City of Escondido

INVESTMENT POLICY

June 2015

Adopted by

Resolution No. 2015-140

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CITY OF ESCONDIDO
INVESTMENT POLICY

I. Policy Statement

This policy establishes the limits within which the City's investment program shall be conducted. Investment goals and objectives are defined. Qualified investment instrumentalities and reporting requirements are identified. Authority, accountability, audit control and procedures governing the investment program are delineated.

The investment policies and practices of the City of Escondido are based upon state law, city ordinance, and prudent money management.

II. Scope

A. Pooled Investments.

This policy applies to the investment of all funds under the control of the City Treasurer. These funds are accounted for in the City of Escondido's Comprehensive Annual Financial Report and include:

- General Fund
- Special Revenue Funds
- Debt Service Funds
- Capital Project Funds
- Enterprise Funds
- Internal Service Funds
- Trust Funds
- Any new fund created from proceeds of bond sales in the custody of the Treasurer or any other funds under his control.

California Government Code Section 53601(1) permits money from bond proceeds, obligations under a lease, installment sales or other agreements to be invested in any security that meets the statutory provisions governing the issuance of the bond or other agreements made by the issuing agency.

B. Investments held separately.

Investments of bond proceeds will be held separately when required by the bond indentures or when necessary to meet arbitrage regulations. If allowed by the bond indentures, or if the arbitrage regulations do not apply, investments of bond proceeds will be held as part of the pooled investments.

This policy does not apply to stocks, bonds, or other securities donated to the Escondido Public Library until such time as the Library Board of Trustees determines to dispose of such securities. Also, this investment policy does not apply to the Employees Deferred Compensation Fund and PERS funds, which are administered separately.

III. Prudence

Pursuant to California Government Code Section 53600.3, as amended, the City Council and all persons authorized to make investment decisions on behalf of the City are trustees of the public funds and therefore fiduciaries subject to the following prudent investor standard.

> When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill prudence and diligence under the circumstances then prevailing, including, but not limited to, 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. Within the limitations of this section and considering individual investments as part of an overall strategy, investments may be acquired as authorized by law.

The City Treasurer and other individuals who are assigned to manage the investment portfolio, when they are acting in accordance with the City's investment policy, with written procedures and in reasonable reliance on existing California statutes and when they have properly exercised due diligence, will be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and appropriate action is taken to control adverse developments.

IV. Investment Objectives

A. The criteria for selecting investments by order of priority shall be:

1. *Safety*. Safety of principal is the City of Escondido's foremost objective. Investments shall seek to ensure that capital losses resulting from institution default, broker-dealer default, or the erosion of market value are avoided. The City of Escondido shall seek to preserve principal by mitigating the two types of risk: credit risk and market risk.

    a. Credit risk, defined as the risk of loss due to failure of the issuer of a security, shall be mitigated by investing in only the highest quality securities (see authorized investments) and by diversifying the investment portfolio so that the failure of any one issuer would not unduly harm the City's cash flow.

    b. Market risk, defined as the risk of market value fluctuations due to overall changes in the general level of interest rates, shall be mitigated by structuring the portfolio to eliminate the need to sell securities prior to

maturity; and by prohibiting the taking of short positions, that is, selling securities that the City does not own. It is explicitly recognized, however, that in a diversified portfolio, occasional measured losses may occur, and must be considered within the context of overall investment return.

2. *Liquidity*. The portfolio will be structured with sufficient liquidity to allow the City to meet expected cash requirements. The investment portfolio shall remain sufficiently liquid to ensure that projected expenditure requirements of the next six months can be met with a combination of anticipated revenues, maturing securities, and highly liquid investments and shall maintain a minimum level of short-term investments (one year or less) equivalent to 25% of the General Fund operating budget. The duration is also mentioned in the "Maturity" section.

3. *Yield*. In a manner consistent with the objectives of safety of principal and liquidity uppermost, a yield higher than the market rate of return shall be sought. The core of investments is limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

   - A security with declining credit may be sold early to minimize loss of principal.
   - A security swap would improve the quality, yield, or target duration in the portfolio.
   - Liquidity needs of the portfolio require that the security be sold.

B. It shall be the policy of the City that all idle funds shall be invested consistent with providing adequate cash to meet the City's obligation.

V. Executive Investment Committee

The Executive Investment Committee will act in an advisory and oversight capacity to review and discuss investment portfolio management and investment policy compliance. The City Manager, City Treasurer, and Director of Administrative Services will serve as permanent members of the Executive Investment Committee. Other members, as deemed necessary or desirable, may be appointed to the committee by the City Treasurer or the City Manager. Treasury and Finance Department personnel shall serve as staff to the committee.

