



**CITY OF ENCINITAS
CITY COUNCIL
AGENDA REPORT
Meeting Date: October 23, 2013**

TO: Honorable City Council

VIA: Gus Vina, City Manager
Tim Nash, Finance Director/City Treasurer *TN*

FROM: Jay Lembach, Finance Manager III/Investment Officer *JLW*

SUBJECT: Adoption of City of Encinitas Investment Policy (*City Administrative Policy F019*)

BACKGROUND: The City of Encinitas adopted its first written investment policy (the “Policy”) in 1994. Major upgrades were done to the Policy in 2002, which were submitted to the Association of Public Treasurers under its *Certificate of Excellence* Program. The Policy achieved certification in that year, indicating that it is judged to be of the highest tier in quality and content, is comprehensive in nature, and demonstrates the incorporation of best management practices in all functional areas.

The Policy, as well as the practice of the Finance Department, is to present the Policy to the Legislative Body at least once per year for review and adoption. Below is a brief summary of the content of the Policy, as it applies to the City of Encinitas Investment Program (the “Program”). The full text of the Policy is included as **Attachment A**, with highlights in YELLOW to indicate changes or clarifications.

Section I – describes the general investment philosophy of the City

Section II – covers the scope of the Policy

Section III – describes the concept and application of prudence in the management of the City’s monies.

Section IV – details the specific objectives of the Program

Section V - addresses the specific delegation(s) of authority to oversee and operate the Program. There have been changes made to this section, which are described in the ANALYSIS section below. (See YELLOW highlights in **Attachment A**)

Section VI – addresses the topics of ethics and conflict of interest.

Section VII - details the requirements and procedures necessary to qualify outside firms (securities brokers and financial institutions) to do business with the City as it relates to the Program. Clarifying language has been added to this section. (See YELLOW highlights in **Attachment A**)

Section VIII - Authorized & Suitable Investments is perhaps the most important section of the Policy. It contains a listing of the investments that the Investment Officer may purchase and hold on behalf of the City. It also discusses the limitations of the CA Gov’t Code and the target allocations, which are meant to promote diversification and lower the overall risk profile of the Portfolio. This section contains some minor changes and clarifications, which are described in the ANALYSIS section below. (See YELLOW highlights in **Attachment A**).

Sections IX through XIII - discuss due diligence requirements, collateralization requirements, the requirement that the City engage an independent third-party custody agent, and the importance of diversification.

Section XIV - addresses the importance of the establishment and maintenance of a strong system of internal controls over investment management. Internal controls over investment management are part of the larger “infrastructure” of general internal controls over all Finance operations. Language has been added to this section describing controls and practices already in place. (See YELLOW highlights in **Attachment A**)

Section XV - discusses the importance of developing and maintaining an effective means to track investment performance, via the establishment of a *Performance Benchmark*. Language has been added to this section to describe the latest methods utilized to account for and report investment results.

Sections XVI and XVII - cover investment accounting and reporting, as well as the annual requirement of adoption of the Policy by the City Council. (See YELLOW highlights in **Attachment A**).

ANALYSIS:

The following paragraphs describe the recommended changes to the Policy and the reasons for those changes:

NOTE: Throughout the document, substitutions of titles have occurred, primarily replacing former titles with “**Finance Director/City Treasurer.**”

Section V – Delegation of Authority Since 1997, the duties and responsibilities of City Treasurer have been delegated to the Investment Officer (Finance Manager III). The change in this section clarifies that (1) some of the duties of the City Treasurer have been delegated to the Investment Officer, however (2) all of the oversight and responsibility for the Program remains with the Finance Director, who is designated as City Treasurer in the Municipal code.

Section VII – Authorized financial Dealers and Institutions The changes in this section are meant to clarify the practices currently in place for selection and retention of investment professionals.

Section VIII – Authorized and Suitable Investments Subsection (4) has been amended to address (potential) changes that may be made to SEC regulation regarding money market funds. The change in subsection (6) clarifies that negotiable certificates of deposit that are fully insured by the FDIC do not require collateralization. The previous maximum maturity of one year was an oversight; it was meant to be five years in line with the CA gov’t code.

