for the most part, with only three members, all holding County positions, for most of 2007 and 2008. In December, 2008, two members representing the public were added. The Government Code recommends that the size of this committee be from 3 to 11 members.

Response: Disagrees wholly with the finding.

The minutes of the committee show that it had three members present from October 31, 2007 through October 15, 2008. Prior to October 31, 2007 there were four to five members. Mr. Jeffrey Thomas was listed in the minutes for the January 31, 2007 and April 25, 2007 meetings and Mr. Ken Henderson, a fifth member, was listed in the minutes for the April 25, 2007 and July 25, 2007 meetings. Mr. George Jeffries, representative for outside participants was present for the October 31, 2008 meeting. A fifth member, Dr. Raghu P. Mathur, public member, was appointed by the Board of Supervisors on October 28, 2008.

- F.7** PFM Asset Management, a consulting firm, was hired in late 2007 to perform a risk analysis of the County's investment pools. In their report PFM concluded that the County's investments were of high quality and managed in a prudent manner. The firm also offered some suggested changes to the IPS that were later adopted. However, PFM reached a questionable conclusion about the Whistlejacket SIV by expressing an opinion that "No portfolio holdings are impaired or in present danger of becoming impaired." Evaluating investment compliance with the IPS was outside the scope of PFM's review. PFM limited its interviews and research to Treasury staff and Treasury documents.

Response: Disagrees partially with the finding.

PFM issued a report on January 28, 2008. Although Whistlejacket had been placed on "credit watch" by the rating agencies on November 30, 2007, there was no information in the market to reach a conclusion that the asset was either impaired or in present danger of becoming impaired. It was still rated as investment grade, and paying the required interest payments as of January 28. Also on January 28, 2008, Moody's Investors Services issued a Global Credit Research Announcement affirming their "A3 rating of Standard Chartered PLC, with a stable outlook following an announcement by the bank that it intends to fund the debt obligations of its Structured Investment Vehicle (SIV) Whistlejacket as they come due." On December 31, 2007, the two assets were priced at 97.701% and 99.138% (of purchase price). It was not until a subsequent downgrade of Whistlejacket on February 12, 2008 followed by a downgrade by Standard and Poor's on February 15, 2008 that questions concerning the impairment of Whistlejacket surfaced. The Grand Jury Report criticizes PFM for being inconsistent with the internal audit of the treasury as of December 31, 2007 which indicated valuation troubles with Whistlejacket. This report was not issued until June 11, 2008, well after the PFM report. The treasurer wrote down the recorded value of Whistlejacket after the Forbes article surfaced indicating problems with the asset. Had the scope of PFM's review included IPS compliance, it would not have affected their opinion concerning the impairment of assets. Moreover, including IPS compliance work in the PFM contract would have been an imprudent use of public funds as the Auditor-Controller had been conducting *daily* compliance work of the entire portfolio. The nature of PFM's work, as indicated by the title of the report was the "Risk Analysis of the Treasurer's Investment Pools." It is expected that their review be limited to the treasury staff and documents.

- F.8** A review of compliance audits by two outside firms that later merged (Moreland & Associates and Macias Gini & O'Connell) showed that the audits were limited in scope. Neither audit completely addresses the sections of Government Code and the IPS regarding prohibited investments.

Response: Disagrees wholly with the finding.

The Grand Jury report infers that the annual audit does not completely address compliance sections of the IPS related to prohibited investments because this specific wording is not included in the report. However, Moreland's audit procedures in Item # 14 of their report on the Annual Audit of Treasury Investment Compliance for the Year Ended 12/31/07 stated: "Investments maintained in the portfolios shall comply with investment criteria as stated in IPS Sections IV, V and VI, including the maximum allowable percentage by type of security, allowable percentage per issuer, max term limits and credit rating requirements." Section V of the IPS for the period audited (from the old IPS for 2007) specifically lists the types of investments that are *prohibited*. This same provision is included in the scope of the audit as detailed in Moreland's engagement letter. Although the Moreland Audit Report does not specifically state that no prohibited investments were found, it does state that they

audited for compliance with Section V. Further, they state: "In our opinion, except for the noncompliance described in the accompanying schedule of findings, recommendations, and responses, management's assertions that the Orange County Treasurer complied with the aforementioned requirements for the year ended December 31, 2007, are fairly stated in all material respects." No noncompliance items were noted concerning prohibited investments.

