

Legal Q&A

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May a city invest its public funds?

Yes, a city may invest its public funds, but only if the city complies with Chapter 2256 of the Texas Government Code, the Public Funds Investment Act (Act).

What does the Act require of a city before a city may invest its public funds?

Before a city may invest its public funds, the Act generally requires the following:

1. A city must adopt a written investment policy.
2. A city may only invest its funds in investments authorized under its written investment policy.
3. Authorized investments must come from the list of proper investments under the Act.
4. An official from the city must complete training regarding the requirements of the Act.

What is the investment policy requirement?

A city must adopt a written investment policy by ordinance or resolution. TEX. GOV'T CODE §2256.005(a). Therefore, regardless of a city's population, it must have a written investment policy if it has any cash or bank investments. A formal policy protects not only the cash assets of the city, but also the elected and finance management officials.

An investment policy must contain a statement emphasizing safety and liquidity. TEX. GOV'T CODE §2256.005(b)(2). The policy must also include a list of authorized investments and the permitted maximum maturity of any individual investment, as well as the maximum weighted average maturity (WAM) of funds. TEX. GOV'T CODE §2256.005(b)(4)(a). The policy must also include the method used by the investing entity to monitor the market price of investments acquired.

Although the actual investment strategy for smaller cities is vastly different from that of larger cities, the primary objectives, which should direct any investment strategy, are safety and liquidity. Safety is the most important objective because public officials have a fiduciary responsibility to manage and maintain taxpayer funds. The Act requires city councils to invest public funds under their control with the same prudence and discretion as such entities would manage their own affairs.

Liquidity, the ability to sell or dispose of an investment, is equally important. Invested funds must be readily available if the need for cash arises and requires the city to liquidate the investment before maturity.

Yield refers to the rate of return received on a particular investment. Yield or income derived from an investment is important, particularly to a city grappling with declining or stagnant

revenues or tax base. However, 1995 amendments to the Act significantly revised the ranking of investment objectives and put yield in last place. The first priority for consideration is the suitability of the investment to the overall cash flow and financial requirements of the entity.

The Act requires that the governing body of an investing entity review its investment policy at least once a year. TEX. GOV'T CODE §2256.005(e). Moreover, the governing body must take formal action stating that the policy and strategy have been reviewed. Any changes to either the policy or strategy must be recorded in the resolution and the investment policy. Changed policies should be sent to all brokers, pools, and advisors. The investing entity must also designate by ordinance or resolution the employee or investment officer(s) who will be responsible for the investment of its funds. TEX. GOV'T CODE §2256.005(f). The policy also should refer to training seminars conducted by independent sources, such as the Texas Municipal League.

What is the training requirement under the Public Funds Investment Act?

The treasurer, the chief financial officer (if the treasurer is not the chief financial officer), and the investment officer of a local government must attend at least one training session in investment laws within 12 months after taking office. TEX. GOV'T CODE §2256.008. The Act is written in a way that requires all cities to appoint someone to one of these positions in order to receive the training. On a continuing basis, the investment training sessions must be attended at least once every two-year period for at least ten hours of instruction.

The entity that provides training must report to the state comptroller a list of the governmental entities that received training. Further, auditors and credit-rating agencies are increasingly paying attention to whether a city is up-to-date on its required training. The Texas Municipal League offers training, as do other entities. City officials may check for upcoming Public Funds Investment workshops under the "Training" tab on the TML Web site at www.tml.org.

If a city invests its funds in certificates of deposit only, does a city official still need to attend training in the Public Funds Investment Act?

Yes. The Public Funds Investment Act training requirement makes no exception or allowance for cities that don't invest, invest very little, or invest only in time deposits. TEX. GOV'T CODE §2256.008.

Certificates of deposit are considered investments under the Act, meaning that their purchase is not proper unless the city has adopted a written investment policy authorizing their use. TEX. GOV'T CODE §2256.010.

According to the Act, what are the legal investment tools that a city may include in its investment policy?