Section XIV – Internal Control The language added here simply states the practices and procedures that are already in place.

Section XV – Performance Benchmark The added language in this section clarifies that the Investment Officer now reports performance on a “book-value” basis only. This was the method utilized by all municipalities until the early 2000’s, when GASB 31 introduced the “total return” basis of reporting. The City of Encinitas utilized both methods for several years, and now uses only the book value method. This alternative method is acceptable practice, and has the “blessing” of the City’s independent auditor.

FISCAL AND STAFF IMPACTS: NONE

RECOMMENDATION: Adopt the updated Investment Policy (*City Admin. Policy F019*)

ATTACHMENTS:

Attachment A City Admin. Policy F019 - Investment Policy

**CITY OF ENCINITAS
ADMINISTRATIVE MANUAL**

Policy Title: Investment Policy

Section: Finance

Responsible Department: Finance

Number: Admin Policy F019

Approved By: City Council

Date Approved: 1994

Last Amended: October 24, 2012

Amendment Date: **October 23, 2013**

I. Philosophy

The Investment Policy of the Encinitas City Council for the City of Encinitas represents the financial guidelines for the City's Investment Program. It is the policy of the City of Encinitas to invest excess public funds in a prudent manner that safeguards the public trust, minimizes the risk of loss of capital, and provides assurance that all financial obligations will be met in the regular course of business. The City Council shall provide direction to the Investment Officer as to the goals and specific objectives of the Investment Program.

II. Scope

This Investment Policy applies to all financial assets under the oversight of the City of Encinitas, except bond proceeds held by outside trustees and funds held by other governmental agencies. The City of Encinitas includes the City and all component units: the Encinitas Housing Authority (EHA), the Encinitas Public Financing Authority (EPFA), and the San Dieguito Water District (SDWD). These funds are accounted for in the City of Encinitas' Comprehensive Annual Financial Report and include:

*GENERAL FUND
SPECIAL REVENUE FUNDS
CAPITAL PROJECT FUNDS
ENTERPRISE FUNDS
INTERNAL SERVICE FUNDS*

This policy also applies to funds that the City manages for other governmental agencies. Currently, the City manages funds for the Encinitas Ranch Golf Authority (ERGA), a legally separate joint powers authority which is not a component unit of the City.

The investment of Bond Proceeds held with trustees is directed by the City, but is governed by the restrictions on Permitted Investments in the applicable Bond Indenture agreements.

A portion of City funds is held by other governmental agencies. These funds are invested under the guidelines of the investment policies of those agencies.

The City retirement plan is with CALPERS, and the City has no authority or oversight over the investments in any of those plans. Further, the City administers several deferred compensation

plans. Assets held in those plans are held in trust for the participants, and are not assets of the City. The City does not have any authority over the investments held in these trusts.

III. Prudence

Investments shall be made with reasonable financial judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

The standard of prudence to be used by investment officials shall be the “prudent person” and/or “prudent investor” standard. California Gov’t Code 53600.3 states that, “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. The standard shall be applied in the context of managing an overall portfolio. Investment officials acting in accordance with established procedures and exercising due prudence shall be relieved of personal responsibility for an individual security’s credit risk or market price changes.

IV. Investment Objectives

A. **Safety of Principal** - *the first objective of this policy is to ensure the safety of principal. The portfolio shall be planned and managed to minimize the risk of actual loss of principal. Principal is defined as the original purchase price of the security, excluding any purchase of accrued interest, up to the par (face) value of the security. Any purchase amount above par value (premium) is considered to be a purchase of accrued interest, and is excluded from the calculation of principal amount. The Investment Officer shall consider both credit risk and concentration risk (the concept of diversification) when assessing safety, and shall follow the guidelines outlined later in this policy to achieve that objective.*

B. **Liquidity** - *The second objective is the maintenance of sufficient liquidity to meet all operating and capital spending requirements that can be reasonably anticipated. Liquidity is further broken down between primary and secondary liquidity. Primary liquidity is defined as funds which are available to the City to pay demands within 48 hours without loss of interest. Secondary liquidity is defined as funds invested in authorized investments that mature within a one-year time period, minimizing market risk.*