- F.11** The investment in SIVs were imprudent for several reasons. Among them are: safety and liquidity, the highest priorities for the County's investments, were not adequately considered; the TOC never reviewed them; and, 56 out of 58 California counties chose not to invest in them.

Response: Disagrees partially with the finding.

Although it is correct that the TOC did not specifically review them, the TOC reviewed their bond ratings and the compliance monitoring reports provided by external sources. It is not within the scope of the TOC to make investment decisions or prudence determinations. The only person who is given the duty and responsibility of determining prudence is the elected Treasurer.

- F.12** There is confusion surrounding the purpose of the TAC, its membership, and the advice it gives to the Treasurer's Office at its quarterly meetings.

Response: Disagrees wholly with the finding.

In the past, the Treasury Oversight Committee has had little contact with the Treasury Advisory Committee (TAC). The TOC had not considered the TAC to be part of the control structure. Accordingly, the TOC has no basis to evaluate the finding. The PFM report recommended occasional joint meetings with the TAC, and the TOC agreed with the recommendation.

Responses to Recommendations: R.2, R.3, R.5(a)(b), R.6(a)(b), R.8, R.9 and R.11

- R.2** The Treasurer-Tax Collector should consider the intent and spirit of the IPS and Government Code in all investment decisions. (F-2, F-2(a), F-2(b), F-2(c), F-3)

Response: The recommendation will not be implemented because it is not reasonable.

Although the TOC believe that the Treasurer-Tax Collector considers the intent and spirit of the IPS and Government Code in all investment decisions, as an oversight committee, the TOC cannot compel him to do so.

- R.3** The Treasurer should exit all SIV investments as soon as practicable. (F-2, F-2(a), F-2(b), F-2(c), F-3,)

Response: *The recommendation will not be implemented because it is not reasonable.*

The TOC cannot speak for the Treasurer.

The Whistlejacket notes were exchanged for pass-through (P-T) notes in a new entity called Serpentine (which is not an SIV).

The TOC has submitted a recommended modification of the Investment Policy Statement to the Board of Supervisors that would specifically exclude the P-T notes from requirements of the IPS. It remains the Treasurer's explicit responsibility to evaluate the appropriate exit strategy.

R.4 The Board of Supervisors should consider the following revisions to the December, 2008, IPS:

R.4(a) This language "...the standard of prudence to be used by County investment officers shall be the prudent investor standard and shall be applied in the context of managing an overall portfolio." should be clarified to mean that all individual investments meet the prudent investor standard. (F-3a)

Response: *The recommendation has not been implemented, but will be implemented in the future.*

The Board of Supervisors will consider recommending revisions to clarify the December 2008 Investment Policy Statement (IPS) to mean that all individual investments meet the prudent investor standard. Recommendations will be conveyed to the Treasury Oversight Committee for consideration and inclusion in the IPS before the end of the fiscal year (June 30, 2010).

R.4(b) The statement "specifically including, but not limited to, the general economic conditions and the anticipated needs of the County and other depositors..." should be further clarified to describe that the County's budget needs will not impact the County's requirement to safeguard principal. (F-3b)

Response: *The recommendation will not be implemented because it is not warranted.*

The language contained in Section III (referred to above) comes directly from Government Code Section 53600.3. The County's interpretation is that the phrase refers to liquidity, not a specifically targeted yield and, thus, requires no clarification.

R.4(c) The language in the IPS "It will be invested primarily in high grade securities commensurate with achieving a higher yield, while also considering preservation of capital" should be clarified to show that yield is not a priority over safety, and that investments will only be made in high-grade securities. (F-3c)

Response: *The recommendation has not been implemented, but will be implemented in the future.*

The Board of Supervisors will consider recommending revisions to clarify the December 2008 Investment Policy Statement (IPS) to indicate that yield is not a priority over safety, and that investments will only be made in high-grade securities. Recommendations will be conveyed to the Treasury Oversight Committee for consideration and inclusion in the IPS before the end of the fiscal year (June 30, 2010).