VI. Required Reporting

The City Treasurer or his designees shall report to the City Manager and City Council the following reports:

A. Quarterly investment report (as per Government Code Section 53601) will include the type of investment, issuer, date of maturity, par, and dollar amount invested and market value for each security held by the City. The report shall state the source of the market value valuation and include a statement denoting the ability to meet the City's expected expenditure requirements for the next six months.

B. An annual report setting forth a statement of investment policy.

VII. Authorized Financial Institutions and Broker/Dealers

A. General criteria for the selection of financial institutions and broker/dealers shall be developed by the City Treasurer and reviewed by the City Investment Committee.

B. Selection of financial institutions and broker/dealers shall be performed by authorized City staff under direction of the Executive Investment Committee. The City has an established formal procedure process in place for the selection of financial institutions and broker/dealers. As determined necessary by the Executive Investment Committee, the City will distribute a broker/dealer questionnaire to interested and known financial institutions and broker/dealers. The City Treasurer will maintain a list of qualified broker/dealers authorized to provide investment services to the City of Escondido. The list may include primary or regional dealers that are credit worthy and qualify under the uniform net capital rule of the Securities & Exchange Commission Rule 15C3-1.

All financial institutions and broker/dealers who desire to provide investment services must participate in the City's formal broker/dealer questionnaire process. To be considered, the financial institution or broker/dealers must supply the following as appropriate:

- Completed broker/dealer questionnaire
- Proof of National Association of Security Dealers (NASD) certification
- License to conduct business in the state of California
- Audited financial statements demonstrating compliance with state and federal capital adequacy guidelines
- Certification of having read and understood and agreeing to comply with the City of Escondido's investment policy
- Evidence of adequate insurance coverage

Qualified broker/dealers selected to do business with the City shall submit annually a current audited financial statement.

After the annual adoption of the City's Investment Policy by the City Council, a copy shall be sent to all broker/dealers approved to do business with the City. Confirmation of receipt of this policy shall be considered evidence that the dealer understands the City's investment policies and intends to sell the City only appropriate investments authorized by this investment policy.

C. General criteria for the selection of banks and savings and loans into which the City shall invest its funds shall be developed by the City Treasurer and reviewed by the Executive Investment Committee subject to the limitations set forth in this policy.

D. Selection of specific institutions in which City funds may be invested shall be performed by authorized City staff under the direction of the Executive Investment Committee.

E. Institutions in which City funds may be invested shall be classified by the City Treasurer and reviewed by the Executive Investment Committee. The classification shall determine the maximum dollar amount allowable for investment in the specified institution.

VIII. Safekeeping and Custody

To protect against potential losses by the collapse of individual securities dealers, all securities owned by the City shall be held in safekeeping by a third party bank trust department acting as agent for the City under the terms of a custody agreement executed by the bank and the City. All securities will be received and delivered using standard delivery versus payment (DVP) procedures.

IX. Accountability and Authority

A. The Escondido Municipal Code vests authority for and control of investments to the City Treasurer.

B. The City Treasurer may delegate the authority to conduct investment transactions to qualified and competent officials and employees of the City. Daily management responsibility of the investment program may be delegated to Finance Department Staff, including the Director or Assistant Director of Finance, the Treasury Manager, and/or the Investment Officer, who shall establish procedures for operation consistent with the investment policy.

X. Ethics and Conflicts of Interest

Officers and employees involved in the investment process shall refrain from personal business activity that conflicts with proper execution of the investment program or impairs their ability to make impartial investment decisions. Additionally the City Treasurer, Revenue Manager, Finance Manager and the Investment Officer are required to annually file a Statement of Economic Interest as mandated by Government Code Section 91013.

XI. Internal Control

The Treasurer or his designee shall establish procedures for controlling daily investment transactions and monthly reconciliation of accounts. Separation of functions between the City Treasurer's Office and the Finance Department is designed to provide an internal review to prevent the potential for converting assets or concealing transactions. The investment portfolio and all related transactions are balanced to appropriate general ledger accounts by the Finance Department on a monthly basis. Such procedures and controls shall be subject to review and comments by the City's independent auditor.

XII. Authorized and Suitable Investments

A. Qualifying Investment Instruments Policy:

1. The following instruments are generally approved as qualifying investment instruments for City funds:

   a. Obligations of the U.S. Government, its agencies, and instrumentalities.

   b. Certificates of deposit with banks and savings and loans doing business in the State of California.

   c. Prime Banker's Acceptances.

   d. Prime Commercial Paper

   e. Repurchase Agreements and Money Market Funds whose underlying collateral consists of the foregoing. (The City may invest in repurchase agreements with which the City has entered into a master repurchase contract, which specifies terms and conditions of repurchase agreements.)

   f. Local Agency Investment Fund (LAIF) of the State of California.

   g. San Diego County's Investment Pool for local agencies, which includes the purchase of Reverse Repurchase Agreements.

   h. Pools and other investment structures incorporating investments listed in a through e.