C. **Return on investments** - *The third objective is yield, specifically, attaining a market rate of return over time, consistent with Council direction as to acceptable levels of risk. Refer to Section XV below for further discussion of performance measurement.*

V. Delegation of Authority

*Authority and responsibility to manage the City of Encinitas’ Investment Program rests first with the City Council. Primary management responsibility rests with the **City Treasurer**. The City of Encinitas Municipal Code designates that the Finance Director shall serve as City Treasurer. The Finance Director/City Treasurer has the option to designate another individual within the organization to assume some, or all, of the duties described in this Policy. The Finance Director has assigned some of those duties to the City Finance Manager III. For purposes day-to-day management of the Investment Program, the Finance Manager III shall be designated as the **Investment Officer**, and the duties referred to herein will generally cite the Investment Officer as performing those tasks.*

Investment Procedures

The Investment Officer is responsible for establishing written investment procedures for the management and operation of the Investment Program, consistent with this Policy. Those procedures shall include reference to such items as: custody/safekeeping, repurchase agreements (if applicable), wire transfer agreements, banking service agreements, and explicit delegation of authority to personnel involved in the processing of banking or investment transactions. No person may engage in any investment transaction except as provided under the terms of this Policy and the established procedures.

VI. Ethics, & Conflict of Interest

The investment responsibility carries with it the responsibility of ensuring that investments placed are done so without improper influence or the appearance of improper influence. All officers and employees (officials) involved in the investment function shall adhere to the State's Code of Economic Interest and to the following:

Officials shall refrain from personal business activity that could conflict with proper and impartial execution of the Investment Program, or that could impair their ability to make impartial investment decisions. Further, officials shall not personally or through a close relative maintain any accounts, interest, or private dealings with any firm with which the City places investments, with the exception of regular savings, checking and money market accounts, or other similar transactions that are offered on a non-negotiable basis to the general public. Any such relationships shall be disclosed annually to the City Clerk in conjunction with annual disclosure statements of economic interest.

VII. Authorized Financial Dealers and Institutions

The Investment Officer shall maintain a list of **qualified financial institutions** authorized to provide financial or investment services to the City.

The City shall contract with one institution to provide **general banking services**, which shall be reviewed at least every five years. City Council shall approve the selected institution and the contract for banking services.

The City shall contract with one institution to provide **investment custody services**, which shall be reviewed at least every five (5) years. City Council shall approve the selected institution and the contract for custody services.

The Investment Officer shall maintain a list of **qualified security broker-dealers** authorized to provide financial or investment services to the City. To be eligible for consideration to become an authorized provider, each Broker/Firm shall meet the following MINIMUM requirements:

- (1) have a net capital position in excess of \$10 million,
- (2) have been in business for at least five years,
- (3) are currently licensed as a broker-dealer or investment adviser in California, and
- (4) Must carry adequate insurance coverage including liability, errors and omissions, and workers compensation (if applicable.)

Firms providing only representation of money market funds are exempt for requirement #1, but must still comply with all other requirements, including those listed below.

The City Council shall approve the initial authorization of any broker-dealer. Authorized firms shall be notified by the Investment Officer via an engagement letter, which outlines each parties' responsibilities (primarily the continuing compliance requirements discussed directly below). There is no contract for professional services or term to the engagement. The Investment Officer shall periodically evaluate the performance of all qualified broker-dealers, and determine if any changes need to be made.

All broker-dealers authorized to do business with the City of Encinitas must also comply with the following requirements:

- (1) Firms must submit audited financial statements annually, within six months of their fiscal year-end,
- (2) Firms must provide proof of their NASD certification, and must disclose to the City immediately any regulatory actions or complaints against the broker assigned to the City account,
- (3) Firms must provide proof of their registration/license to do business in the State of California, and shall immediately disclose to the City any change in that status.
- (4) Firms must certify in writing that they have received, read, and agree to comply with the City of Encinitas' most recently adopted Investment Policy.