- R.5(a)** The TOC should rewrite its bylaws to clarify its role in oversight, the activities it will conduct, and how its members are expected to participate. (F-4)

Response: *The recommendation will not be implemented because it is not warranted.*

As noted in the response to finding F.4., the Bylaws mirror the Government Code. The Government Code was carefully crafted as to not impinge on the statutory authority and discretion granted to the Treasurer: "Nothing in this article shall be construed to allow the county treasury oversight committee to... impinge on the day-to-day operations of the county treasury." The Government Code Sections related to the TOC were enacted in 1995 by Senate Bill 866. According to the floor analysis of SB 866, "The role of the oversight committee is to review and monitor an investment policy that is prepared by the county treasurer." Clearly, the IPS is the primary tool used to control county investments. Prior to the Grand Jury report, the TOC revised the Investment Policy Statement to include a provision that requires new investment types to be thoroughly examined by the committee.

- R.5(b)** The investment report produced monthly by the Treasurer's Office should be reviewed by the TOC. The structure of the TOC meetings should allow for the Treasurer to be questioned as to the portfolio's performance, recent investment decisions, and the strategies being employed. Since financial markets and economic conditions can change rapidly, the TOC should fully understand at all times how the Treasurer intends to "safeguard the principal." (F-4)

Response: *The recommendation has been implemented.*

The TOC bylaws (Rule 27) call for the Treasurer to provide the TOC with copies of an investment report. Future agendas will contain a provision to receive and file the report to allow for discussion of the report contents. Prior to the Grand Jury Report, the Investment Policy Statement was rewritten to stress the safeguarding of principal.

- R.6(a)** The TOC should consider expanding to seven members including four members of the public. This will achieve a better balance between County and public membership and serve to enhance the Committee's expanded role in oversight

of the investment pools. Since the Committee recently added two members of the public, two additional members of the public are recommended. (F-5)

Response: *The recommendation requires further analysis.*

The TOC is currently comprised of five members:

1. The County Auditor-Controller - represents County constituents while fulfilling the statutory responsibilities for overseeing the treasury;
2. The County CEO - a representative of the Board which is statutorily responsible for the treasury;
3. The Superintendent of Schools - protects the interests of approximately one-half of the depositors;
4. A city treasurer - represents the interests of outside participants;
5. A public member who serves as a community college chancellor

The interests of the depositors are well represented. It is very difficult securing the services of qualified public volunteers. The provisions of Government Code Section 27132.3 add further constraints since members cannot serve in the financial services industry during their term of service and for one year after leaving the committee. The TOC will deliberate this recommendation and decide prior to December 31, 2009.

R.6(b) While Section 27132 (1) of the Government Code requires at least two of the public members be well versed in public finance and investment techniques, all four of the public members should be so qualified. (F-5)

Response: *The recommendation requires further analysis.*

The TOC has always required its public members to be well versed in public finance and investment techniques. However, if the committee is expanded to include four public members, this will likely become difficult to implement due to the restrictions on membership imposed by the Government Code noted in the response to recommendation R.6(a) above. The TOC will deliberate this recommendation and decide prior to December 31, 2009.

R.8 The TOC, in its expanded role, should direct the activities of consulting firms used to conduct independent reviews or risk assessments of the County's investment pools. This will increase independent and effective oversight and may help expose shortcomings in future reviews. (F-7)

Response: *The recommendation will not be implemented because it is not warranted.*

The TOC has debated the appropriate entity to commission the independent review noted in Finding F.7— either the TOC or the Board of Supervisors. The TOC concluded that the Board of Supervisors should commission the report through the CEO because the Treasurer's Office provides the administrative support for the

TOC. Accordingly, the TOC wanted to avoid the appearance of a conflict of interest.

- R.9** The TOC should insure that an annual compliance audit be conducted that addresses all elements of the Government Code as well as the IPS. The audit should be conducted by a firm or firms that have legal as well as investment expertise in the types of investments included in the investment pools. (F-8, F-9, F-10)

Response: *The recommendation will not be implemented because it is not warranted.*

All elements of the Government Code as well as the IPS were addressed and will continue to be addressed in the future annual compliance audits. Firms are bound by professional standards to possess the requisite knowledge in the areas they audit. It is reasonable to assume that any firm taking on this assignment would have legal as well as investment expertise in the types of investments included in the investment pools.

- R.11** The Treasurer's Office should schedule an annual meeting between the TAC and the TOC to discuss the safety and quality of the investment pools, the current investing climate and any issues previously raised with the Treasurer's Office. (F-12)

Response: *The recommendation has not been implemented, but will be implemented in the future.*

A meeting between the TAC and the TOC will be held prior to December 31, 2009.