2. Within the qualified investment instrument listing, the Executive Investment Committee may further define, qualify, and restrict use of City investment monies.

3. Additional investment instruments may be added by the City Treasurer from time to time but shall be reported in the next regular monthly report to the City Council and City Manager.

4. Investments of bond funds will be made in conformance with the trust indenture for each bond issue. Such investments will be held separately when required.

B. Diversification by Type of Investment:

The City is governed by California Government Code, Sections 53600 (et seq.). It shall be the policy of the City that investments shall be diversified with respect to the type of investment instruments used. Within the context of these limitations, the following investments are generally approved as qualifying investment instruments for City funds, as further limited herein:

1. United States Treasury Bills, Bonds, and Notes, or those for which the full faith and credit of the United States are pledged for payment of principal and interest. There is no limitation as to the percentage of the portfolio, which can be invested in this category. The target for investment in United States Government Securities will be 80 percent of the portfolio. United States Government

Securities will be defined as 100 percent of the investments defined in XII (B)1 and 2 (U.S. Government Treasuries and U.S. Government Agency obligations), and the applicable percent of the investment defined in item XII(B)5 (Local Agency Investment Fund (LAIF)), equal to the LAIF's portfolio composition percentage of investment in United States Government Securities. The percentage will fluctuate depending on market conditions, but in no case be lower than 70 percent. If the percentage falls below 80 percent, the 80 percent target rate will be restored within six months.

2. Obligations issued by the United States Government Agencies such as the Government National Mortgage Association (GNMA), Federal Farm Credit Bank System (FFCB), the Federal Home Loan Bank Board (FHLB), the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), and the Student Loan Marketing Association (SLMA). Although there is no percentage limitation of the dollar amount that can be invested in these issues, the "prudent investor" rule shall apply for any single agency name.

3. Bills of exchange or time drafts drawn on and accepted by a commercial bank otherwise known as banker's acceptances. Purchases of banker's acceptances may not exceed 180 days to maturity or 20 percent of the market value of the portfolio. No more than ten percent of the market value of the portfolio may be invested in banker's acceptances issued by any one bank.

4. Commercial paper ranked P1 by Moody's Investor Services and A1 by Standard and Poor's, and issued by a domestic corporation having assets in excess of $500 million and having an A or better rating on its long-term debentures as provided by Moody's or Standard and Poor's. Purchases of eligible commercial paper may not exceed 180 days to maturity or 15 percent of the market value of the portfolio. No more than ten percent of the market value of the portfolio may be invested in commercial paper issued by any one corporation.

5. Local Agency Investment Fund. The City may invest in the Local Agency Investment Fund (LAIF) established by the State Treasurer for the benefit of local agencies up to the maximum amount permitted by State Law. The City's investment in LAIF will be determined according to the City's liquidity needs, and may not exceed $50 Million. When calculating this limit, the City does not include Bond proceeds invested with LAIF. These bond proceeds are held separately to meet arbitrage regulations and are not part of our pooled investments. LAIF has traditionally limited investments to short-term government type bonds. Treasury staff reviews the LAIF statements quarterly to ensure that this practice is maintained.

6. Money market funds are limited to 20 percent of the market value of the portfolio. The funds must be rated in the highest category of Moody's or Standard and Poor's, or must be administered by a domestic bank with long-term debt rated in one of the top two categories of Moody's or Standard and Poor's. A thorough investigation of any money market fund or investment pool

is required prior to investing, as well as on an ongoing basis. The following information should be obtained and analyzed:

a. A description of eligible investment securities.

b. A written statement of investment policies and objectives.

c. A description of interest calculation and their distribution, and the treatment of gains and losses.

d. A description of how the securities are safeguarded and how often the securities are priced and the program audited.

e. Information about the size and frequency of deposits and withdrawals allowed, and how much notice is needed for withdrawals.

f. A schedule for receiving statements and portfolio listings.

g. A fee schedule, as well as how and when the fees are assessed.

h. The rating of the pool/fund.

i. Information about investment advisers, including registration with the Securities and Exchange Commission, length of experience and total assets under management.

7. Ineligible Investments. Investments not described herein, including, but not limited to, common stocks and corporate bonds, are prohibited from use in this portfolio. Investments, which exceed five years in maturity, require authorization by City Council prior to purchase. Further, any investments, purchased after January 1, 1996, that are in the form of inverse floaters, range notes, or mortgage-derived interest-only strips are prohibited.

C. Diversification by Institution.

1. Not more than $100,000 shall be placed in any qualifying institution unless collateralized in accordance with this policy.

2. All certificates of deposit investments shall be collateralized by government securities with a market value of 110 percent of the City's investment or mortgages in value equal to 150 percent of the City's investments. Each investment institution must meet specific financial criteria as determined by the Executive Investment Committee.