The Act limits the types of investments that a city may authorize under its investment policy. Essentially, an investment must be legal under the Act, *and* included in the city's investment policy, before a city may use that investment.

Following are the common legal investments under the Act (there are some additional legal investments that apply only to certain cities or entities):

1. **Governmental Obligations.** United States and State of Texas obligations, such as bonds, are legal investments. So are obligations of local governments, provided the obligations are “A” rated. Mortgage-backed obligations are not legal, however. TEX. GOV’T CODE §2256.009.
2. **Certificates of Deposit (CDs).** CDs are a legal investment provided they are issued by a bank with its main office or a branch office in Texas. TEX. GOV’T CODE §2256.010. CDs must be collateralized (secured) for amounts greater than FDIC insurance (\$250,000).
3. **Repurchase Agreements.** Certain fully-collateralized repurchase agreements are legal investments. TEX. GOV’T CODE §2256.011.
4. **Securities Lending Programs.** TEX. GOV’T CODE §2256.0115.
5. **Banker’s Acceptances.** TEX. GOV’T CODE §2256.012.
6. **Commercial Paper.** Commercial paper is a legal investment provided it has a maturity date of 270 days or less and is rated at least “A-1” or “P-1” by at least two credit rating agencies. TEX. GOV’T CODE §2256.013.
7. **Certain Mutual Funds.** TEX. GOV’T CODE §2256.014. (See below for details about legal mutual funds.)
8. **Guaranteed Investment Contracts.** Guaranteed investment contracts are legal investments if they have a defined termination date, are fully secured, and are pledged to the city. TEX. GOV’T CODE §2256.015.
9. **Investment Pools.** Investment pools are legal investment vehicles if: (a) the city council passes an ordinance or resolution authorizing investment pools; (b) the investment officer of the city receives a detailed prospectus from the pool; (c) the pool makes detailed periodic reports to the city; and (d) the pool is continuously rated “AAA” or “AAA-m.” TEX. GOV’T CODE §2256.016.

May a city invest in corporate stocks?

No. Stocks, also known as equities, are not listed among the legal investments under the Act.

Which mutual funds may a city invest in?

It depends. Whether a city can invest in a mutual fund and how much depends on the type of mutual fund in question. An outline of the law for each type of permissible mutual fund follows, but it is recommended that the investment officer read the statute in question before making the investment:

- 1) A city may invest in no-load money market mutual funds only if all the following are true:
 - a) the fund is registered and regulated by the Securities and Exchange Commission (SEC);
 - b) the fund provides a certain type of prospectus;
 - c) the fund has a dollar-weighted average stated maturity of 90 days or fewer; and

- d) the fund includes in its investment objectives the maintenance of a stable net asset value of one dollar per share.
- 2) A city may invest in no-load mutual funds (that is, non-money market) only if all the following are true:
- a) the fund is registered with the SEC;
 - b) the fund has an average weighted maturity of less than two years;
 - c) the fund invests exclusively in obligations already approved elsewhere in the Public Funds Investment Act (thus excluding most stock funds);
 - d) the fund is continuously rated as to investment quality by at least one nationally recognized investment rating firm of not less than AAA or its equivalent;
 - e) the city invests no more than 15 percent of its eligible funds in the mutual fund (that is, excluding city's bond and debt funds);
 - f) the city does not invest its bond or debt service funds in this type of fund; and
 - g) city investments do not exceed ten percent of the value of the fund. TEX. GOV'T CODE § 2256.014.

Of course, the Public Funds Investment Act does not permit investment of any city funds until the city adopts a written investment policy that authorizes each type of investment in question. A written investment policy that does not authorize mutual funds would thus exclude their use, despite state law.

What is the consequence of failure to comply with the Public Funds Investment Act training requirements?

Though the Act contains no penalty provision, auditors and credit-rating agencies are increasingly knowledgeable about the Act's requirements. Failure to obtain the necessary training could result in negative marks on the city's audit or a downgrade in a city's credit rating, which could affect municipal borrowing.