

CITY OF MISSOULA INVESTMENT POLICY

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Modeled After Government Finance Officers Association
Sample Investment Policy
Committee on Cash Management

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I. Scope

This policy applies to the investment of short-term operating funds. Proceeds from certain bond issues will be covered by a separate policy.

1. *Pooling of Funds*

Except for cash in certain restricted and special funds, the City of Missoula will consolidate cash balances from all funds to maximize investment earnings.

Investment income will be allocated to the various funds based on their respective participation and in accordance with generally accepted accounting principles.

II. General Objectives

The primary objectives, in priority order, of investment activities shall be safety, liquidity, and yield:

1. *Safety*

Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective will be to mitigate credit risk and interest rate risk.

a. Credit Risk

The City of Missoula will minimize credit risk, the risk of loss due to the failure of the security issuer *or* backer, by:

- Limiting investments to the safest types of securities
- Pre-qualifying the financial institutions, broker/dealers, intermediaries, and advisers with which the City of Missoula will do business
- Diversifying the investment portfolio so that potential losses on individual securities will be minimized.

b. Interest Rate Risk

The City of Missoula will minimize the risk that the market value of securities in the portfolio will fall due to changes in general interest rates, by:

- Structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity
 - Investing operating funds primarily in shorter-term securities, money market mutual funds, or similar investment pools.

2. *Liquidity*

The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands (static liquidity).

Furthermore, since all possible cash demands cannot be anticipated, the portfolio should consist largely of securities with active secondary or resale markets (dynamic liquidity). A portion of the portfolio also may be placed in money market mutual funds or local government investment pools, which offer same-day liquidity for short-term funds.

3. *Yield*

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments are limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall not be sold prior to maturity with the following exceptions:

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

III. Standards of Care

1. *Prudence*

The standard of prudence to be used by investment officials shall be the "prudent person" standard and shall be applied in the context of managing an overall portfolio. Investment officers acting in accordance with written procedures and this investment policy and exercising due diligence shall 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 the liquidity and the sale of securities are carried out in accordance with the terms of this policy.

Investments shall be made with 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.

2. *Ethics and Conflicts of Interest*

Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with the proper execution and management of the investment program, or could impair their ability to make impartial decisions. Employees and investment officials shall disclose any material interests in financial institutions with which they conduct business. They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio. Employees and officers shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the City of Missoula.

3. *Delegation of Authority*

Authority to manage the investment program is granted to the City's Finance Director/Treasurer, hereinafter referred to as investment officer and derived from the

following: 7-6-201 M.C.A. Responsibility for the operation of the investment program is hereby delegated to the investment officer, who shall act in accordance with established written procedures and internal controls for the operation of the investment program consistent with this investment policy.

Procedures should include references to: safekeeping, delivery vs. payment, investment accounting, repurchase agreements, wire transfer agreements, and collateral/depository agreements. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the investment officer. The investment officer shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials.

IV. Safekeeping and Custody

1. Authorized Financial Dealers and Institutions

A list will be maintained of financial institutions authorized to provide investment services. In addition, a list also will be maintained of approved security broker/dealers selected by creditworthiness (e.g., a minimum capital requirement of \$10,000,000 and at least five years of operation). These may include "primary" dealers or regional dealers that qualify under Securities and Exchange Commission (SEC) Rule 15C3-1 (uniform net capital rule).

All financial institutions and broker/dealers who desire to become qualified for investment transactions must supply the following as appropriate:

- Audited financial statements
- Proof of National Association of Securities Dealers (NASD) certification
- Proof of state registration
- Completed broker/dealer questionnaire
- Certification of having read and understood and agreeing to comply with the City of Missoula's investment policy.

An annual review of the financial condition and registration of qualified financial institutions and broker/dealers will be conducted by the investment officer. (See the GFOA Recommended Practice on "Governmental Relationships with Securities Dealers," in Appendix 3.)

From time to time, the investment officer may choose to invest in instruments offered by minority and community financial institutions. In such situations, a waiver to the criteria under Paragraph 1 may be granted. All terms and relationships will be fully disclosed prior to purchase and will be reported to the appropriate entity on a consistent basis and should be consistent with state or local law. These types of investment purchases should be approved by the appropriate legislative or governing body in advance.

2. Internal Controls

The investment officer is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City of Missoula are protected from loss, theft or misuse. The internal control structure shall be designed

to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management.

Accordingly, the investment officer shall establish a process for an annual independent review by an external auditor to assure compliance with policies and procedures. The internal controls shall address the following points:

- Control of collusion
- Separation of transaction authority from accounting and record-keeping
- Custodial safekeeping
- Avoidance of physical delivery securities
- Clear delegation of authority to subordinate staff members
- Written confirmation of transactions for investments and wire transfers
- Development of a wire transfer agreement with the lead bank and third-party custodian

3. *Delivery vs. Payment*

All trades where applicable will be executed by delivery vs. payment (DVP) to ensure that securities are deposited in an eligible financial institution prior to the release of funds. Securities will be held by a third-party custodian as evidenced by safekeeping receipts.

V. Suitable and Authorized Investments

1. *Investment Types*

Consistent with the GFOA Policy Statement on State and Local Laws Concerning Investment Practices, the following investments will be permitted by this policy and are those defined by state and local law (7-6-2 01 M.C.A., 7-6-202 M.C.A., 7-6-206 M.C.A. 17-6-204 M.C.A.) where applicable:

7-6-201. Deposit of public funds in financial institutions. (1) Except as provided in 7-6-202, 7-6-206 or 7-6-2701, it shall be the duty of all county and city treasurers and town clerks to deposit all public money in their possession and under their control in any solvent banks, building and loan associations, savings and loan associations, or credit unions located in the county, city, or town of which such treasurer is an officer, subject to national supervision or state examination as the local governing body may designate, and no other.

(2) Said local governing body is hereby authorized to deposit such public money not necessary for immediate use by such county, city, or town in a savings or time deposit with any bank, building and loan association, savings and loan association, or credit union authorized above or in a repurchase agreement as authorized in 7-6-213.

(3) The treasurer or town clerk shall take from such bank, building and loan association, savings and loan association, or credit union such security as the local governing body may prescribe, approve, and deem fully sufficient and necessary to insure the safety and prompt payment of all such deposits, together with the interest on any time or savings deposits.

(4) All such deposits shall be subject to withdrawal by the treasurer or town clerk in such amounts as may be necessary from time to time. No deposit of funds shall be made or permitted to remain in any bank, building and loan association, savings and loan association, or credit union until the security for such deposits shall have been first approved by the local governing body and delivered to the treasurer or town clerk.

7-6-202. Investment of public money in direct obligations of United States.

(1) A local governing body may invest public money not necessary for immediate use by the county, city, or town in the following eligible securities:

(a) United States government treasury bills, notes, and bonds and in United States treasury obligations, such as state and local government series (SLGS), separate trading of registered interest and principal of securities (STRIPS), or similar United States treasury obligations;

(b) United States treasury receipts in a form evidencing the holder's ownership of future interest or principal payments on specific United States treasury obligations that, in the absence of payment default by the United States, are held in a special custody account by an independent trust company in a certificate or book-entry form with the federal reserve bank of New York; or

(c) obligations of the following agencies of the United States, subject to the limitations in subsection (2):

- (i) federal home loan bank;
- (ii) federal national mortgage association;
- (iii) federal home mortgage corporation; and
- (iv) federal farm credit bank.

(2) An investment in an agency of the United States is authorized under this section if the investment is a general obligation of the agency and has a fixed or zero-coupon rate and does not have prepayments that are based on underlying assets or collateral, including but not limited to residential or commercial mortgages, farm loans, multifamily housing loans, or student loans.

(3) The local governing body may invest in a United States government security money market fund if;

(a) the fund is sold and managed by a management-type investment company or investment trust registered under the Investment Company Act of 1940 (15 U.S.C. 80a-64), as may be amended;

(b) the fund consists only of eligible securities as described in this section;

(c) the use of repurchase agreements is limited to agreements that are fully collateralized by the eligible securities, as described in this section, and the investment company or investment trust takes delivery of the collateral for any repurchase agreement, either directly or through an authorized custodian;

(d) the fund is listed in a national financial publication under the category of "money market mutual funds", showing the fund's average maturity, yield, and asset size; and

(e) the fund's average maturity does not exceed 397 days.

(4) Except as provided in subsection (5), an investment authorized in this part may not have a maturity date exceeding 5 years, except when the investment is used in an escrow account to refund an outstanding bond issue in advance.

(5) An investment of the assets of a local government group self-insurance program established pursuant to 2-9-211 or 39-71-2103 in an investment authorized in this part may not have a maturity date exceeding 10 years, and the average maturity of all those authorized investments of a local government group self-insurance program may not exceed 6 years.

(6) This section may not be construed to prevent the investment of public funds under the state unified investment program established in Title 17, chapter 6, part 2.

7-6-206. Time deposits—repurchase agreement. (1) Public money not necessary for immediate use by a county, city, or town that is not invested as authorized in 7-6-202 may be placed in time or savings deposits with a bank, savings and loan association, or credit union in the state or placed in repurchase agreements as authorized in 7-6-213. Money placed in repurchase agreements is subject to subsection (2).

