



Due Diligence Review

Local Government Investment Pool

Submitted to Speaker Marco Rubio

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Introduction

On February 25, 2008, the Florida House of Representatives, Marco Rubio, Speaker, retained Tanya Beder of SB Consulting Corp. and Thomas Tew of Tew Cardenas LLP to conduct a due diligence review (the “Review”) of the Local Government Investment Pool (the “Pool”), managed by the Florida State Board of Administration (the “SBA”) to recommend legislation, if appropriate, to restore confidence in the Pool. Speaker Rubio announced, “Our goals are to assist in restoring public confidence in the Pool and to ensure that from the law making perspective the Pool managers have a framework in state statutes that supports best investment practices.” The House review is led by State Representative Carl Domino.

The focus of this Review is to evaluate the Pool on a forward-looking basis and to identify those strengths and weaknesses of the Pool in order to recommend legislation or suggestions to increase confidence in the Pool and the SBA franchise. Restoring confidence is critical; to put it in the words of the SBA, “No one is calling anymore.” We have conducted our interviews and have asked those questions a local government would ask when considering new investments in the Pool.

We wish to stress at the outset that we find no fault in the decision to purchase the securities that were bought within the Pool’s guidelines and subsequently downgraded (the “Securities”). Nor do we fault the decision to continue to hold the Securities, as long as the Participants in Fund B can wait to receive their monies.¹ We believe this decision to hold these Securities and enter into workouts gives the Pool the best opportunity to maximize recoveries. The SBA is not alone in experiencing losses during the recent period of market turmoil. A global group of regulators from the United States, France, Germany, Switzerland and the United Kingdom stated in their March 6, 2008 report *Observations on Risk Management Practices During the Recent Market Turbulence* that “firms did not recognize the possibility that losses on underlying MBS [mortgage-backed securities] could reach levels that could impair the value of even the super-senior tranches of ABS CDOs [asset-backed collateralized debt obligations]”. See the Appendix for a timeline of market dynamics from February 2007 to March 2008.²

As market events progress, additional factors may come to light and our recommendations may not prove to be final. Perhaps the largest caveat is that this analysis was completed prior to the disposition of the Fund B assets. Accordingly, this Review may be revised.

We wish to acknowledge the cooperation of Interim Executive Director General Bob Milligan in making SBA staff available for as many interviews as we requested, including on

¹ The loss anticipated in the Pool’s Fund B (see “History of the Pool”) had its genesis in the purchase of four securities from two brokerage firms in July and August, 2007. See “The Four Troublesome Securities.” An evaluation of the Pool’s potential claims for recovery against these firms and others was not within the scope of this Due Diligence Review. However, if requested by the Speaker we will endeavor to obtain, by House subpoena if necessary, the documents relevant to these sales to determine if the brokerage firms made full disclosure in the sale of these securities to the Fund and other SBA entities.

² Source: Algo FIRST database of case studies. For additional information, refer to the following web site: <http://www.algorithmics.com/EN/solutions/casestudies/>.

weekends. We also thank Trustees CFO Alex Sink and AG Bill McCollum for their input and making their staffs available for in-depth discussions of the issues facing the Pool and the SBA³. We thank the representatives of the Investment Advisory Council, John Jaeb and Roman Martinez IV who took the time to be interviewed by telephone. Finally, we wish to acknowledge the cooperation of the previous Executive Director, Coleman Stipanovich, who granted us an extensive interview to answer our questions and to discuss the SBA and the Pool.

³ Governor Charlie Christ was not available.

Executive Summary: 16 Recommendations

Our Review identifies 16 recommendations that the Legislature can consider for possible legislation. The recommendations are summarized below and discussed as part of the sections that follow. In our opinion, each is critical to restoring confidence in the Pool.

Recommendation 1: Create a new pool.

Create a new pool in the form of a new trust that takes all future investments and allows the current Pool, both Funds A and B, to self-liquidate. This recommendation is explicitly conditioned upon the implementation of the risk and control safeguards we found missing in the Pool's current operation. See "Why a New Pool".