3. In no event may any institution have City investments exceeding $5,000,000 without approval of the Executive Investment Committee. This restriction shall not apply for periods of seven days or less when the City is receiving substantial funds (e.g., proceeds of bond sales) or is consolidating funds for a major transaction.

D. Collateralization

1. An independent third party with whom the City has a current custodial agreement must always hold collateral.

2. State law regarding collateralization of deposits of public funds requires that securities must be held by an agent (i.e. a trust company) of the bank, which may include the bank's trust department, only if acceptable to both the bank and the Treasurer, pursuant to California Government Code Section 53656 and 53658. Under the provisions of California Government Code Section 53652, banks are required to secure the deposits of public funds, including certificates of deposits, by: a) pledging government securities with a value of 110 percent of the principal and accrued interest; b) pledging first trust deed mortgage notes having a value 150 percent of the total agency deposit; or c) a letter of credit drawn on the Federal Home Loan Bank of 105 percent of the total agency deposit. Deposits must be secured at all times with eligible securities pursuant to section 53651.

3. Collateralization of repurchase agreements must be at least 102 percent of the market value of principal and accrued interest. Collateral must consist of U.S. Treasury obligations or U.S. Agency obligations. Other specific requirements on repurchase agreements must be addressed in a master repurchase agreement of the City and the financial institution or broker/dealer.

E. Investment compliance review

All securities held by the City will be maintained in compliance with Section XII, Authorized and Suitable Investments. The investment portfolio shall be reviewed quarterly to determine compliance with these parameters. Noncompliance events will be evaluated to determine and initiate actions needed to adjust investment yields, maturities, percentage requirements or other, in order to bring the portfolio back into compliance. In the event an instance of non-compliance is recommended by the Treasurer, authorization may be given by the Executive Investment Committee and Mayor if done unanimously. All major and critical incidences of noncompliance shall be reported in the quarterly treasurer's report to the City Council

XIII. <u>Maturity Goals</u>

1. Subject to the availability of funds, short –term investments (maturity of one year or less) of the city shall not be less than 25% of the General Fund annual operating budget of the city.

2. The percentage of the City's portfolio that may be invested intermediate term (maturity term over one year and not greater than five years) shall be determined by the City Treasurer based on estimated cash requirements.

3. Long-term investments (over five years to maturity date) shall be made only after review and approval by the City Council. Accordingly, no fixed percentage of the City's portfolio is designed for long-term investments.

4. Additional and/or clarifying maturity guidelines shall be adopted from time to time as devised by the City Treasurer and reviewed by the Executive Investment Committee.

XIV. Policy Review

This investment policy shall be reviewed at least annually to ensure its consistency with the overall objectives of preservation of principal, liquidity, yield, and its relevance to current law and financial and economic trends. The City of Escondido's investment policy shall be approved by the City Council on an annual basis.

XV. Investment Procedures

The City Treasurer and his/her del

egated staff shall establish written investment policy procedures for the day-to-day operations of the investment program consistent with this policy. The procedures should include reference to cash balancing, safekeeping, wire transfer agreements, collateral/depository agreements, and the selection process for financial institutions and broker/dealers. The procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the City Treasurer.

XVI. Investment Strategy and Performance Standards

The City's investment strategy is passive (buy and hold.) Given this strategy, the basis used by the City Treasurer to determine whether market yields are being achieved shall be to identify a comparable benchmark to the City's portfolio investment duration. Given the liquidity objective (25 % of general fund operating budget shall be invested one year or less) and the portfolio duration, the 2-Year U.S. Treasury Note shall be the City's selected benchmark.

APPENDIX

CITY OF ESCONDIDO
INVESTMENT PROCEDURE MANUAL

Purpose

The purpose of these guidelines is to help create a Procedure Manual to assist Treasury staff with day-to-day investment operations.

References and subjects at the beginning of each section refer to elements in the Investment Policy.

Cash Review

I. Policy
II. Scope
IX. Accountability and Authority

The Treasurer or his/her designee, must review the cash balances and investment portfolio daily, or as needed. Items to be reviewed should include:

a) Balance of City of Escondido's General Account

b) Maturing Investments (includes all investments)

c) Large incoming wires from the State, County and other miscellaneous agencies

d) Large outgoing wires such as debt service payments and routine wires such as San Diego County Water Authority, Kaiser, and Workers' Compensation Service provider and any other routine that may be added

e) Accounts payable and payroll disbursements

Investment Selection

III. Prudence
IV. Objective
XII. Authorized and Suitable Investments
XII B. Diversification
XIII. Maturity Goals

The Treasurer or designee determines how much of the cash balance is available for investment and selects the area of the yield curve that most closely matches the required maturity date based on cash flow needs.