(2) The local governing body may solicit bids for time or savings deposits from a bank, savings and loan association, or credit union in the state. The local governing body may deposit public money in the institutions unless a local financial institution agrees to pay the same rate of interest bid by a financial institution not located in the county, city, or town. The governing body may solicit bids by notice sent by mail to the investment institutions that have requested that their names be listed for bid notice with the department of administration.

17-6-204. Investment of local government funds. (1) The governing body of any city, county, school district, or other local government unit or political subdivision having funds which are available for investment and are not required by law or by any covenant or agreement with bondholders or others to be segregated and invested in a different manner may direct its treasurer to remit such funds to the state treasurer for investment under the direction of the board of investments as part of the pooled investment fund.

(2) A separate account, designated by name and number for each such participant in the fund, shall be kept to record individual transactions and totals of all investments belonging to each participant. A monthly report shall be furnished to each participant having a beneficial interest in the pooled investment fund, showing the changes in investments made during the preceding month. Details of any investment transaction shall be furnished to any participant upon request.

(3) The principal and accrued income, and any part thereof, of each and every account maintained for a participant in the pooled investment fund shall be subject to payment at any time from the fund upon request. Accumulated income shall be remitted to each participant at least annually.

(4) No order or warrant shall be issued upon any account for a larger amount than the principal and accrued income of the account to which it applies, and if any such order or warrant is issued, the participant receiving it shall reimburse the excess amount to the fund from any funds not otherwise appropriated, and the state treasurer shall be liable under his official bond for any amount not so reimbursed.

Investment in derivatives of the above instruments is not authorized by the City of Missoula's investment policy. (See the GFOA Recommended Practice on "Use of Derivatives by State and Local Governments," 1994.)

2. *Collateralization*

Where allowed by state law and in accordance with the GFOA Recommended Practices on the Collateralization of Public Deposits, collateralization will be required on non-negotiable certificates of deposit to the extent allowable by state law. (See GFOA Recommended Practices, Appendix 3.) Montana state law (7-6-207 M.C.A. and 7-6-208 M.C.A) establishes the deposit security requirements for City investments:

7-6-207. Deposit security. (1) The local governing body may require security only for that portion of the deposits which is not guaranteed or insured according to law and, as to such unguaranteed or uninsured portion, to the extent of:

(a) 50% of such deposits if the institution in which the deposit is made has a net worth to total assets ratio of 6% or more; or

(b) 100% if the institution in which the deposit is made has a net worth to total assets ratio of 6%. The security shall consist of those enumerated in 17-6-103 or cashier's checks issued to the depository institution by any federal reserve bank.

(2) When negotiable securities are furnished, such securities may be placed in trust. The trustee's receipt may be accepted in lieu of the actual securities when such receipt is in favor of the treasurer or town clerk and his successors. All warrants or other negotiable securities must be properly assigned or endorsed in blank. It is the duty of the appropriate governing body, upon the acceptance and approval of any of the above-mentioned bonds or securities, to make a complete minute entry of the acceptance and approval upon the record of their proceedings, and the bonds and securities shall be reapproved at least quarterly thereafter.

7-6-208. Substitution of deposit security. (1) Any bank, building and loan association, savings and loan association, or credit union pledging securities as provided in 7-6-207, at any time it deems advisable or desirable, may substitute like securities for all or any part of the securities pledged. The collateral so substituted shall be approved by the governing body of the county, city, or town at its next official meeting.

(2) Such securities so substituted shall at the time of substitution be at least equal in principal amount to the securities for which substitution is made. In the event that the securities so substituted are held in trust, the trustee shall, on the same day the substitution is made, forward a receipt by registered or certified mail to the county, city, or town and to the depository bank, building and loan association, savings and loan association, or credit union. The receipt shall specifically describe and identify both the securities so substituted and those released and returned to the depository bank, building and loan association, savings and loan association, or credit union.

Securities eligible for pledging to secure deposits of public funds are enumerated in 17-6-103 M.C.A.

3. *Repurchase Agreements*

Repurchase agreements shall be consistent with GFOA Recommended Practices on Repurchase Agreements, (See GFOA Recommended Practices, Appendix 3.)

VI. Investment Parameters

1. *Diversification*

The investments shall be diversified by:

- limiting investments to avoid over concentration in securities from a specific issuer or business sector (excluding U.S. Treasury securities),
- limiting investment in securities that have higher credit risks, investing in securities with varying maturities, and
- continuously investing a portion of the portfolio in readily available funds such as local government investment pools (LGIPs), money market funds or overnight repurchase agreements to ensure that appropriate liquidity is maintained in order to meet ongoing obligations. (See the GFOA Recommended Practice on "Diversification of Investments in a Portfolio" in Appendix 3.)

2. *Maximum Maturities*

To the extent possible, the City of Missoula shall attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, the City of Missoula will not directly invest in securities maturing more than five (5) years from the date of purchase or in accordance with state and local statutes and ordinances. The City of Missoula shall adopt weighted average maturity limitations (which often range from 90 days to 3 years), consistent with the investment objectives. (See the GFOA Recommended Practice on "Maturities of Investments in a Portfolio" in Appendix 3.)

Because of inherent difficulties in accurately forecasting cash flow requirements, a portion of the portfolio should be continuously invested in readily available funds such as LGIPs, money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

VII. Reporting

1. *Methods*

The investment officer shall prepare an investment report at least quarterly, including a management summary that provides an analysis of the status of the current investment portfolio and transactions made over the last quarter. This management summary will be prepared in a manner, which will allow the City of Missoula to ascertain whether investment activities during the reporting period have conformed to the investment policy. The report should be provided to the investment officer, the legislative body, and any pool participants. The report will include the following:

- a. Listing of individual securities held at the end of the reporting period.
- b. Realized and unrealized gains or losses resulting from appreciation or depreciation by listing the cost and market value of securities over one-year

duration that are not intended to be held until maturity (in accordance with Governmental Accounting Standards Board (GASB) requirements).

- c. Average weighted yield to maturity of portfolio on investments as compared to applicable benchmarks.
- d. Listing of investment by maturity date.
- e. Percentage of the total portfolio, which each type of investment represents.

2. *Performance Standards*

The investment portfolio will be managed in accordance with the parameters specified within this policy. The portfolio should obtain a market average rate of return during a market/economic environment of stable interest rates. A series of appropriate benchmarks shall be established against which portfolio performance shall be compared on a regular basis.

3. *Marking to Market*

The market value of the portfolio shall be calculated at least quarterly and a statement of the market value of the portfolio shall be issued at least quarterly. This will ensure that review of the investment portfolio, in terms of value and price volatility, has been performed consistent with the GFOA Recommended Practice on "Mark-to-Market Practices for State and Local Government Investment Portfolios and Investment Pools." (See GFOA Recommended Practices, Appendix 3.) In defining market value, considerations should be given to the GASB Statement 31 pronouncement.

VIII. Policy Considerations

1. *Exemption*

Any investment currently held that does not meet the guidelines of this policy shall be exempted from the requirements of this policy. At maturity or liquidation, such monies shall be reinvested only as provided by this policy.

2. *Amendments*

This policy shall be reviewed on an annual basis. Any changes must be approved by the investment officer and any other appropriate authority, as well as the individual(s) charged with maintaining internal controls.

Appendix 1: Glossary

The following is a glossary of key investing terms, many of which appear in GFOA's Sample Investment Policy.

Accrued Interest — The accumulated interest due on a bond as of the last interest payment made by the issuer.

Agency — A debt security issued by a federal or federally sponsored agency. Federal agencies are backed by the full faith and credit of the U.S. Government. Federally sponsored agencies (FSAs) are backed by each particular agency with a market perception that there is an implicit government guarantee. An example of federal agency is the Government National Mortgage Association (GNMA). An example of a FSA is the Federal National Mortgage Association (FNMA).

Amortization — The systematic reduction of the amount owed on a debt issue through periodic payments of principal.

Average Life — The average length of time that an issue of serial bonds and/or term bonds with a mandatory sinking fund feature is expected to be outstanding.

Basis Point — A unit of measurement used in the valuation of fixed-income securities equal to 1/100 of 1 percent of yield, e.g., "1/4" of 1 percent is equal to 25 basis points.

Bid — The indicated price at which a buyer is willing to purchase a security or commodity.

Book Value — The value at which a security is carried on the inventory lists or other financial records of an investor. The book value may differ significantly from the security's current value in the market.

Callable Bond — A bond issue in which all or part of its outstanding principal amount may be redeemed before maturity by the issuer under specified conditions.

Call Price — The price at which an issuer may redeem a bond prior to maturity. The price is usually at a slight premium to the bond's original issue price to compensate the holder for loss of income and ownership.

Call Risk — The risk to a bondholder that a bond may be redeemed prior to maturity.

Cash Sale/Purchase — A transaction that calls for delivery and payment of securities on the same day that the transaction is initiated.

*This glossary has been adapted from an article, entitled "Investment terms for everyday use," that appeared in the April 5, 1996, issue of *Public Investor*, GFOA's subscription investment newsletter.

Collateralization — Process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security.