VIII. Authorized & Suitable Investment Instruments

As a unit of local government in the State of California, the City of Encinitas is restricting itself to the investments authorized by Government Cod, Sections 53600 through 53635 (the Gov't "Code") except as otherwise provided herein by specific additional Council actions.

SPECIFIC INVESTMENT TYPES AND AMOUNTS - The Investment Officer is authorized to invest in only the following types of investments listed below in **Section VIII.**, unless specifically authorized in advance by the **Finance Director/City Treasurer.**

INVESTMENT ALLOCATIONS - The **Maximum** allocations listed below refer to the percentage of the total portfolio that may be invested in each instrument under the provisions of the Gov't Code. The **Target** allocations refer to guidelines the Investment Officer generally follows, in order to effect proper diversification of the portfolio and limit concentration risk. The Investment Officer is permitted to exceed these target allocations for temporary periods. Any asset allocation that exceeds the **target** for a period of more than three months shall be reported to the **Finance Director/City Treasurer.**

For purposes of calculating the percentage allocations, the assumption will be applied that the size of the portfolio for any fiscal year shall be determined by the total par value of the portfolio at the beginning of the first day of the fiscal year. Any investment types that exceed the maximum allowable under the Gov't Code shall be reported to the City Council in the quarterly investment report.

INVESTMENT ALLOCATIONS

	<u>MAXIMUM STATE LAW</u>	<u>TARGET INV POLICY</u>
(1) Repurchase agreements	NO LIMIT	20%
<i>This type of investment is only authorized in relation to the City's general banking arrangements, in which excess cash balances are "swept" into an interest earning account overnight. Maximum maturity is one day. All balances are required to be properly collateralized at 102% of par value in accordance with State requirements.</i>		
(2) CA Local Agency Inv Fund (LAIF)	\$80 million	30%
<i>The \$80 million listed under "MAXIMUM STATE LAW" refers to the LAIF limit on maximum deposits per local agency, not to the CA gov't code restrictions. The City of Encinitas maintains two accounts with the LAIF, one in the name of the City and the other in the name of the San Dieguito Water District. Each account has a deposit limit of \$40 million. Since San Dieguito Water District is a component unit of the City, the City may legally utilize the SDWD account in the operation of the City Pool. Thus, SDWD owns its ratable share of all City Pooled investments, but does not have a direct ownership interest in the LAIF account in its name.</i>		
(3) Other Gov't Managed Pools	NO LIMIT	NO LIMIT
Per Issuer		10% per Pool
<i>Investments in individual pools shall be limited to 10% of the total portfolio. Currently approved pools are the San Diego County Investment Pool and the California Asset Management Program (CAMP). The City Council must approve the addition of any other governmental pools.</i>		
(4) Mutual Funds (Total)	20%	20%
Per Issuer	10%	10%
(A) Money Market Mutual Funds	N/A	20%
Per Issuer	N/A	10%

Money Market Mutual Funds have a stable NAV (net asset value) of \$1.00 as defined under United States Securities and Exchange Commission (SEC) rule 2a-7. Qualifying funds must meet one of the following criteria: (1) Attained the highest ranking or the highest letter and numerical rating provided by not less than two nationally recognized statistical rating organizations, OR (2) Retained an Investment Advisor registered or exempt from registration with the SEC with not less than five years' experience managing money market mutual funds with assets under management in excess of \$500 million.

INVESTMENT ALLOCATIONS (continued)

	<u>MAXIMUM STATE LAW</u>	<u>TARGET INV POLICY</u>
(B) Bond Mutual Funds	N/A	10%
Per Issuer	N/A	\$5 million

Bond Mutual Funds are similar to Money Market Mutual Funds, and are subject to the same limitations as Money Market Mutual Funds. In other words, the total allocation to Mutual Funds (investment types 4 & 5) is limited to 20% of the total portfolio. Bond Mutual Funds typically have a weighted average maturity of greater than 70 days, and are subject to more volatility and market risk. They have a net asset value (price) that can change based on market conditions. Because of the higher risk profile, the City is limiting investment in Bond Mutual Funds to no more than 10% of the total portfolio, and to \$5 million per issuer.