In determining the maturity date, the Investment Officer or other Treasurer designee, should consider liquidity, cash flow and expected expenditures. A review of some of the following sources should determine whether the investments should be placed to match projected expenditures or shorter, or take advantage of current and expected interest rate environments

a) Review daily business publications and commentaries from financial institutions and brokers.

b) Read publications, Wall Street Journal and watch media (CNBC) for general trends of economic interests.

c) Input from approved broker/dealers.

Purchasing an Investment

VII. Authorized Financial Institutions and
VIII. Broker/Dealers

VIII. Safekeeping and Custody

XII. Authorized and Suitable Investments

XII B. Diversification of Investments

XIII. Maturity Goals

Financial institutions are selected through a "Request for Proposal" (RFP) process. Broker/dealers are selected through a formal questionnaire process, which helps provide the following evaluation:

a) Financial conditions, strength and capability to fulfill commitments.

b) Overall reputation with other investors.

c) Regulatory status of the broker/dealer (all providers).

d) Background and expertise of the individual representative.

Selection of financial institutions and broker/dealers shall be performed by authorized City staff under direction of the Executive Investment Committee. The City has an established formal procedure process in place for the selection of financial institutions and broker/dealers. Every three to five years the City will distribute a broker/dealer questionnaire to interested and known financial institutions and broker/dealers. The City Treasurer will maintain a list of qualified broker/dealers authorized to provide investment services to the City of Escondido. The list may include primary or regional dealers that are credit worthy and Rule 15C3-1.

All financial institutions and broker/dealers who desire to provide investment services must participate in the City's formal broker/dealer questionnaire process. To be considered, the financial institution or broker/dealers must supply the following as appropriate:

- Completed broker/dealer questionnaire

- Proof of National Association of Security Dealers (NASD) certification
- License to conduct business in the state of California
- Audited financial statements demonstrating compliance with state and federal capital adequacy guidelines
- Certification of having read and understood and agreeing to comply with the City of Escondido's investment policy
- Evidence of adequate insurance coverage

Qualified broker/dealers selected to do business with the City shall submit annually current audited financial statement.

After the annual adoption of the City's investment policy by the City Council, a copy shall be sent to all broker/dealers approved to do business with the City. Confirmation of receipt of this policy shall be considered evidence that the dealer understands the City's investment policies and intends to sell the City only appropriate investments authorized by this investment policy.

The Treasury Manager, Investment Officer or other Treasurer designee shall be as specific as possible in requesting the offering in purchasing a security. If a particular type of investment or a particular agency is to be excluded due to policy limitations that should be stated to the providers. If collateral is required (i.e. for Repo's or CD's) the collateral limitations (excess margin, types of securities, maximum maturity, etc.) should be specified. The City may invest in repurchase agreements provided it has a signed master repurchase contract, which specifies terms and conditions of repurchase agreements.

The following must be determined prior to contacting the providers:

a) Settlement – cash, regular (next day), corporate (3 business days) or when-issued if a new issue.
b) Amount – either par value or total dollars to be invested.
c) Type of security to be purchased or type to be excluded.
d) Targeted maturity or maturity range.
e) Time limit to show offering – 5 minutes, 15 minutes, or a specified time.

If choosing an external pool or (LAIF or Money Market) as the preferred investment vehicle at the time, the following should be available for inspection prior to purchase and at reasonable time thereafter:

a) LAIF written investment policy and a copy of the "LAIF ANSWER BOOK" (which contains detailed information about LAIF).
b) A prospectus for the Money Market funds or bank-managed funds.
c) The balance of the LAIF account is reviewed to adhere to the City's investment pool limit – not to exceed the investment policy limits of up to $50 million.

Before concluding the transaction, the following should be validated:

a) The security selected for purchase meets all criteria, including portfolio-diversification, collateralization (if appropriate) and maturity. If the security has any imbedded options such as call provisions or coupon adjustments, these should also be reviewed. Current practice is to buy bullet securities, no callable. The strategy is buy and hold.

b) Verify yield.

c) Total purchase cost (including accrued interest) does not exceed funds available for investment.

d) Advise the successful provider that their offering has been selected for purchase.

e) After confirmation of the purchase, as a courtesy, notify the other broker/dealers that you have placed the investment. Best price may be disclosed if the other broker/dealers ask.

After consummation of the transaction, and prior to settlement date, the following information should be confirmed with the provider in order to ensure prompt and uninterrupted settlement:

a) Reconfirm amounts of transaction (principal, accrued interest if any total cost).

b) Reconfirm settlement date.

c) Acquire CUSIP number of security, if applicable.

d) Obtain a copy of the Bloomberg (trade ticket plus description page).

All qualified broker/dealers have the City's delivery instructions, which consist of the following:

a) Name of third-party safekeeping agent (currently Bank of New York Mellon Trust, contact designated customer service representative)

b) ABA number of safekeeping agent.

c) Safekeeping account number.