Commercial Paper - An unsecured short-term promissory note issued by corporations, with maturities ranging from 2 to 270 days.

Convexity — A measure of a bond's price sensitivity to changing interest rates. A high convexity indicates greater sensitivity of a bond's price to interest rate changes.

Coupon Rate — The annual rate of interest received by an investor from the issuer of certain types of fixed-income securities. Also known as the "interest rate."

Credit Quality — The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit quality ratings are provided by nationally recognized rating agencies.

Credit Risk — The risk to an investor that an issuer will default in the payment of interest and/or principal on a security.

Current Yield (Current Return) — A yield calculation determined by dividing the annual interest received on a security by the current market price of that security.

Delivery Versus Payment (DVP) — A type of securities transaction in which the purchaser pays for the securities when they are delivered either to the purchaser or his/her custodian.

Derivative Security — Financial instrument created from, or whose value depends upon, one or more underlying assets or indexes of asset values.

Discount — The amount by which the par value of a security exceeds the price paid for the security.

Diversification — A process of investing assets among a range of security types by sector, maturity, and quality rating.

Duration — A measure of the timing of the cash flows, such as the interest payments and the principal repayment, to be received from a given fixed-income security. This calculation is based on three variables: term to maturity, coupon rate, and yield to maturity. The duration of a security is a useful indicator of its price volatility for given changes in interest rates.

Fair Value — The amount, at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Federal Funds (Fed Funds) — Funds placed in Federal Reserve banks by depository institutions in excess of current reserve requirements. These depository institutions may lend fed funds to each other overnight or on a longer basis. They may also transfer funds among each

other on a same-day basis through the Federal Reserve banking system. Fed funds are considered to be immediately available funds.

Federal Funds Rate — Interest rate charged by one institution lending federal funds to the other.

Government Securities — An obligation of the U.S. government, backed by the full faith and credit of the government. These securities are regarded as the highest quality of investment securities available in the U.S. securities market. See "Treasury Bills, Notes, and Bonds."

Interest Rate — See "Coupon Rate."

Interest Rate Risk — The risk associated with declines or rises in interest rates, which cause an investment in a fixed-income security to increase or decrease in value.

Internal Controls — An internal control structure designed to ensure that the assets of the entity are protected from loss, theft, or misuse. The internal control structure is designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that 1) the cost of a control should not exceed the benefits likely to be derived and 2) the valuation of costs and benefits require estimates and judgments by management. Internal controls should address the following points:

1. Control of collusion — Collusion is a situation where two or more employees are working in conjunction to defraud their employer.
2. Separation of transaction authority from accounting and record keeping — By separating the person who authorizes or performs the transaction from the people who record or otherwise account for the transaction, a separation of duties is achieved.
3. Custodial safekeeping — Securities purchased from any bank or dealer including appropriate collateral (as defined by state law) shall be placed with an independent third party for custodial safekeeping.
4. Avoidance of physical delivery securities — Book-entry securities are much easier to transfer and account for since actual delivery of a document never takes place. Delivered securities must be properly safeguarded against loss or destruction. The potential for fraud and loss increases with physically delivered securities.
5. Clear delegation of authority to subordinate staff members - Subordinate staff members must have a clear understanding of their authority and responsibilities to avoid improper actions. Clear delegation of authority also preserves the internal control structure that is contingent on the various staff positions and their respective responsibilities.
6. Written confirmation of transactions for investments and wire transfers - Due to the potential for error and improprieties arising from telephone and electronic transactions, all transactions should be supported by written communications and approved by the appropriate person. Written communications may be via fax if on letterhead and if the safekeeping institution has a list of authorized signatures.
7. Development of a wire transfer agreement with the lead bank and third-party custodian - The designated official should ensure that an agreement will be entered into and will address the following points: controls, security provisions, and responsibilities of each party making and receiving wire transfers.

Inverted Yield Curve — A chart formation that illustrates long-term securities having lower yields than short-term securities. This configuration usually occurs during periods of high inflation coupled with low levels of confidence in the economy and a restrictive monetary policy.

Investment Company Act of 1940 — Federal legislation which sets the standards by which investment companies, such as mutual funds, are regulated in the areas of advertising, promotion, performance reporting requirements, and securities valuations.

Investment Policy — A concise and clear statement of the objectives and parameters formulated by an investor or investment manager for a portfolio of investment securities.

Investment-grade Obligations - An investment instrument suitable for purchase by institutional investors under the prudent person rule. Investment-grade is restricted to those obligations rated BBB or higher by a rating agency.

Liquidity — An asset that can be converted easily and quickly into cash.

Local Government Investment Pool (LGIP) — An investment by local governments in which their money is pooled as a method for managing local funds.

Mark-to-market — The process whereby the book value or collateral value of a security is adjusted to reflect its current market value.

Market Risk — The risk that the value of a security will rise or decline as a result of changes in market conditions.

Market Value — Current market price of a security.

Maturity — The date on which payment of a financial obligation is due. The final stated maturity is the date on which the issuer must retire a bond and pay the face value to the bondholder. See "Weighted Average Maturity."

Money Market Mutual Fund — Mutual funds that invest solely in money market instruments (short-term debt instruments, such as Treasury bills, commercial paper, bankers' acceptances, repos and federal funds).

Mutual Fund — An investment company that pools money and can invest in a variety of securities, including fixed-income securities and money market instruments. Mutual funds are regulated by the

Investment Company Act of 1940 and must abide by the following Securities and Exchange Commission (SEC) disclosure guidelines:

1. Report standardized performance calculations.
2. Disseminate timely and accurate information regarding the fund's holdings, performance, management and general investment policy.
3. Have the fund's investment policies and activities supervised by a board of trustees, which are independent of the adviser, administrator or other vendor of the fund.
4. Maintain the daily liquidity of the fund's shares.

5. Value their portfolios on a daily basis.
6. Have all individuals who sell SEC-registered products licensed with a self-regulating organization (SRO) such as the National Association of Securities Dealers (NASD).
7. Have an investment policy governed by a prospectus that is updated and filed by the SEC annually.

Mutual Fund Statistical Services — Companies that track and rate mutual funds, e.g., IBC/Donoghue, Lipper Analytical Services, and Morningstar.

National Association of Securities Dealers (NASD) — A self-regulatory organization (SRO) of brokers and dealers in the over-the-counter securities business. Its regulatory mandate includes authority over firms that distribute mutual fund shares as well as other securities.

Net Asset Value — The market value of one share of an investment company, such as a mutual fund. This figure is calculated by totaling a fund's assets which includes securities, cash, and any accrued earnings, subtracting this from the fund's liabilities and dividing this total by the number of shares outstanding. This is calculated once a day based on the closing price for each security in the fund's portfolio. (See below.)

$$[(\text{Total assets}) - (\text{Liabilities})]/(\text{Number of shares outstanding})$$

No Load Fund — A mutual fund, which does not levy a sales charge on the purchase of its shares.

Nominal Yield — The stated rate of interest that a bond pays its current owner, based on par value of the security. It is also known as the "coupon," "coupon rate," or "interest rate."

Offer — An indicated price at which market participants are willing to sell a security or commodity. Also referred to as the "Ask price."

Par — Face value or principal value of a bond, typically \$1,000 per bond.

Positive Yield Curve — A chart formation that illustrates short-term securities having lower yields than long-term securities.

Premium — The amount by which the price paid for a security exceeds the security's par value.

Prime Rate — A preferred interest rate charged by commercial banks to their most creditworthy customers. Many interest rates are keyed to this rate.

Principal — The face value or par value of a debt instrument. Also may refer to the amount of capital invested in a given security.

Prospectus — A legal document that must be provided to any prospective purchaser of a new securities offering registered with the SEC. This can include information on the issuer, the issuer's business, the proposed use of proceeds, the experience of the issuer's management, and certain certified financial statements.

Prudent Person Rule — An investment standard outlining the fiduciary responsibilities of public funds investors relating to investment practices.

Regular Way Delivery — Securities settlement that calls for delivery and payment on the third business day following the trade date (T+3); payment on a T+1 basis is currently under consideration. Mutual funds are settled on a same day basis; government securities are settled on the next business day.

Reinvestment Risk — The risk that a fixed-income investor will be unable to reinvest income proceeds from a security holding at the same rate of return currently generated by that holding.

Repurchase Agreement (repo or RP) — An agreement of one party to sell securities at a specified price to a second party and a simultaneous agreement of the first party to repurchase the securities at a specified price or at a specified later date.

Reverse Repurchase Agreement (Reverse Repo) — An agreement of one party to purchase securities at a specified price from a second party and a simultaneous agreement by the first party to resell the securities at a specified price to the second party on demand or at a specified date.

Rule 2a-7 of the Investment Company Act — Applies to all money market mutual funds and mandates such funds to maintain certain standards, including a 13- month maturity limit and a 90-day average maturity on investments, to help maintain a constant net asset value of one dollar (\$1.00).

Safekeeping — Holding of assets (e.g., securities) by a financial institution.

Serial Bond — A bond issue, usually of a municipality, with various maturity dates scheduled at regular intervals until the entire issue is retired.