Currently, SEC regulations are being drafted that will likely change the accounting and measurement focus for certain money market funds. Specifically, certain funds will no longer be permitted to maintain a "stable NAV" of \$1.00. They will be required to "mark-to-market" all investments every working day. This could, and likely will periodically, change the overall value of the fund. This would create either a gain or loss on the fund, depending on the effect of interest rate and credit risk changes. For the next period, the City of Encinitas will not be investing in any money market funds which are required to, or actually adopt, what is referred to as a "floating NAV."

(5) Certificates of Deposit (CD's)	NO LIMIT	10%
Per Issuer	NO LIMIT	\$1 million

All CD's must be either insured by the FDIC or properly collateralized, pursuant to Section X below. Maturity shall not exceed one year. No more than \$1 million per issuer. To be eligible to receive deposits from the City of Encinitas, each qualified financial institution must have received an overall rating of not less than "satisfactory" in its most recent evaluation by regulators of its record of meeting the credit needs of its community.

(6) Negotiable Certificates of Deposit	30%	10%
Per Issuer		\$1 million

*All Negotiable CD's must be issued by a provider rated either: (1) **Aaa** by Moody's, (2) **AAA** by Standard & Poors, or (3) **Aa1** by Moody's and **AA+** by Standard & Poors. Investments with institutions rated at least Aa3 and AA- will be allowed, but shall be properly collateralized pursuant to Section X below. Investments of \$250,000 or less that are fully insured by the FDIC are exempt from the above credit rating requirements. Maturity shall not exceed five years. No more than \$1 million per issuer.*

INVESTMENT ALLOCATIONS (continued)

		<u>MAXIMUM STATE LAW</u>	<u>TARGET INV POLICY</u>
(7)	Bankers Acceptances	40%	10%
	Per Issuer	30%	\$1 million

*Bankers Acceptances (BA's) represent a time draft drawn on and accepted by a Bank for payment of the shipment or storage of merchandise. They are generally considered a very safe investment since both the credit of the issuer and the Bank is pledged for repayment. They must not exceed 180 days maturity. BA's must have an underlying credit rating of **A1/P1**, and are limited to \$1 million per issuer.*

(8)	U.S. Treasury Bills, Notes and Bonds	NO LIMIT	50%
(9)	U.S. Government-Sponsored Agencies	NO LIMIT	60%
	Per Issuer		15%

City shall invest primarily in securities issued by Federal Home Loan Bank (FHLB), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal Farm Credit Bureau (FFCB). City may invest in Student Loan Marketing Association (SLMA), Private Equity Funding Corporation (PEFCO) and Tennessee Valley Authority (TVA); however, the overall limit of 60% still applies. City may also invest in the Government National Mortgage Association, but only via authorized Mutual Funds cited in Category 5 above, and subject to those limitations.

(10)	Commercial Paper	25%	25%
	Per Issuer	(see below)	\$5 million

Commercial Paper (CP) is a short-term I.O.U. issued by large corporations of high credit standing which is unsecured. Investments are limited to only "prime quality" CP issued with the highest letter and number rating provided by one of the three nationally recognized rating agencies. City limits itself only to CP rated A-1 or better by Standard & Poors and P-1 by Moodys. Issuing corporations must be (1) organized and operating within the United States, (2) have total assets in excess of \$500 million, and (3) have a "A" or higher rating for the issuers other debt obligations. Organized and operating within the United States includes global companies that sponsor United States commercial paper programs. City may not purchase more than 10% of outstanding commercial paper of any single corporate issuer. The maximum allowable maturity is 270 days or less.