Settlement and Follow-Through

IX. Accountability and Authority

The Treasurer or other designee should forward to the safekeeping agent, by fax or e-mail, detailed information regarding investment transaction. The detailed information of the purchased security will consist of:

a) Type of security.

b) Par amount, stated coupon, interest yield, maturity date, and CUSIP number.

c) Specified dollar amount (principal amount, accrued interest, if applicable, and total cost).

d) Note the broker of the investment transaction.

e) Signature of the Treasurer designee.

A phone call should be made to the safekeeping agent to inform of purchase and confirm receipt of the investment information. When applicable the following should be verified:

a) Provision of receipt or disbursement of funds.

b) Internal transfer or wiring of funds.

c) Written validation from safekeeping agent.

d) Notification of discrepancy prior to acceptance or rejection of the transaction.

e) Immediate notification if a fail has occurred: by provider if they are responsible, by safekeeping agent if they are responsible.

f) That all verbal and written verifications have been forwarded to and received from applicable parties to ensure that transaction was successfully executed.

Investment Strategy and Performance Standards

XVI. Accountability and Authority

The City's strategy is buy and hold (passive v. active). The strategy is to ladder out the portfolio five years, taking cash flow into consideration. Given this strategy, the basis used by the Treasurer to determine whether market yields are being achieved shall be to identify a comparable benchmark to the City's portfolio investment duration. The 2-Year U.S. Treasury Note shall be the City's benchmark.

GLOSSARY OF TERMS

Agencies — agencies of the federal government set up to supply credit to various classes of institutions (e.g., S&Ls, small business firms, students, farmers, housing agencies, etc.)

Amortized Cost — cost of investments adjusted for premiums and discounts. Amortized cost is used to maintain comparability with market value.

Arbitrage Regulation — law to control the use of profit making by purchasing securities on one market for immediate resale on another in order to profit from a price difference.

Asked — the price at which securities are offered.

Bankers Acceptance (BA) — a draft, bill or exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill, as well as the issuer.

Benchmark — a comparative base for measuring the performance or risk tolerance of the investment portfolio. A benchmark should represent a close correlation to the level of risk and the average duration of the portfolio's investments.

Bid — price a prospective buyer is ready to pay.

Bond Indenture — written agreement specifying the terms and conditions for issuing bonds, stating the form of the bond being offered for sale, interest to be paid, the maturity date, call provisions and protective covenants, if any, collateral pledged, the repayment schedule, and other terms. It describes the legal obligations of a bond issuer and the powers of the bond trustee, who has the responsibility for ensuring that interest payments are made to registered bondholders.

Book value — a term synonymous with amortized cost.

Broker/Dealer — individual or firm acting as principal in securities transaction.

Buy and Hold Strategy — investments in which management have the positive intent and ability to hold each issue until maturity.

Callables — securities that the issuer has the right to redeem prior to maturity.

Certificates of Deposit (CD) — a time deposit with a specific maturity evidenced by a certificate.

Collateral — securities pledged to secure repayment of a loan.

Commercial Paper – short-term IOU, or unsecured money market obligation, issued by prime rated commercial firms and financial companies, with maturities from 2 days up to 270 days. It is a promissory note of the issuer used to finance current obligations, and is a negotiable instrument.

Comprehensive Annual Financial Report (CAFR) — an annual financial report that contains at a minimum, three sections: introductory, financial and statistical, and whose financial section

provides information on each individual fund and component unit. (Definition source: 2005 Governmental Accounting, Auditing, and Financial Reporting (GAAFR)

Coupon — a) the annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value; b) a certificate attached to a bond evidencing interest due on a payment date.

Custody — a banking service that provides safekeeping for the individual securities in a customer's investment portfolio under a written agreement which also calls for the bank to collect and pay out income, to buy, sell, receive and deliver securities when ordered to do so by the principal.

Debenture — a bond secured only by the general credit of the issuer.

Delivery vs. Payment — there are two methods of delivery of securities: Delivery versus payment and delivery versus receipt. Delivery versus payment is delivery of securities with a simultaneous exchange of money. Delivery versus receipt is delivery of securities with an exchange of a signed receipt for the securities.

Derivatives — a) financial instruments whose return profile is linked to, or derived from, the movement of one or more underlying index or security, and may include a leveraging factor; b) financial contracts based upon notional amounts whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities or commodities).

Discount — the difference between the cost price of a security and its maturity when quoted at lower than face value. A security selling below original offering price shortly after sale also is considered to be at a discount.

Discount Securities — non-interest bearing money market instruments that are issued a discount and redeemed at maturity for full face value, e.g., U.S. Treasury Bills.

Diversification — dividing investment funds among a variety of securities offering independent returns.

