

# OFFICE OF THE TREASURER-TAX COLLECTOR



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September 18, 2009

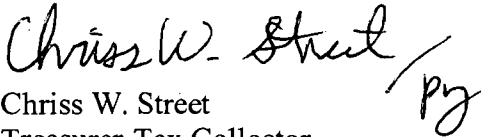
The Honorable Kim Dunning  
Presiding Judge of the Superior Court  
700 Center Drive West  
Santa Ana, CA 92701

Dear Presiding Judge Dunning:

Enclosed is our response to the 2008-2009 Orange County Grand Jury Report: "Orange County Investments: The Need for Stronger Oversight." In accordance with California Penal Code §933.05, the response was limited the findings and recommendations as requested by the Grand Jury. Accordingly, our lack of response to the detailed information contained elsewhere in the report should not be construed to imply our agreement with that information.

We would like to thank the members of the Grand Jury who participated in this important review. Please note that the lack of concurrence with some of the findings and recommendations resulted from the complexity of the subject and our limited ability to respond to the draft report prior to issuance. Although we were allowed to review the detailed section of the report within the confines of the Grand Jury Offices, we were not privy to the summary findings (conclusions) and report recommendations. A complete response was only possible by comparing the report to detailed source documents in our offices. Although we did not concur with some of the findings and recommendations, we found the examination useful and appreciate the opportunity to improve our processes.

Respectfully submitted,

  
Chriss W. Street  
Treasurer-Tax Collector

Enclosure

Treasurer-Tax Collector Response to 2008-2009 Orange County Grand Jury Report: "Orange County Investments: The Need for Stronger Oversight"

cc: **Grand Jury**  
Board of Supervisors  
Members of the Treasury Oversight Committee

**2008-09 Grand Jury Report**  
**“Orange County Investments: The Need for Stronger Oversight”**  
**Treasury-Tax Collector**  
**Responses to Findings and Recommendations**

**Responses to Findings F.1, F.2, F.2(a)(b)(c), F.3(a)(b)(c), F.6, F.7, F.11 and F.12**

**F.1** In December, 2008 Standard & Poor’s issued its AAAM rating for the County’s two Money Market Funds. This rating does not apply to the County’s Extended Funds. In June, 2008, Moody’s issued a comparable high-quality rating that included the Extended Funds except for a separate fund that contained the defaulted Whistlejacket SIV.

**Response: *Agrees with the finding.***

**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.***

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). According to County Counsel, the investments in structured investment vehicles did not directly, nor indirectly, violate the Investment Policy Statement.

We disagree that the intent of the policies and laws were not considered prior to making these investments. The County had been investing in SIVs over eight (8) years (since 2001). All investment decisions are made with due consideration of the prudent investor rule and the statutory objectives of public funds investment.

**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.**

The Treasurer agrees that one measure of prudence is with reference to the entire portfolio, and endeavors to meet the standards of prudence in the broader sense of Government Code Section 27000.3(c) (referenced in IPS Section III) which 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.)

**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 Treasurer's interpretation and direct application is that the phrase deals solely with ensuring appropriate liquidity to meet the cash flow needs of pool participants.

**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.***

"High grade securities" are considered those rated AAA and/or AA, by Moody's or Standard & Poors. According to the Investment Policy Statement approved by the Treasury Oversight Committee and the Board of Supervisors, the Extended Fund may not invest in securities rated less than AA.

**F.6** The Treasurer produced financial statements with mark-to-market values that were unsupported according to the County's own internal auditors.

***Response: Partially Agrees with the finding.***

The Treasurer agrees that internal auditors issued a qualified opinion stating they were "unable to obtain sufficient appropriate audit evidence to support Treasury management's valuation of the fair market value" for both Whistlejacket and Sigma Finance SIV holdings.

The Treasurer disagrees the values were unsupported. The Treasurer's office provided internal audit analyses to support values. The Treasurer utilized mark-to-market rules as set forth by *Level 3 measurements in Statement of Financial Accounting Standards No. 157, Fair Value Measurements*, for pricing securities. The Treasurer valued both these securities with reference to similarly rated investments, comparable yields, and a forecast of cash flows.

- 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). Subsequent to the PFM report, Whistlejacket was downgraded on February 12, 2008 by Moody's and by Standard and Poor's on February 15, 2008.

- 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.***

Treasury staff exercised prudence in their credit and analytical research regarding safety and liquidity. During the eight (8) years that the Treasurer's office had been invested in these type of securities, the sponsors of these investment vehicles continuously reviewed.

The Treasurer's office can not verify that 56 out of 58 California Counties chose not to invest in these securities.

- 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 with the finding***

The Treasurer's office has no confusion regarding the purpose and membership of the Treasurer's Advisory Committee.

**Responses to Recommendations: R.1, R.2, R.3, R.10 and R.11**

- R.1** The Treasurer-Tax Collector should establish measureable safety goals for both Money Market and Extended Funds

***Response: The recommendation has been implemented.***

The Treasurer and the Treasury Oversight Committee (TOC) collaborated in making numerous changes to the Treasurer's IPS and these changes were approved, with minor modifications, by the Board of Supervisor's in December 2008. The new IPS prohibits any investments in structured investment vehicles, and requires that any new types of securities not specifically authorized in the IPS be reviewed by the TOC and specifically approved by the Board of Supervisors, prior to investment by the Treasurer. Changes to the IPS emphasize the priority of safety and liquidity. IPS changes included additional safeguards and limitations, such as reducing the weighted average maturity (WAM) of the Money Market Funds from a maximum WAM of 90 days to 60 days.

The Investment Policy Statement (IPS) establishes the measurable restrictions and limitations on what investments are permitted and it is more conservative than what is permitted by Government Code. The Treasurer also maintains additional policies and procedures to provide internal controls. The two Money Market Funds are rated AAAM by Standard & Poors; the highest possible principal stability fund rating.

- 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 has been implemented.***

The Treasurer-Tax Collector always considers the intent and spirit of the IPS and Government Code in all investment decisions.

- 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 has already been implemented.***

- R.10** There is a general tendency to over rely on the ratings issued by the major credit ratings. In these times when credit rating agency credibility is being called into question, it is recommended that Treasury staff conduct thorough and independent evaluations of prospective investments, rather than just rely on the rating issued by the major credit agencies. Proper due diligence begins with a review of credit ratings; it doesn't end there.

***Response: The recommendation has already been implemented.***

Treasury staff have always conducted a thorough and independent evaluation of each issuer prior to investment; there is no tendency to over rely on credit ratings. Evaluations of possible issuer's and their credit information has been and continues to be based on fundamental financial analysis, including evaluations of the issuer's position in their respective market, review of credit rating agencies' research on issuers, discussions with an issuer's management, review of financial statements and financial ratios, and ongoing monitoring of the current economic and political environment. This fundamental analysis is summarized for each proposed issuer of investments and presented to the Treasurer's Investment Committee, consisting of the Treasurer, investment staff, senior Treasury management for approval.

- 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 will be implemented in the future.***

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