(11)	Commercial Medium-Term Notes	30%	15%
	Per Issuer		\$1 million

*Medium-Term Notes are defined as all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating in the United States or by depository institutions licensed by the United States. State Code requires a credit rating of "A" or better by one nationally recognized rating agency. The City is further limiting itself to notes that are rated **Aa3 or better** (Moody's) and **AA- or better** (S & P).*

INVESTMENT ALLOCATIONS (continued)

	<u>MAXIMUM STATE LAW</u>	<u>TARGET INV POLICY</u>
(12) Guaranteed Investment Contracts Per Issuer		10% \$5 million

*Guaranteed Investment Contracts (GIC's) are corporate obligations similar to medium-term notes, but are issued directly to the Agency by the issuer in the form of an investment contract. They are generally longer term in nature. They are generally utilized for the investment of bond proceeds, but may be utilized for the investment of Pooled funds. Uncollateralized GIC's are permitted only with issuers rated **Aaa** (Moody's) and/or **AAA** (Standard & Poors) Collateralized GIC's are permitted with issuers rated **Aa2 or better** (Moody's) and **AA or better** (Standard & Poors). No more than \$5 million per issuer.*

(13) Demand Deposits (non-interest bearing) Per Issuer	0-2% 0-2%
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Non-interest bearing demand deposits with a financial institution approved to do business with the City shall be an allowable investment for the City Pool. These types of accounts are necessary to carry on the regular day-to-day financial operations of the City, and are reported as "cash" on the monthly investment reports. When available, the Investment Officer shall execute a "sweep arrangement" with the designated financial institution, to provide for excess overnight balances to earn interest.

(14) Demand Deposits (interest bearing) Per Issuer	20% \$20 million
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Interest-bearing demand deposits with a financial institution approved to do business with the City shall be an allowable investment for the City Pool. These types of accounts generally serve as an alternative to bank certificates of deposit, and have a stated minimum balance requirement. These types of accounts require a separate agreement with the financial institution, and must be fully collateralized as Public Deposits under California law. In addition, some part of the deposit (currently \$250,000) may be insured by the Federal Deposit Insurance Corporation (FDIC) in lieu of collateralization. Deposits (excluding accrued interest) above \$20 million must be approved in advance by the City Manager, and shall be reported at the next scheduled report date to the City Council.

SUMMARY TABLE of INVESTMENT ALLOCATIONS

	<u>STATE LAW</u>	<u>INV POLICY</u>
(1) REPURCHASE AGREEMENTS	NO LIMIT	20%
(2) CALIFORNIA LAIF	NO LIMIT	30%
(3) OTHER GOV'T POOLS <i>Per Issuer</i>	NO LIMIT	30% 10%
(4) MUTUAL FUNDS <i>Per Issuer</i>	20% 10%	20% 10%
(5) CD's <i>Per Issuer</i>	NO LIMIT	10% \$1 Million
(6) NEGOTIABLE CD's <i>Per Issuer</i>	30%	10% \$1 Million
(7) BANKERS ACCEPTANCES <i>Per Issuer</i>	NO LIMIT 30%	10% \$1 Million
(8) U.S. TREASURYS	NO LIMIT	50%
(9) U.S. FEDERAL AGENCIES <i>Per Issuer</i>	NO LIMIT	60% 15%
(10) COMMERCIAL PAPER <i>Per Issuer</i>	25%	25% \$5 Million
(11) COMMERCIAL MTN NOTES <i>Per Issuer</i>	30%	15% \$1 Million
(12) GIC's <i>Per Issuer</i>	NO LIMIT	10% \$5 Million
(13) Demand Deposits (non-interest bearing) <i>Per Issuer</i>	NO LIMIT	0-2% 0-2%
(14) Demand Deposits (interest bearing) <i>Per Issuer</i>	NO LIMIT	20% \$20 Million

The State of California Government Code restricts local agencies from investing in securities with final maturity dates greater than five (5) years, except as specifically authorized by the City Council. This Policy authorizes two specific exceptions to the above restriction.

- (1) The City may invest in up to \$5 million (par value) of securities (at date of purchase) rated AAA or equivalent with maturities of greater than five (5) years, but not exceeding seven (7) years.
- (2) The City's General Contingency Reserve is not a part of normal operating reserves, and the related funds are not expected to be utilized in the foreseeable future, thus, the likelihood of liquidation is very small. The objective(s) of investment in this area are to maximize earnings with safety, while recognizing that liquidity is less of an issue than with operating or capital funds. Consistent with these objectives, the Investment Officer is authorized to invest contingency funds in securities rated AAA or equivalent with maturities greater than seven (7) years that have a ready market should the need arise to liquidate the investment.