Executive Investment Committee — a committee chaired and appointed by the City Treasurer to oversee the day-to-day investment program of the City.

Federal Credit Agencies — agencies of the federal government set up to supply credit to various classes of institutions and individuals, e.g., S&L's, small business firms, students, farmers, farm cooperatives and exporters.

Federal Deposit Insurance Corporation (FDIC) — a federal agency that insures bank deposits. Deposit coverage increased from $100,000 to $250,000 per depositor in 2008. The increased coverage limits of $250,000 per depositor, per insured institution, was extended indefinitely effective July 2010 with the passage of the Dodd-Frank Act.

Federal Farm Credit Bank System (FFCB) — created by Congress in 1916, this nationwide system of banks and associations provides mortgage loans, credit and related services to farmers, rural homeowners, and agricultural and rural cooperatives. The banks and associations are cooperatively owned, directly or indirectly, by their respective borrowers. The banks of the Farm

Credit System issue securities on a consolidated basis through the Federal Farm Credit Banks Funding Corporation.

Federal Funds Rate — the rate of interest associated with borrowing a Federal Reserve Bank's excess reserves. This rate is currently pegged by the Federal Reserve through open-market operations.

Federal Home Loan Bank System (FHLB) — created in 1932, this system consists of 12 regional banks, which are owned by private member institutions and regulated by the Federal Housing Finance Board. Functioning as a credit reserve system, the system facilitates extension of credit through its owner-members in order to provide access to housing and to improve the quality of communities. Federal Home Loan Bank issues are joint and several obligations of the 12 Federal Home Loan Banks and issued through the Federal Home Loan Banks Office of Finance.

Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) — a stockholder-owned corporation established by Congress in 1970 to provide a continuous follow of funds to mortgage lenders, primarily through developing and maintaining an active nationwide secondary market in conventional residential mortgages. Freddie Mac purchases a large volume of conventional residential mortgages and uses them to collateralize mortgage-backed securities. Freddie Mac is a publicly held corporation; its stock trades on the New York Stock Exchange. Effective in 2008, the FHLMC was placed under U.S. Government conservatorship through the Federal Housing Finance Authority agency.

Federal National Mortgage Association (FNMA or Fannie Mae) — a federally chartered but privately owned corporation which traces its roots to a government agency created in 1938 to provide additional liquidity to the mortgage market. Fannie Mae carries a congressional mandate to promote a secondary market for conventional and FHA/VA single- and multifamily mortgages. Fannie Mae is a publicly held company whose stock trades on the New York Stock Exchange. Effective in 2008, the FNMA was placed under U.S. Government conservatorship through the Federal Housing Finance Authority agency.

Federal Open Market Committee (FOMC) — a committee that sets interest rate and credit policies for the Federal Reserve System, the United States' central bank. The FOMC has 12 members. Seven are the members of the Federal Reserve Board, appointed by the president of the United States. The other five are presidents of the 12 regional Federal Reserve banks. Of the five, four are picked on a rotating basis; the other is the president of the Federal Reserve Bank of New York, who is a permanent member. The committee decides whether to increase or decrease interest rates through open market operations of buying or selling government securities. The committee's decisions are closely watched and interpreted by economists and stock and bond market analysts, who try to predict whether the Fed is seeking to tighten credit to reduce inflation or to loosen credit to stimulate the economy.

Federal Reserve System — system established by the Federal Reserve Act of 1913 to regulate the U.S. monetary and banking system. The Federal Reserve System (the Fed) is comprised of 12 regional Federal Reserve Banks, their branches, and all national and state that are a part of the system. The Federal Reserve System's main functions are to regulate the national money supply, set reserve requirements for member banks, supervise the printing of currency at the mint, act as clearinghouse for transfer of funds throughout the banking system, and examine member banks to make sure they meet various Federal Reserve regulations.

Government National Mortgage Association (GNMA or Ginnie Mae) — government-owned corporations, nicknamed Ginnie Mae, which is an agency of the U.S. Department of Housing and Urban Development. Security holder is protected by full faith and credit of the U.S. government. Ginnie Mae securities are backed by the FHA, VA or FM mortgages. The term "pass throughs" is often used to describe Ginnie Maes.

Interest Rate Risk — the risk that investments will lose market value because of increases in market interest rates. A rise in market interest rates will cause the market value of investments made earlier at lower interest rate to lose value. The reverse will cause a gain in market value.

Intermediate Maturity — investment period greater than one year but less than five years and one day.

Investment Committee — a committee chaired by the City Treasurer to advise the City Treasurer on policies governing the City's investment program.

Laddered Portfolio — bond investment portfolio with securities in each maturity range (e.g. monthly) over a specified period of time (e.g. five years).

Leverage — investing with borrowed money with the expectation that the interest earned on the investment will exceed the interest paid on the borrowed money.

