

## Legal Q&A

By **Bill Longley**, TML Legislative Counsel

### **Q. May a city invest its public funds?**

**A.** 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 (PFIA).

### **Q. What does the PFIA require of a city before a city may invest its public funds?**

**A.** Before a city may invest its public funds, the PFIA 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 PFIA; and
4. An official from the city must complete training regarding the requirements of the PFIA.

### **Q. What is the investment policy requirement?**

**A.** 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. *Id.* § 2256.005(b)(2). If the policy applies to the financial assets of all funds or fund types, that fact should be clearly stated. A distinction should be made between shorter-term cash management and the management of longer-term investments.

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. *Id.* § 2256.005(b)(4)(a) & (c). The policy must also include (among other things) the method used by the investing entity to monitor the market price of investments acquired, as well as procedures to monitor rating changes in investments acquired with public funds and the liquidation of such investments. *Id.* § 2256.005(b)(4)(d) & (f).

Although the actual investment strategy for smaller cities is vastly different from 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 PFIA requires governing bodies of local governments

and state agencies 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 PFIA significantly revised the ranking of investment objectives and put yield in last place. *Id.* § 2256.005(d). The first priority for consideration is the suitability of the investment to the overall cash flow and financial requirements of the entity. *Id.* § 2256.005(d).

The PFIA requires that the governing body of an investing entity review its investment policy at least once a year. *Id.* § 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. *Id.* § 2256.005(f). The policy also should refer to training seminars conducted by independent sources, such as the Texas Municipal League.

**Q. What is the training requirement under the PFIA?**

**A.** 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, ten-hour, training session in investment laws within twelve months after taking office. *Id.* § 2256.008. The PFIA 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 eight hours of instruction. The two-year period begins on the first day of the city's fiscal year and consists of the two consecutive years after that date. *Id.* § 2256.008(a-1).

As of September 1, 1999, the entity that provides training must report to the 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 PFIA workshops on the TML website or [www.tmlpfia.org](http://www.tmlpfia.org).

**Q. If a city does not invest any of its funds, or invests its funds only in interest-bearing deposit accounts or certificates of deposit, does a city official still need to attend training under the PFIA?**

**A.** Yes and no. The relevant city officials still must take the initial ten-hour investment training session within twelve months of taking office or assuming duties, even if the city has little or no

investments. *Id.* § 2256.008(a)(1). Legislation passed in 2015 that eliminated any continuing investment training requirement for finance officials in a city that does not invest city funds or only deposits city funds in interest-bearing deposit accounts or certificates of deposit as authorized by the PFIA. *Id.* § 2256.008(f). However, due to an error in the way the bill was drafted, it is not clear that this bill will have the intended effect. As a result, cities with little or no investments should consult with local counsel prior to making a decision about attending continuing investment training.

**Q. According to the PFIA, what are the legal investment tools that a city may include in its investment policy?**

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

Following are the legal investments under the PFIA:

- (1) **Governmental Obligations.** United States (including the Federal Home Loan Banks) and State of Texas obligations, such as bonds, are legal investments. So are obligations of local governments, provided the obligations are "A" rated. Certain interest-backed banking deposits are permitted as well. Mortgage-backed obligations are not legal, however. *Id.* § 2256.009.
- (2) **Certificates of Deposit (CDs).** CDs are a legal investment provided they are issued by a bank or authorized broker with its main office or a branch office in Texas. *Id.* § 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. *Id.* § 2256.011.
- (4) **Securities Lending Programs.** *Id.* § 2256.0115.
- (5) **Banker's Acceptances.** *Id.* § 2256.012.
- (6) **Commercial Paper.** Commercial paper is a legal investment if 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. *Id.* § 2256.013.
- (7) **Certain Mutual Funds.** *Id.* § 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. *Id.* § 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. An investment pool may invest its funds in money market mutual funds to the extent permitted by state law and the investment policies and objectives adopted by the pool. *Id.* § 2256.016.

- (10) **Municipal Utility.** A city that owns an electric utility may enter into a hedging contract and related security and insurance agreements in relation to fuel oil, natural gas, coal, nuclear fuel, and electric energy to protect against loss due to price fluctuations. *Id.* § 2256.0201.
- (11) **Municipal Funds from Management and Development of Mineral Rights.** A city may invest excess funds derived from contracts or leases made on city-owned mineral rights in any investment authorized to be made by a trustee under the Texas Trust Code. *Id.* § 2256.0202.
- (12) **Decommissioning Trust.** A city that owns an electric utility may invest funds held in a nuclear generation facility decommissioning trust in any investment authorized by the Texas Trust Code. *Id.* § 2256.0205.
- (13) **Hedging Transaction.** A city with a principal amount of at least \$250 million in outstanding long-term indebtedness or long-term indebtedness proposed to be issued that is rated in one of the four highest rating categories by a nationally recognized rating agency for municipal securities may invest in a hedging transaction, including a hedging contract. *Id.* § 2256.0206(a). Before investing in a hedging transaction, the governing body of an eligible entity must first establish the entity's policy regarding hedging transactions. *Id.* § 2256.0206(c).

#### **Q. May a city invest in corporate stocks?**

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

#### **A. Which mutual funds may a city invest in?**

It depends. Essentially, 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 (TEX. GOV'T CODE § 2256.014):

- (1) A city may invest in no-load money market mutual funds only if all of 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 complies with SEC rules related to money market mutual funds; and
  - (d) the city's investments do not exceed ten percent of the value of the fund.
- (2) A city may invest in other no-load mutual funds (that is, non-money market) only if all of 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 either: (i) has a duration of one year or more and invests exclusively in obligations already approved elsewhere in the PFIA

- (thus excluding most stock funds); or (ii) has a duration of less than one year and the investment portfolio is limited to investment grade securities, excluding asset-backed securities;
- (d) the city invests no more than 15 percent of its eligible funds in the mutual fund (i.e., excluding the city's bond and debt funds);
  - (e) the city does not invest its bond or debt service funds in this type of fund; and
  - (f) the city's investments do not exceed ten percent of the value of the fund.

Of course, the PFIA 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.

**Q. What is the consequence of failure to comply with the PFIA training requirements?**

**A.** Though the PFIA contains no penalty provision, auditors and credit rating agencies are increasingly knowledgeable about its 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.