The City Council has directed the Investment Officer not to invest in securities of companies involved in the production of tobacco or alcohol related products. The City recognizes that, due to the extreme complexity of today's corporate structures, it is possible that investments may be placed in good faith in corporations that have an interest in tobacco or alcohol related products that is not widely known or properly disclosed by those corporations. The Investment Officer shall make his/her best efforts, including notice to broker/dealers, to assure that any corporate investments are placed with companies who are not in the tobacco or alcohol business. This policy applies at the time of purchase only.

Certain investments are specifically prohibited by the State Code. Local Agencies may not invest in the following: Inverse floating-rate notes, range notes, or mortgage-derived interest-only strips. The Code also states that "A local Agency shall not invest in any security that could result in zero interest accrual if held to maturity." The City's interpretation of this Code section is that it does not prohibit investment in U.S. Treasury or Federal Agency securities which carry a variable rate of interest; because the chance that such notes could result in zero interest accrual to maturity is remote.

IX. Due Diligence Requirements for Investment Pools, Mutual Funds, and CD's

Investments of these types are authorized in **Section VIII.** above. Before investing any funds in pools or mutual funds, the Investment Officer shall perform a thorough investigation of the fund(s) to determine the suitability of the investment for the City of Encinitas Pooled Investment Fund. This investigation shall include, at a minimum: review of the Funds investment policy and/or prospectus, a review of the performance history of the Fund, review of ratings (where applicable), review of the latest published portfolio composition, review of fees and charges, and references from other agencies who invest in the Fund.

The Investment Officer shall monitor placement of Certificates of Deposit with financial institutions on a regular basis. Compliance with collateral requirements shall be monitored (if applicable).

X. Collateralization of Public Deposits

Collateralization will be required on two types of investments: certificates of deposit (which are not fully insured by FDIC) and repurchase agreements. The Finance Director/City Treasurer has agreed to waive collateral requirements on the first \$250,000 of CD's from each institution, which are insured by FDIC. In order to anticipate market changes and provide a level of security for all invested funds, the required collateralization levels will be:

- | | | |
|-----|-------------------------|---|
| (1) | Overnight repurchases | 102% of market value |
| (2) | Certificates of Deposit | 100% of market value |
| (3) | Demand Deposits | in accordance with CA law regarding Public Deposits |

Collateral must be held by an independent third party with whom the entity has a current custodial agreement. Collateral for overnight repurchases (sweep agreements) may be held by the Trust Department of the institution providing such sweep services. Sweep contracts shall provide for a perfected security interest for the City in collateralized securities.

Collateral shall be provided by the issuing institution in accordance and compliance with the California Gov't Code Sections 53630 et al. Issuing institution is responsible for compliance with all collateral requirements, and must provide the City periodic evidence of that compliance, in a form acceptable to the City.

XI. Safekeeping and Custody

All security transactions entered into by the City shall be conducted on a delivery-versus-payment (DVP) basis. Securities shall be held by an independent third-party custodian approved by the City Council. All broker-dealers shall send a transaction confirmation to the Investment Officer, and all security transactions confirmations shall be treated as a "Vital Record" by City personnel and kept safe per the requirements of City policy on Vital Records. Broker-dealers shall also send a monthly activity statement to the City showing all transactions entered into in the period. No City securities or cash will be held by any broker-dealer. The custodian sends a monthly statement to the Investment Officer covering all investment activity handled by that institution.

XII. Diversification

The City will diversify its investments by security type and institution, to avoid incurring unreasonable risks inherent in over-investing in specific instruments or individual financial institutions. This Policy sets limits on maximum allocations by investment type and by issuer. Refer to Section VIII. above for a listing of authorized investments and the maximum allocation by type of investment. Section VIII. also details specific limitations per issuer. For purposes of this Policy, those limits each apply to the overall portfolio.