Sinking Fund — Money accumulated on a regular basis in a separate custodial account that is used to redeem debt securities or preferred stock issues.

Swap — Trading one asset for another.

Term Bond — Bonds comprising a large part or all of a particular issue that come due in a single maturity. The issuer usually agrees to make periodic payments into a sinking fund for mandatory redemption of term bonds before maturity.

Total Return — The sum of all investment income plus changes in the capital value of the portfolio. For mutual funds, return on an investment is composed of share price appreciation plus any realized dividends or capital gains. This is calculated by taking the following components during a certain time period.

$$(\text{Price Appreciation}) + (\text{Dividends paid}) + (\text{Capital gains}) = \text{Total Return}$$

Treasury Bills — Short-term U.S. government non-interest bearing debt securities with maturities of no longer than one year and issued in minimum denominations of \$10,000.

Auctions of three- and six-month bills are weekly, while auctions of one-year bills are monthly. The yields on these bills are monitored closely in the money markets for signs of interest rate trends.

Treasury Notes — Intermediate U.S. government debt securities with maturities of one to 10 years and issued in denominations ranging from \$1,000 to \$1 million or more.

Treasury Bonds — Long-term U.S. government debt securities with maturities of ten years or longer and issued in minimum denominations of \$1,000. Currently, the longest outstanding maturity for such securities is 30 years.

Uniform Net Capital Rule — SEC Rule 15C3-1 outlining capital requirements for broker/dealers.

Volatility — A degree of fluctuation in the price and valuation of securities.

"Volatility Risk" Rating — A rating system to clearly indicate the level of volatility and other non-credit risks associated with securities and certain bond funds. The ratings for bond funds range from those that have extremely low sensitivity to changing market conditions and offer the greatest stability of the returns ("aaa" by S&P; "V-1" by Fitch) to those that are highly sensitive with currently identifiable market volatility risk ("ccc-" by S&P, "V-10" by Fitch).

Weighted Average Maturity (WAM) — The average maturity of all the securities that comprise a portfolio. According to SEC rule 2a-7, the WAM for SEC registered money market mutual funds may not exceed 90 days and no one security may have a maturity that exceeds 397 days.

When Issued (WI) — A conditional transaction in which an authorized new security has not been issued. All "when issued" transactions are settled when the actual security is issued.

Yield — The current rate of return on an investment security generally expressed as a percentage of the security's current price.

Yield-to-call (YTC) — The rate of return an investor earns from a bond assuming the bond is redeemed (called) prior to its nominal maturity date.

Yield Curve — A graphic representation that depicts the relationship at a given point in time between yields and maturity for bonds that are identical in every way except maturity. A normal yield curve may be alternatively referred to as a positive yield curve.

Yield-to-maturity — The rate of return yielded by a debt security held to maturity when both interest payments and the investor's potential capital gain or loss are included in the calculation of return.

Zero-coupon Securities — Security that is issued at a discount and makes no periodic interest payments. The rate of return consists of a gradual accretion of the principal of the security and is payable at par upon maturity.

Appendix 2: Investment Pools

1. Definition

In most states, there are provisions for the creation and operation of a government investment pool. The purpose of a pool is to allow political subdivisions to pool investable funds in order to achieve a potentially higher yield.

There are basically three (3) types of pools: 1) state-run pools; 2) pools that are operated by a political subdivision where allowed by law and the political subdivision is the trustee; and 3) pools that are operated for profit by third parties. Prior to any political subdivision being involved with any type of pool, a thorough investigation of the pool and its policies and procedures must be reviewed.

2. Pool Questionnaire

Prior to entering a pool, the following questions and issues should be considered:

Securities:

Government pools may invest in a broader range of securities than an entity may invest in. It is important to be aware of, and comfortable with, the securities a pool buys. The following is a list of questions an investment officer may wish to ask a prospective pool:

1. Does the pool provide a written statement of investment policy and objectives?
2. Does the statement contain:
 - a. a description of eligible investment instruments?
 - b. the credit standards for investments?
 - c. the allowable maturity range of investments?
 - d. the maximum allowable dollar weighted average portfolio maturity?
 - e. the limits of portfolio concentration permitted for each type of security?
 - f. the policy on reverse repurchase agreements, options, short sales and futures?
3. Are changes in the policies communicated to the pool participants?
4. Does the pool contain only the types of securities that are permitted by your investment policy?

Interest:

Interest is not reported in a standard format, so it is important to know how interest is quoted, calculated, and distributed in order to make comparisons with other investment alternatives.

Interest Calculations:

1. Does the pool disclose the following about yield calculations:
 - a. the methodology used to calculate interest? (simple maturity, yield to maturity, etc.)
 - b. the frequency of interest payments?
 - c. how interest is paid? (credited to principal at the end of the month, each quarter; mailed?)
 - d. how are gains/losses reported? factored monthly or only when realized?

Reporting:

1. Is the yield reported to participants of the pool monthly? (If not, how often?)
2. Are expenses of the pool deducted before quoting the yield?
3. Is the yield generally in line with the market yields for other investment alternatives?

4. How often does the pool report? What information does that report include? Does it include the market value of securities?

Security:

The following questions are designed to help safeguard funds from loss of principal and loss of market value.

1. Does the pool disclose safekeeping practices?
2. Is the pool subject to audit by an independent auditor at least annually?
3. Is a copy of the audit report available to participants?
4. Who makes the portfolio decisions?
5. How does the manager monitor the credit risk of the securities in the pool?
6. Is the pool monitored by someone on the board of a separate neutral party external to the investment function to ensure compliance with written policies?
7. Does the pool have specific policies with regard to the various investment vehicles?
 - a. What are the different investment alternatives?
 - b. What are the policies for each type of investment?
8. Does the pool mark the portfolio to its market value?
9. Does the pool disclose the following about how portfolio securities are valued:
 - a. the frequency with which the portfolio securities are valued?
 - b. the method used to value the portfolio (cost, current value, or some other method)?

Operations:

The answers to these questions will help determine whether this pool meets the entity's operational requirements:

1. Does the pool limit eligible participants?
2. What entities are permitted to invest in the pool?
3. Does the pool allow multiple accounts and sub-accounts?
4. Is there a minimum or maximum account size?
5. Does the pool limit the number of transactions each month? What is the number?
6. Is there a limit on transaction amounts for withdrawals and deposits?
 - a. What is the minimum and maximum withdrawal amount permitted?
 - b. What is the minimum and maximum deposit amount permitted?
7. How much notice is required for withdrawals/deposits?
8. What is the cutoff time for deposits and withdrawals?
9. Can withdrawals be denied?
10. Are the funds 100 percent withdrawable at anytime?
11. What are the procedures for making deposits and withdrawals?
 - a. What is the paperwork required, if any?
 - b. What is the wiring process?
12. Can an account remain open with a zero balance?
13. Are confirmations sent following each transaction?

Statements:

It is important for *(the designated official)* and the agency's trustee (when applicable), to receive statements monthly so the pool's records of activity and holdings are reconciled by *(the designated official)* and its trustee.

1. Are statements for each account sent to participants?
 - a. What are the fees?
 - b. How often are they passed?
 - c. How are they paid?
 - d. Are there additional fees for wiring funds? (What is the fee?)
2. Are expenses deducted before quoting the yield?

Questions to Consider for Bond Proceeds:

It is important to know (1) whether the pool accepts bond proceeds and (2) whether the pool qualifies with the U.S. Department of the Treasury as an acceptable commingled fund for arbitrage purposes.

1. Does the pool accept bond proceeds subject to arbitrage rebate?
2. Does the pool provide accounting and investment records suitable for proceeds of bond issuance subject to arbitrage rebate?
3. Will the yield calculation reported by the pool be acceptable to the IRS or will it have to be recalculated?
4. Will the pool accept transaction instructions from a trustee?
5. Are separate accounts allowed for each bond issue so that the interest earnings of funds subject to rebate are not commingled with funds not subject to regulations?

Appendix 3: GFOA Recommended Practices and Policy Statements

GFOA's Standing Committee on Cash Management has developed recommended practices and policy statements pertaining to the prudent investment of public funds. State and local governments should carefully consider the factors outlined in the GFOA recommended practices and policy statements when making investment decisions and entering into investment transactions. (A complete set of recommended practices and policy statements can be obtained from GFOA's Chicago office by calling 312/977-9700.)

The following recommended practices and policy statements are attached:

- Collateralization of Public Deposits (1984, 1987 and 1993)
- Diversification of Investments in a Portfolio (1997)
- Governmental Relationships with Securities Dealers (1986 and 1988)
- Market Risk (Volatility) Ratings (1995)
- Mark-to-Market Practices for State and Local Government Investment Portfolios & Investment Pools (1995)
- Master Trust and Custodial Bank Security Lending Programs (1995)
- Maturities of Investments in a Portfolio (1997)
- Repurchase Agreements, Reverse Repurchase Agreements Leveraging, and Prudent Investment Practices for Cash Management (1986 and 1995)
- Selection of Investment Advisers (1992)
- State and Local Laws Concerning Investment Practices (1997)
- Use and Application of Voluntary Agreements and Guidelines and Support for Written Investment Policies for State and Local Governments (1995)
- Use of Derivatives by State and Local Governments (1994)
- Use of Various Types of Mutual Funds by Public Cash Managers (1987)
- Same-Day Funds Settlement Procedures (1994)
- Electronic Transactions for State and Local Governments (1997)
- Procurement of Banking Services (1997)
- Check Fraud Protection (1999)
- Frequency of Purchased Securities Valuation in Repurchase Agreements (1999)
- Purchasing Card Programs (1998)

GFOA Recommended Practice

Collateralization of Public Deposits (1984, 1987 and 1993)

Background. The safety of public funds should be the foremost objective in managing public funds. Collateralization of public deposits through pledging of appropriate securities by depositories is the only way to fully guarantee the safety of such deposits. State programs pertaining to the collateralization of public deposits have generally proved to be cost-effective and beneficial for both the public sector and its depositories.