Liquidity — the ability to turn an asset into cash. The ability to buy or sell an asset quickly and in large volume without substantially affecting the asset's price.

Local Agency Investment Fund (LAIF) — the aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

Long-Term Maturity — investment period greater than five years.

Long-Term Investment — maturity on investment greater than five years, as of the date of purchase.

Market Value — the price at which a security is trading, usually the liquidation value.

Master Repurchase Agreement — a written contract covering all future transactions between the parties to repurchase reverse repurchase agreements that establish each party's rights in the transactions. A master repurchase agreement will often specify the right of the buyer-lender to liquidate the underlying securities in the event of default by the seller-borrower.

Maturity — the date upon which the principal or stated value of an investment becomes due and payable.

Modified Duration — a measure of the sensitivity that the value of a fixed-income security has to changes in market rates of interest. Modified duration is the best single measure of a portfolio's or security's exposure to market risk. Modified duration identifies the potential gain/loss in value before the gain/loss actually occurs. It is a prospective measurement, e.g., a modified duration of 1.5 indicates that when and if a 1% change in market interest rates occurs, a 1.5% change in the value of a security will result. Investments with modified durations of one to three are considered to be relatively conservative.

Money Market — the market in which short-term debt instruments (Treasury bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

Offer — price at which someone who owns a security offers to sell it, also known as the asked price.

Open Market Operations — activities by which the Securities Department of the Federal Reserve Bank of New York, popularly called the desk, carries out instructions of the Federal Open Market Committee designed to regulate the money supply. Open market operations are the Federal Reserve's most important and most flexible monetary policy tool.

Pooled Investment — grouping of sources for the common advantage of the participants.

Portfolio — collection of securities held by an investor.

Primary Dealer — investment dealers authorized to buy and sell government securities in direct dealings with the Federal Reserve Bank of New York in its execution of Fed Open Market Operations. Such dealers must be qualified in terms of reputation, capacity, and adequacy of staff and facilities.

Prudent Person Rule — standard adopted by some U.S. states to guide those with responsibility for investing money of others. Such fiduciaries, such as trustees, must act as a prudent man or woman would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital, and in general, avoid speculative investments. States not using the prudent-man system use the *legal list* system, allowing fiduciaries to invest only in a restricted list of securities, called the *legal list.*

Qualified Investment — an investment instrument (such as an insured certificate of deposit of $100,000 with California chartered savings and loan), which is approved by this policy or pursuant to procedures set forth in this policy.

Range Note — an investment instrument that pays a high interest rate, if a given index falls within a stipulated range, but pays no interest if the stipulated index falls outside that range.

Rate of Return — the yield obtainable on security based on its purchase price or its current market price.

Repurchase Agreement (RP or REPO) — agreement between a seller and a buyer, usually of U.S. government securities, whereby the seller agrees to repurchase the securities as an agreed upon price and usually, at a stated time. The security "buyer" in effect lends the "seller" money for the period of the agreement, and the terms of the agreement are structured to compensate him for this. Dealers use RP extensively to finance their positions. Exception: when the Fed is said to be doing RP, it is lending money that is, increasing bank reserves.

Required Reports — Section 53646 of the California Government Code specifies that certain information may be periodically transmitted to the City's governing body and chief executive officers by the City's chief fiscal or investment officer.

Safety — the ability of a security issuer to guarantee redemption of their security.

Safekeeping — sees custody

Secondary Market — a market made for the purchase and sale of outstanding issues following the initial distribution.

Securities & Exchange Commission — agency created by Congress to protect investors in securities transactions by administering securities legislation.

SEC Rule 15C3-1 — see Uniform Net Capital Rule.

Short-term Maturities — investment period of one year or less.

Tennessee Valley Authority (TVA) — a wholly owned corporation of the U.S. government that was established in 1933 to develop the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense. Power operations are separated from non-power operations. TVA securities represent obligations of TVA, payable solely from TVA's net power proceeds, and are neither obligations of nor guaranteed by the United States. TVA is currently authorized to issue debt up to $30 billion. Under this authorization, TVA may also obtain advances from the Treasury of up to $150 million.

Treasury Bills — a non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Treasury Bills have a maturity of one year or less.

Treasury Bonds — long-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities of more than 10 years.

Treasury Notes — medium-term coupon bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities from one to ten years.

Uniform Net Capital Rule — Securities and Exchange Commission requirement that all SEC registered broker/dealers maintain sufficient liquid resources to promptly satisfy their liabilities, including all claims by customers, creditors and other broker-dealers. The rule requires broker-dealers to maintain the greater of (1) a specified percentage of net capital as it relates to either total broker indebtedness or total customer receivables, or (2) a specified dollar amount.

Yield -The annual rate of return on an investment generally expressed as a percentage of the securities current price.