XIII. Maximum Maturities

To the extent possible, the City of Encinitas will attempt to match its investments with anticipated cash flow requirements, after taking into consideration interest rate (market) risk and the potential benefits of extending investment maturities. The City conforms to the California Gov't Code requirements limiting investments in notes to five (5) years, subject to the exceptions cited in Section VIII. This relates principally to funds classified as reserves, which may be invested in specified instruments with maturities greater than five (5) years. In addition, the City maintains primary and secondary liquidity pools, as described in Section IV. (2) above. Primary liquidity shall be maintained of \$10 million minimum, with secondary liquidity maintained at an additional \$10 million. Primary liquidity above the \$10 million minimum shall count towards the secondary liquidity requirement.

XIV. Internal Control

The Investment Officer shall establish a system of internal controls over all cash management and investment transactions, designed to provide reasonable assurance that assets are safeguarded and that all transactions are properly and timely recorded.

The City's independent auditor shall annually review the system of internal controls and report any deficiencies and/or suggestions for improvements to the Investment Officer and Finance Director/City Treasurer. Any confirmed significant deficiencies shall be reported to the City Manager and City Council in writing, along with the City's response to the audit findings.

XV. Performance Standards:

The City's investment strategy is active, and as such, the organization has determined that periodic quantitative measurement of investment portfolio performance is an important component of the overall monitoring of the investment program. As stated in Section IV(C) above, the performance objective of the Program is attaining a market rate of return over time consistent with the overall risk tolerance of the organization.

The Investment Officer is charged with determining an appropriate **benchmark** by which to measure periodic performance. The chosen **benchmark** shall be designed to match as closely as practicable the City's tolerance for investment risk. Utilization of the benchmark and analysis of actual performance vs. the benchmark represent an important risk management tool, and analysis of significant variations shall be reported to the City Council in a timely manner. At the same time, it is recognized that the benchmark represents a guideline only, and that performance may vary, especially over relatively short time periods. A timeframe of 2-3 years is considered to be the minimum time period necessary for judging overall performance, due to changing market conditions, cash flow requirements and the fact that no chosen performance benchmark will exactly mirror the City's portfolio.

Attaining a market rate of return over time shall be measured and reported to the City Council, at least quarterly, via the utilization of the following benchmark to measure performance.

The one (1) year constant maturity Treasury index

Any change to the above performance benchmark shall be reported to the City Council during the Investment Officer's quarterly investment report.

The Investment Officer shall report performance on a quarterly basis based on the book yield (standard income) approach. Book yield calculates the earnings on an investment based on actual interest earned during any reporting period, including the accretion of purchase discounts and/or the amortization of purchase premiums. The Investment Officer shall also report the estimated market value of investments held (as provided by a third-party data provider) with each periodic report. The City no longer reports investment income on a total return basis each fiscal year (the alternative method presented in Gov't Actg. Standards Board (GASB) Statement No. 31) as the results over time are roughly comparable.

XVI. Investment Accounting and Reporting

The Investment Officer shall prepare (or have prepared) monthly investment reports sufficient to properly track and record all investment transactions and activity. The Investment Officer shall report investment positions and results of the Pooled Investment Fund to the City Council at least quarterly, in a form acceptable to the City Council (currently in a summary fashion.) These reports shall either be presented as an Agenda Report or as a memo report to the City Council members, at the discretion of the City Manager. The Investment Officer shall report positions and results of the Pooled Investment Fund and the Investment of Bond Proceeds annually to the City Council at a Public Meeting. Detailed annual reports of the Pooled Investment Fund shall be made available on the City's WebSite for Public Review.

XVII. Investment Policy Adoption:

The Investment Policy shall be reviewed and adopted by the City Council at a Public Meeting at least annually, regardless of whether there are any proposed changes to the Policy. The Policy shall be posted for public review on the City's WebSite (www.encinitasCA.gov) under City Departments/Finance.

Any typographical errors of other minor errors or inconsistencies shall be investigated and interpreted by the Investment Officer, who shall then seek the concurrence of the Finance Director before making any changes to policies or procedures. Any unresolved matters, which are judged to be insignificant in the overall context of the Policy, shall be presented to the City Manager for a final determination.