However, federal law imposes certain limitations on collateral agreements between financial institutions and public entities to provide adequate collateral for public entities to secure sizeable public unit deposits. Under certain circumstances, the Federal Deposit Insurance Corporation (FDIC) may be able to avoid a perfected security interest and leave the public depositor with only the right to share with other creditors in the pro rata distribution of the assets of a failed institution.

Recommendation. The Government Finance Officers Association (GFOA) favors the use of pledging requirements as protection for state or local governments and as incentives for the use of state and local obligations in the satisfaction of such pledges. GFOA further favors and encourages state and local governments to establish adequate and efficient administrative systems to maintain such pledged collateral, including state or locally administered collateral pledging or collateral pools. To accomplish these goals, GFOA recommends that:

1. Public entities implement programs of prudent risk control. Such programs could include a formal depository risk policy, credit analysis, and use of fully secured investments. In the absence of an effective statewide collateralization program, local officials should establish and implement collateralization procedures.
2. State and local government depositors take all possible actions to comply with federal requirements in order to ensure that their security interests in collateral pledged to secure deposits are enforceable against the receiver of a failed financial institution. Federal law provides that a depositor's security agreement, which tends to diminish or defeat the interest of the FDIC in an asset acquired by it as receiver of an insured depository, shall not be valid against the FDIC unless the agreement:
 - is in writing;
 - was executed by the depository institution and any person claiming an adverse interest, contemporaneously with the acquisition of the asset by the depository institution;
 - was approved by the board of directors of the depository or its loan committee; and

- has been, continuously, from the time of its execution, an official record of the depository institution.

GFOA Recommended Practice

Diversification of Investments in a Portfolio (1997)

Background. State and local governments are charged with observing the investment management objectives of safety, liquidity, and yield. Portfolio risk includes all the risks associated with investments, such as credit risk and market risk. Risks to safety and liquidity can be mitigated through diversifying the types and maturities of securities purchased. Because ensuring safety and liquidity are paramount, entities should seek to reduce portfolio risk as much as possible in their investment policies through appropriate diversification of investments in the portfolio and restrictions on maturity provisions.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments diversify their investments to reduce portfolio risk through such means as:

- limiting investments to avoid over concentration in securities from a specific issuer or business sector, excluding U.S. Treasury securities;
- limiting investments in securities that have higher credit risks;
- investing in securities of varying maturities; and
- continuously investing a portion of the portfolio in readily available funds, such as local government investment pools (LGIPs), money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

GFOA Recommended Practice

Governmental Relationships with Securities Dealers (1986 and 1988)

Background. State and local governments represent one of the largest sources of investment funds available to purchase U.S. Government Securities. Without broad participation by state and local government investors, the government securities market would lack liquidity and the U.S. Treasury's cost of borrowing would increase. At the same time, governmental investors are expected to protect public funds from losses arising from default and to ensure that securities are purchased and sold at the best price available in the competitive marketplace.

Recommendation. The Government Finance Officers Association (GFOA) make the following specific recommendations to state and local government investors in selecting depositories and securities dealers for the purpose of investment transactions in government securities:

1. Select or qualify depositories, custodians, and dealers through competitive procedures, including requests for proposals for banking services. All securities purchases should be made through competitive bidding. In the event that a governmental unit does not obtain competitive price bids, investors are urged to obtain written documentation of price markups prior to completing the transaction.
2. Require securities dealers conducting transactions with governmental entities to comply with the Federal Reserve Bank of New York's capital adequacy guidelines as a condition of doing business. Before investing public funds, governmental investors should obtain compliance certifications from the dealer and an independent auditor.
3. Secure acknowledgement from depositories and dealers that they have received written copies of their investment policies, portfolio risk constraints, and investment trading requirements.
4. Be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments before they are purchased. Additionally, securities dealers have a responsibility to disclose unreasonable risks.

GFOA Recommended Practice

Market Risk (Volatility) Ratings (1995)

Background. State and local governments have long relied on credit ratings as an independent analytical source to gauge the credit risk of an investment option. However, credit risk analysis alone is not sufficient to safeguard against the assumption of other risk components, including market, interest rate, and liquidity risks. Through the securitization and structuring process, AAA rated securities and funds also may carry extreme market and other risks that are wholly unaddressed by credit ratings. Rating agencies now provide market risk ratings that evaluate the volatility of the security under a wide range of potential interest rate and mortgage prepayment scenarios.

Risk components, such as interest rate, prepayment, credit, spread and liquidity, and currency risks are analyzed to assess how aggressively a fund uses derivatives and leveraging, and what risks their use presents to fund managers and investors in the fund. Results indicate the degree of potential variability in the prospective fund performance. Historical performance and volatility of fund returns relative to appropriate benchmarks also are evaluated.

When applied to individual collateralized mortgage obligations (CMOs), market risk ratings provide a useful benchmark to governmental entities as they establish guidelines for prudent management of derivative investments.

Recommendation. The Government Finance Officers Association (GFOA) encourages state and local governments to augment information they receive from brokers, dealers, or advisers with independent research when conducting due diligence of potential investments. Information sources include historical trading ranges, trend and volume data, brokerage firm research, cash flow and present value analysis, and credit ratings research.

GFOA encourages investment in only those CMOs and funds that seek market risk ratings from rating agencies to provide comprehensive disclosure of risks to public investors. Although volatility ratings currently are not mandatory, public investors may wish to consider limiting their investments to CMOs and funds that have received favorable volatility ratings from a nationally recognized rating agency.

GFOA Recommended Practice

Mark-to-Market Practices for State and Local Government Investment Portfolios and Investment Pools (1995)

Background. As the investment portfolios of state and local governments are subjected to increased scrutiny, it is essential that reporting standards be enhanced so that investors, governing bodies, and the public remain informed of the current market value of the portfolio. Regular disclosure of the value of a governmental entity's investments is an important step to furthering taxpayer and market confidence in state and local government investment practices.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government officials responsible for investment portfolio reporting determine the market value of all securities in the portfolio on at least a quarterly basis. These values should be obtained from a reputable and independent source and disclosed to the governing body or other oversight body at least quarterly in a written report. It is recommended that the report include the market value, book value, and unrealized gain or loss of the securities in the portfolio.

Many state and local government officials are allowed to invest in various state and local government investment pools available in their state or region. GFOA recommends that pool administrators, on at least a monthly basis, determine the market value of all securities in the pool and report this information to all pool participants on at least a quarterly basis. These values should be obtained from a reputable and independent source. This information should be included in the report to the governing body prepared on at least a quarterly basis.

GFOA Recommended Practice

Master Trust and Custodial Bank Security Lending Programs (1995)

Background. The lending of securities helps to maintain an orderly market while providing incremental income to the participant. Broker/dealers borrow primarily to cover fails (the non-delivery of a security expected to be delivered on a date certain) and short sales (the sale of security not presently owned by the seller in order to take advantage of an expected lower market price), and to execute arbitrage transactions. Their preferred partners in these transactions are the master trust and custodial banks, since their huge portfolios basically offer, “one-stop shopping.”

As part of their trust and custody management services, banks, like other money managers, offer to lend securities owned by institutional clients to brokers in exchange for collateral. The collateral, which is usually cash, is reinvested at a rate higher than the rebate rate paid to the broker. The resulting proceeds are subsequently split between the lending agent and the client.

As security lending transaction is similar to a reverse repurchase transaction and subject to many of the same risks. While the indemnifications offered may vary, the lending agreement may provide that broker credit risk, broker default risk, and collateral maintenance are risks undertaken by the lending agent. The degree of risk assumed by the lending agent generally is reflected in the split of proceeds. Lending agent credit risk, lending agent default risk, and collateral reinvestment risk are undertaken by the institutional client.

Unsound collateral reinvestment practices can result in some master trust and custodial banks incurring losses on behalf of their institutional security lending program customers. Additionally, rapidly changing interest rates, lending short and investing long, investing in speculative derivatives, and paying a fixed rebate rate while investing in floating rebate rate securities under adverse market conditions are examples of situations that can produce investment losses.

Liquidity requirements are often accepted by and guaranteed by the lending agent upon one day's notice, as substitution of the lending client in large lending programs is easily accomplished and essentially riskless. Programs that require the client to undertake responsibility for managing the liquidity present greater risks and require that the client place limits on the amount of the portfolio, which may be put on loan. The term of the securities on loan and the reinvestment of the proceeds must be carefully established by the client and strictly managed.

Recommendation. While investment strategies that include security lending programs are not inherently risky when employed judiciously with appropriate precautions and controls, the Government Finance Officers Association (GFOA) urges state and local government officials to exercise extreme caution in their use of security lending programs. Prior to participating in a

security lending program, finance officers should carefully evaluate:

- whether security lending is legally permissible under state statute and the jurisdiction's written investment policy;
- the terms of the lending agreements;
- the indemnification provisions;
- the reinvestment guidelines and terms of the lending, including the maturity of loans as well as the securities purchased;
- the liquidity provisions and risks;
- the credit risks to be undertaken; and
- the resources required to monitor compliance with the agreement.

GFOA Recommended Practice

Maturities of Investments in a Portfolio (1997)

Background. Securities are issued in a variety of maturities. To ensure that liquidity is maintained and to reduce interest rate risk in operating funds, most state and local governments limit the maximum maturity (the date on which payment of a financial obligation is due) on any specified purchased security and the maximum weighted average maturity (the average maturity or reset period of all securities that comprise a portfolio) of the entire portfolio.

The longer the maturity horizon that is selected, the greater the price volatility. In accordance with the Governmental Accounting Standards Board reporting requirements, the portfolio could show unrealized losses or gains for any reporting period.

Recommendation. The Government Finance Officers Association (GFOA) recommends that, to the extent possible, state and local governments should match investments with anticipated cash flow requirements. GFOA supports the following practices to achieve this objective:

1. Unless matched to a specific cash requirement, governments should not directly invest in securities maturing more than five years from the date of purchase. Reserve or other funds with longer-term investment horizons may be invested in securities exceeding five years, if the maturities of such investments are made to coincide as nearly as practicable with the expected use of funds. The intent to invest in securities with longer maturities should be disclosed in writing to the legislative body through a written investment policy.
2. Governments should adopt weighted average maturity limitations, which often range from 90 days to three years, consistent with the government's investment objectives.
3. Because of inherent difficulties in accurately forecasting cash flow requirements, a portion of the portfolio should be continuously invested in readily available funds such as local government investment pools (LGIPs), money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

GFOA Recommended Practice

Repurchase Agreements, Reverse Repurchase Agreements, Leveraging, and Prudent Investment Practices for Cash Management (1986 and 1995)

Background. Repurchase agreements (repos) are the sale by a bank or dealer of a government security with the simultaneous agreement to repurchase the security on a later date. Repos are commonly used by public entities to secure money market rates of interest and are an integral part of an investment program of state and local governments. In a reverse repurchase agreement (reverse repo), an investor owns securities, such as a Treasury note, U.S. government agency bond or other security, that a bank or dealer purchases under an agreement to sell back to the investor on a specified date, at an agreed-upon interest rate.

Reverse repos generally have two basic uses: first, reverse repos may be one way to avoid liquidating a portfolio to meet unexpected or immediate cash flow requirements. This straightforward use of the instrument is accepted by most public finance officers as a legitimate management practice. The second, potentially more controversial, use of the reverse repo is to enhance portfolio returns through the purchase of securities financed through repurchase transactions. The cash obtained can then be invested in another higher-yielding instrument. The conservative and prudent approach to this use of reverse repos involves short-term contracts in which the term of the reverse repo is matched with the maturity of the reinvestment. Losses of state and local government funds have occurred as the result of the inappropriate use of reverse repos in leveraging portfolios to increase investment returns and as a result of other unsound investment practices.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government finance officers develop policies and procedures to insure the safety of repos and reverse repos. The following actions are recommended:

1. Governmental entities and investment officers should exercise special caution in selecting parties with whom they will conduct repurchase transactions and be able to identify the parties acting as principals to the transaction.
2. Proper collateralization practices are necessary to protect the public funds invested in repurchase agreements. Risk is significantly reduced by delivery of underlying securities through physical delivery or safekeeping with the purchaser's custodian. Over-collateralization, commonly called "haircuts," or marking-to-market practices should be mandatory procedures.
3. Master repurchase agreements should be employed, subject to appropriate legal and technical review. Governments using the prototype agreement developed by the Public Securities Association should include appropriate supplemental provisions regarding delivery, substitution, margin maintenance, margin amounts, seller representations, and governing law.
4. Reverse repo proceeds generally should not be invested in securities whose maturity does not match the term of the reverse repo. For example, borrowing short to lend long can

produce losses in adverse markets. Further, the possibility exists that other factors can go wrong, such as default by the dealer or adverse market changes that erode the value of the underlying securities.

5. The use of reverse repos should be considered only by entities that have the expertise and resources required to successfully engage in the technique. Additionally, state statutes may prohibit or discourage the use of reverse repos. Government officials who engage in reverse repos should verify whether such uses of reverse repos are legally sanctioned.
6. Public officials should not engage in investment practices, such as purchasing securities on margin (by borrowing funds from a counterparty), selling securities short (by borrowing the security from a third party and selling in anticipation of higher interest rates), purchasing long-term bonds with short-term funds, and trading futures contracts without an exact offsetting cash market position.

GFOA Recommended Practice

Selection of Investment Advisers (1992)

Background. Some state and local governments have augmented their investment programs by retaining investment advisers to perform various portfolio services, ranging from advice-only consultation to fully discretionary management. In many cases, the results of these engagements have been favorable but there also have been cases of reported investment losses resulting from governmental units transacting business with certain investment advisers. Unlike the highly regulated bank trust and mutual funds sectors, federal regulatory inspection of independent investment advisers is infrequent and relatively superficial.

Recommendation. The Government Finance Officers Association (GFOA) has recommended consistently that state and local governments exercise caution in their selection of investment advisers and implement an ongoing risk control management program. The Association urges state and local governments considering or retaining independent investment advisers to carefully review the credentials, procedures, and controls of firms offering investment advisory services. Recommended precautionary measures include:

- delivery versus payment,
- third-party custody arrangements,
- prohibitions against self-dealing,
- independent audits,
- timely reconciliations, and
- other appropriate internal control measures.

GFOA Recommended Practice

State and Local Laws Concerning Investment Practices (1997) (Amends State Statutes Concerning Investment Practices approved in 1992)

Background. The authority of state and local governments to invest in public funds is derived through the power of state and local legislative bodies and state statutes and local laws that reflect Public policies. Some state and local laws and practices may permit investments that are inappropriate for local government, while others may be overly restrictive with regard to permissible instruments or eligible financial entities. Many state and local governments have modified their cash management and investment laws and policies to improve the safety of their investments while obtaining a favorable rate of return on invested public funds.

GFOA Position. The Government Finance Officers Association (GFOA) encourages state and local legislative bodies to remove artificial restrictions upon the efficient investment of public funds by:

1. Amending state and local laws regulating local government investment authority to permit prudent investment of public funds in prime money market instruments and investment securities, such as:
 - U.S. government obligations, U.S. government agency obligations, and U.S. government instrumentality obligations, which have a liquid market with a readily determinable market value;
 - Canadian government obligations (payable in local currency);
 - Certificates of deposit and other evidences of deposit at financial institutions, bankers' acceptances, and commercial paper, rated in the highest tier (e.g., A1, P1, F1 or D1 or higher) by a nationally recognized rating agency;
 - Investment-grade obligations of state, provincial and local governments and public authorities;
 - Repurchase agreements whose underlying purchased securities consist of the foregoing; and
 - Money market mutual funds regulated by the Securities and Exchange Commission and whose portfolios consist only of dollar-denominated securities.

Investment in derivatives of the above instruments shall require authorization by the appropriate governing authority. (See GFOA Recommended Practice on "use of Derivatives by State and Local Government," 1994.)

2. Authorizing and encouraging the efficient, professional investment of public funds in local government investment pools, either state-administered or through joint powers statutes and other intergovernmental agreement legislation, to take advantage of portfolio diversification and liquidity.

3. Authorizing and encouraging professional investments by removing geographical restrictions on eligible financial entities.

GFOA Recommended Practice

Use and Application of Voluntary Agreements and Guidelines and Support for Written Investment Policies for State and Local Governments (1995)

Background. Various participants in the investment process are seeking to clarify the relationship of parties in an investment transaction by undertaking voluntary efforts to develop model agreements and guidelines. Some of these documents contain legal assumptions that might affect the validity of a transaction. Others would require certain statements to be in writing in order to be effective. Although the enforceability of such guidelines is uncertain, state and local government investors should be aware of their existence and the possibility that their counter parties may be operating under these or similar guidelines.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments consider carefully any agreement or guideline presented for their use because many of these documents affect a public entity's rights and responsibilities in a given transaction. Further more, GFOA recommends that:

1. Governmental investors be aware of the federal, state, and local laws that govern investment contracts and agreements, as well as statutes and regulations affecting suitability obligations of broker/dealers, which require that a broker/dealer should only recommend a product after that broker/dealer has taken steps to determine that it is suitable for the customer.
2. Governmental investors use the GFOA-developed Broker/Dealer Request for Information, Sample Agreement for Securities Service and (Optional) Statement of Work in dealing with broker/dealers, modified as necessary, which have been formulated specifically by and for state and local government investors.
3. Governmental investors use the GFOA-developed Sample Agreement for Investment Advisory Services when contracting for investment advisers.
4. Governmental investors protect their existing statutory and regulatory rights by ensuring that such rights are not inadvertently waived through the use of "boiler-plate" language in contracts with counter parties.
5. Governmental investors develop written investment policies using the GFOA-developed Sample Investment Policy.

GFOA Recommended Practice

Use of Derivatives by State and Local Governments (1994)

Background. Derivative products are financial instruments created from or whose value depends on (is derived from) the value of one or more underlying assets or indexes of asset values. Derivatives include instruments or features such as collateralized mortgage obligations (CMOs), interest-only (IOs) and principal-only (POs), forwards, futures, currency and interest rate swaps, options, floaters/inverse floaters, and caps/floors/collars. State and local governments may use derivatives in their roles as debt, cash, and pension fund managers.

Recommendation. The Government Finance Officers Association (GFOA) urges state and local government finance officers to exercise extreme caution in the use of derivatives and to consider their use only when they have developed a sufficient understanding of the products and the expertise to manage them. Because new derivative products are increasingly complex, state and local governments should use these instruments only if they can evaluate the following factors, among others, to determine their appropriateness:

1. Governmental entities must observe the objectives of sound asset and liability management policies that ensure safety, liquidity, and yield. Because of the risks involved, the use of derivatives by governmental entities should receive particular scrutiny. Certain derivative products may not be appropriate for all governmental investors. Characteristics of such products can include high price volatility, illiquid markets, products that are not market-tested, highly leveraged products, products requiring a high degree of sophistication to manage, and products that are difficult to value.
2. Governmental entities should understand that state and local laws may not specifically address the use of derivatives and examine such considerations as:
 - the constitutional and statutory authority of the governmental entity to execute derivative contracts,
 - the potential for violating constitutional or statutory provisions limiting the entity's authority to incur debt resulting from the transaction, and
 - the application of the governmental entity's procurement statutes to derivative transactions.
3. Governmental entities should be aware of all the risks associated with use of derivatives, including counterparty credit, custodial, market, settlement, and operating risk.
4. Governmental entities should establish internal controls for each type of derivative in use to ensure that these risks are adequately managed. For example:
 - the entity should provide a written statement of purpose and objectives for derivative use;
 - written procedures should be established that provide for periodic monitoring of derivative instruments;

- managers should receive periodic training and have sufficient expertise and technical resources to oversee derivative programs;
- record keeping systems should be sufficiently detailed to allow governing bodies, auditors, and examiners to determine if the program is functioning in accordance with established objectives;
- managers should report regularly on the use of derivatives to their governing body and appropriate disclosure should be made in official statements and other disclosure documents; and
- reporting on derivative use should be in accordance with generally accepted accounting principles, and because use of these instruments is a complex matter, early discussion with public accountants is essential to determine if specialized reporting may be required.

5. Governmental entities should be aware if their broker/dealer is merely acting as an agent or intermediary in a derivatives transaction or is taking a proprietary position. Possible conflicts of interest should be taken into consideration before entering into a transaction.
6. Governmental entities should be aware that there may be little or no pricing information or standardization for some derivatives. Competitive price comparisons are recommended before entering into a transaction.
7. Governmental entities should exercise caution in the selection of broker/dealers or investment managers and ensure that these agents are knowledgeable about, understand and provide disclosure regarding the use of derivatives, including benefits and risks. The entity should secure written acknowledgment from broker/dealers that they have received, read, and understood the entity's debt and investment policies, including whether derivatives are currently authorized under the entity's investment policy and that the broker/dealer or investment manager has ascertained that the recommended product is suitable for the governmental entity.
8. Governmental entities are responsible for ensuring this same level of safeguards when derivative transactions are conducted by a third party acting on behalf of the governmental entity.

GFOA Recommended Practice

Use of Various Types of Mutual Funds by Public Managers (1987)

Background. State and local government cash managers can sometimes benefit from investing public funds through mutual funds. The Government Finance Officers Association (GFOA) has endorsed the use of money market mutual funds by public cash managers through the Association's model investment legislation for state and local governments. Portfolio diversification, liquidity, and professional management are desirable features of these investment vehicles.

Recommendation. The GFOA recommends that state and local governments using mutual funds study the fund's prospectus and statement of additional information to determine:

- the integrity and experience of the investment company,
- sales fees and operating expenses,
- fundamental portfolio policies, and
- portfolio composition.

State and local government cash managers should use special care when investing in bond mutual funds. Mutual funds investing exclusively in short-and intermediate-term instruments may be appropriate investments in some jurisdictions. However, mutual funds investing in long-term securities should be avoided by investors of short-term funds. Market price risks could impair the safety of assets, which is the foremost objective of public cash managers.

GFOA Recommended Practice

Same-Day Funds Settlement Procedures (1994)

Background. A variety of participants in the securities markets have determined ways in which the date, timing and type of funds paid to depositories should be modified to transform the securities settlement system from a “next-day” funds to a “same-day” funds system. The purpose of the recommendations of these market participants is to standardize payments, reduce risk, improve efficiency, and reduce costs involved in securities settlement and to coordinate with changes in daylight overdraft and settlement procedures mandated by the Federal Reserve.

Recommendation. To ensure that principal and income payments will be made using same-day funds, the Government Finance Officers Association (GFOA) endorses the following recommendations to state and local governments that have been made by other market participants.

1. All new issues should be depository-eligible and principal and interest should be paid in same-day funds on the payment date.
2. For all existing issues, payments of principal and income should be made to depositories in same-day funds on the payment date.
3. Each depository should pay bondholders in same-day funds on payment date.
4. On, or prior to the morning of payment date, CUSIP number identification and dollar amount notifications should be sent to each depository using automated communications.

GFOA also makes these additional recommendations:

1. Issuers and their paying agents should enter into discussions to assure that funds are made available early on payment date for paying agents to pass on to depositories.
2. Issuers should distribute these recommendations to everyone involved in the payment process, including bond counsel and investment bankers.
3. Issuers should appoint a staff person to be responsible for keeping the organization informed about changes in the payments system and to coordinate implementation of this process.
4. Issuers should assure that all affected operations and systems personnel within the government unit understand these procedures.
5. Issuers should request system specifications from the depository and additional questions about these procedures should be addressed to the depository.

Reference

- “Report of the Same-Day Funds Payment Task to the U.S. Working Committee,” Clearance and Settlement Project, Group of Thirty, August 1993.

GFOA Recommended Practice

Electronic Transactions for State and Local Governments (1997)

Background. State and local governments are responsible for making a wide variety of payments to their employees, program recipients, vendors and other governments. In addition, governments receive revenue and fees from a wide variety of sources. Processing these disbursements and receipts can be very time-consuming and costly.

Many governments and private sector entities are moving towards the electronic movement of funds to achieve the following types of benefits:

- reduced bank fees;
- faster deposit and investment of funds;
- improved cash flow certainty allowing better investment decisions;
- easier and less expensive bank reconciliations;
- reduced check production and distribution costs (e.g., supplies, printing, signing, bursting, mailing and handling);
- reduced check stock and associated storage and security costs; and
- fewer lost, stolen, and reissued checks.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments evaluate opportunities to make and receive electronic payments in the following areas:

- payroll,
- vendor payments,
- retirement payments,
- intergovernmental payments,
- grant payments,
- other large, repetitive incoming payments (e.g., utility service),
- tax payments, and
- license payments.

In evaluating the costs and benefits of electronic payments, governments should consider at least the following factors:

- bank fees,
- experience with fraudulent or returned checks,
- supply costs,
- administrative and processing costs,
- mail fees, and
- impact (either positive or negative) on the availability of funds and interest earnings.

To the extent that electronic transactions are used, governments should implement the following safeguards:

- written agreements for electronic transactions with financial institutions in compliance with UCC4A,
- dual controls for the authorization of non-repetitive transactions,
- dual controls for the establishment of repetitive transactions,
- establishment of dollar limits per transaction per authorized personnel,
- establishment and use of passwords for authorized personnel to initiate transactions,
- call-back procedures to verify transactions,
- confirmations of transactions from financial institutions,
- establishment and use of adequate controls against unauthorized automated clearinghouse debits, and
- adequate internal controls addressing access control, confidentiality of data, integrity of data, and other information security issues as appropriate.

References

- *Model Electronic Payments Agreement and Commentary*, prepared by the EDI and Information Technology Division Section of Science and Technology, American Bar Association, 1996.
- *Negotiating Wire Transfer Agreements, A Guide for Treasury Executives, Bankers and Attorneys*, Paul S. Turner, Treasury Management Association, 1996.
- *An Introduction to Electronic Commerce: Government Cash Management Programs*, GFOA, 1998.
- *An Introduction to Treasury Management Practice*, GFOA, 1998.

GFOA Recommended Practice

Procurement of Banking Services (1997)

Background. State and local governments use a wide variety of banking services for the deposit, disbursement, and safekeeping of public monies. Prudent procurement practices necessitate the reevaluation of banking services on a periodic basis. In addition, recent changes in technology, cash management practices, and bank-industry structure offer public investors opportunities to reevaluate banking services and costs.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments should undertake the following practices to receive effective banking services at a reasonable cost:

1. Periodically initiate competitive-bidding and negotiation processes, in accordance with state and local laws and regulations, for major banking services. The processes should include requests for proposals and should cover services, fees, earnings credit rates, and availability schedules for deposited funds.
2. Have contracts for banking services that specify services, fees, and other components of compensation.
3. Evaluate the relative benefits and costs of paying for services through direct fees, compensating balances, or a combination of the two. Compensating-balance arrangements can offer convenience and seemingly low costs. However, because of uncompetitive earnings credit rates, reserve requirements, and insurance fees on deposits, compensating banks through fees or a combination of fees and balances generally is financially advantageous.
4. Evaluate their needs against the cost and benefits of specific banking services, including but not limited to:
 - controlled disbursement accounts,
 - zero-balance accounts,
 - positive-pay services,
 - reconciliation services,
 - lock-box services,
 - electronic-balance and transaction-reporting services,
 - electronically placed stop payments,
 - electronic payments,
 - electronically transmitted analysis statements,
 - electronic or digitized storage of paid checks,
 - overnight sweep accounts
 - safekeeping and custody arrangements,
 - credit-card receipt merchant services, and
 - procurement cards.

References

- *Banking Relations: A Guide for Governments*, Rhett Harrell, GFOA, 1986.
- *Cash Management for Small Governments*, edited by Ian J. Allan, GFOA, 1989.
- *An Introduction to Treasury Agreements*, Linda Sheimo, GFOA, 1992.
- *An Introduction to Treasury Management Practices*, GFOA, 1998.

GFOA Recommended Practice

Check Fraud Protection (1999)

Background. Despite the increase in use of electronic payments, reports of check fraud also are increasing. Recent technological advances in computer hardware, software, scanners, Magnetic Ink Character Recognition (MICR) equipped printers, and photocopiers make it increasingly possible to produce fraudulent checks. Moreover, recent revisions to the Uniform Commercial Code sometimes shift liability for fraudulent items from banks to government and corporate account holders, particularly if an entity has not taken reasonable steps to protect against losses.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments consider the following steps to protect themselves against check fraud.

- Make use of check stock with security features such as watermarks, “void” pantograph (which displays the word “void” when the check is photocopied), micro printing, laid lines and other backgrounds with multiple patterns or colors, special ink that can be read under ultra violet light, and chemical coatings that react to attempts at alteration.
- Secure Check stock daily. Remove continuous forms from printer, lock printer, and secure check stock in a locked environment.
- Require two signatures on checks over a specified amount.
- Update signature cards when staff changes.
- Reconcile all bank statements and notify banks of discrepancies on a timely basis.
- Provide for physical security of returned checks and check copies or digital images.
- Ensure proper segregation of duties among staff initiating, authorizing, preparing, signing, and mailing payments and reconciling bank statements.
- Conduct periodic and surprise audits or reviews of procedures.
- Set dollar limits for individual checks, particularly on smaller accounts.
- Make use of “positive pay” services provided by banks, through which banks pay only those items that match a check issue file provided to the bank.
- Provide written instructions to local banks regarding the honoring or returning of checks.
- Make use of electronic check presentment (ECP) with the disbursement bank, if available.
- Consider outsourcing the payment process.
- Promote use of Electronic Funds Transfer (EFT).

Reference

- *An Introduction to Treasury Management Practices*, GFOA, 1998.

GFOA Recommended Practice

Frequency of Purchased Securities Valuation in Repurchase Agreements (1999)

Background. A repurchase agreement (repo) is a transaction between a bank or securities dealer and an investor in which the bank (dealer) sells the securities to the investor (governmental entity) with a simultaneous agreement to buy the securities back from the investor at a specific time and at a price that will result in a predetermined yield to the investor. Securities sold are usually U.S. Treasury obligations, although agency securities and other alternative securities are also used. Repo transactions can be effected overnight, for a specified number of days, or as a continuing open contract. The repo market encompasses a broad range of debt and other securities, is highly liquid, and offers returns slightly above Treasury bills for investors.

Public funds have used repos since the 1970s. In September 1996, the Bond Market Association (TBMA) published a revised version of its master Repurchase Agreement, which previously had been amended in 1987. The revised agreement includes modifications designed to reflect the expansion of the repo market and changes in the law with respect to liquidation and closeout. Policies of governmental entities regarding securitization and safekeeping for deposits and investments, including repos, must be disclosed under the Governmental Accounting Standards Board (GASB) Statement 3.

The valuation of securities is an important factor in managing the risk of default in repurchase transactions. To protect the buyer from a decline in the price of the security during the term of the repo agreement, the seller usually delivers underlying securities in an amount necessary to sufficiently cover the governmental entity's investment plus accrued interest. The value of the securities must be monitored frequently to insure that the market value remains above the principal and interest earned to date in case of default of a counterparty. If the counterparty does not default, the value of the securities will not affect the repo agreement.

The frequency of the valuation depends on the duration of the investment, security types and any established margin percentage. Less frequent valuations should require higher margin percentages since the risk exposure period is longer; the risk of market price declines is greater over longer time periods.

Recommendation. The Government Finance Officers Association (GFOA) recommends that government entities establish a policy and procedure for monitoring the value of the purchased securities to insure that it does not drop below the value of the repo. Though unnecessary for overnight investments, government entities should periodically revalue longer-term purchased securities and continuous repo transactions to avoid incurring a loss. Government entities should consider the use of third-party financial sources in their valuation process to price and transfer purchased securities.

In order to facilitate the determination of market value when negotiating a master repurchase agreement, government entities should specify both the types of securities that are acceptable for the transaction and the pricing source for the securities. Price information for the securities

should be readily available from a generally recognized source. As of any specific date during the transaction, the purchased securities should be prices at market value (including the value of the accrued interest) before applying any margin percentage because the investor may need to liquidate the securities in the secondary market in the event the seller does not complete the repurchase agreement transaction.

References

- *Considerations for Governments in Developing a Master Repurchase Agreement, Second Edition*, GFOA Committee on Cash Management, 1988.
- *An Introduction to Broker/Dealer Relations for State and Local Governments*, M. Corinne Larson, GFOA, 1994.
- Master Repurchase Agreement, The Bond Market Association, September 1996.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, M. Corinne Larson, GFOA, 1996.
- “Investor Alert: Repo Agreements,” *Public Investor*, April 3, 1998.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- “Tri-Party Repo,” *Public Investor*, GFOA, October 2, 1998.
- “Flexible Repurchase Agreements,” *Public Investor*, GFOA, January 1, 1999.

GFOA Recommended Practice

Purchasing Card Programs (1998)

Background. The purpose of a purchasing card (also known as a procurement card) program is to provide an efficient, cost-effective method of purchasing and paying for small-dollar as well as high-volume, repetitive purchases. This type of program is designed as an alternative to the traditional purchasing process and can result in a significant reduction in the volume of purchase orders, invoices, and checks processed. Purchasing cards can be used whenever a purchase order, check request, or petty cash would have been processed and with any vendor that accepts credit cards.

There are numerous benefits to a purchasing card program. Benefits to the cardholder include:

- convenience of purchasing without a purchase order,
- expedited delivery of goods,
- expanded list of merchants from whom purchases can be made, and
- reduced paperwork.

Benefits to the government's internal departments include:

- simplified purchasing process,
- lower overall transaction processing costs per purchase,
- increased management information on purchasing histories,
- reduced paperwork, and
- the ability to set and control purchasing dollar limits.

Benefits to the vendor include:

- expedited payments,
- reduced paperwork, and
- lowered risk of nonpayment.

Purchasing cards may be issued in a designated individual's name with the government's name clearly indicated on the card as the buyer of goods and services. The purchasing card and any transactions made with the card may become a liability of the governmental entity. For this reason, it is important that governments be aware of the risks related to the use of purchasing cards and develop plans to address those risks.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments explore the use of purchasing cards to improve the efficiency of their purchasing procedures. A competitive process should be used to select a purchasing card provider.

Purchasing card programs should be designed to be simple and easy to use; however, governments need to maintain appropriate controls to ensure the ongoing success of a purchasing card program. These controls should include:

- written agreements with banks, which include fee schedules and processing procedures,
- written policies and procedures for internal staff,
- instructions on employee responsibility and written acknowledgements signed by the employee,
- spending and transaction limits for each cardholder both per transaction and on a monthly basis,
- written requests for higher spending limits,
- record keeping requirements, including review and approval processes,
- clear guidelines on the appropriate uses of purchasing cards, including approved and unapproved merchant category codes (MCC),
- guidelines for making purchases by telephone and fax or over the Internet,
- periodic audits for card activity and retention of sales receipts and documentation of purchases,
- procedures for handling disputes and unauthorized purchases,
- procedures for card issuance and cancellation, lost or stolen cards, and employee termination, and
- segregation of duties for payments, accounting, and reconciliations.

References

- *An Elected Official's Guide to Procurement*, Patricia C. Watt, GFOA, 1995.
- *An Introduction to Electronic Commerce: Government Cash Management Programs*, GFOA, 1998.