Recommendation 2: Update risk and control safeguards.

Implement several new and augment several current risk and control safeguards to ensure best market practices. A strong control environment protects investors in the Pool (the "Participants"). The Pool and its securities are not registered with the Securities and Exchange Commission (SEC) and the SBA staff members that deal with the public are not licensed. The Pool, its securities and sales personnel are exempt from federal regulation under a governmental exclusion clause. These exemptions and the lack of federal oversight mean that state oversight plus strong controls and safeguards are necessities to protect Participants.

Recommendation 3: Improve transparency.

A formal and transparent system should be developed to keep account information current and easily understood by all stakeholders.⁴ Pool investment earnings should be apportioned to individual accounts. All fees, charges and reserves should be spelled out in advance in all correspondence and other dealings with Participants, including on the Pool's webpage. In conjunction with this, the Legislature should review several amendments to Florida Statutes Chapter 218 and Chapter 19-1 Florida Administrative Code: the board's ability to administer a rate of return for the Pool (Rule 19-7.015 added in 1998); the permission for management to assess reserves in the Pool from the "Pool investment earnings" (Rule 19-7.017 added in 1998); authorization for penalties for early withdrawal (Rule 19-7.015 added in 1998); and the suspensions of redemptions (Rule 19-7.012 added in 1998).

Recommendation 4: Require an independent financial audit.

Require an annual, independent financial audit of the new pool. In addition, the Trustees should weigh the costs and benefits of requiring an independent financial audit of Funds A and B if they are self-liquidating. An audit of Funds A and B will necessitate retaining experts to work to model the "impaired" Securities in Fund B. Outside legal opinions will be required as well. See "Why a New Pool". These costs will reduce the proceeds returned to Participants in Funds A and B.

⁴ Stakeholders include Participants, SBA employees, Trustees, the Investment Advisory Council and taxpayers among others.

Recommendation 5: Require escalation and exception reporting.

Bolster interim oversight by requiring the SBA to provide exception reporting under formal escalation guidelines to all review bodies of the SBA including the Trustees and the Investment Advisory Council. Escalation procedures should review all major issues that occurred during each period and expose any remaining open items so they may be addressed on a timely basis. As we discuss in this Review, there were several opportunities to address the Pool's problems as early as August 2007 in order to avoid a run on the Pool and the division of the Pool into Funds A and B.

Recommendation 6: Ensure immediate disclosure of material information.

Make it clear to members of SBA senior management ("Senior Management") that it is their duty to timely disclose material information to Participants. While the Pool's securities are exempt from federal registration, their sale is not exempt from the Securities and Exchange Act of 1934, which mandates full disclosure in the sale of securities. Two members of SBA Senior Management stated "It is up to Participants to ask rather than the duty of the Pool to disclose." This attitude must change. We note however that we did not find that those underneath such members of Senior Management had that attitude.

Recommendation 7: Address "step-child" status of the Pool.

Review the staffing, compensation, budget and organizational structure at the SBA and how these impact the Pool and consider adding a "CEO of the Pool." Over the past few years, while SBA mandates grew and complexities increased in the financial markets, the SBA's budget remained flat. The Pool (\$30.9 billion at June 30, 2007), although historically several times the size of the largest Florida-based bank, was treated by SBA Senior Management as a step-child to the Florida Retirement System (FRS) Pension Plan (\$136.3 billion), FRS Investment Plan (\$3.7 billion) and Lawton Chiles Endowment (\$2.3 billion).⁵ Critical enterprise risk initiatives were implemented for these mandates but not for the Pool; strapped head count in critical legal, audit and operations functions focused on these first.

Recommendation 8: Train SBA staff.

Require that the SBA implement an ongoing training program for new and existing employees regarding their understanding of their fiduciary responsibilities to Pool Participants.

Recommendation 9: Ensure ongoing oversight of the Pool.

Meetings of oversight bodies up and through the Trustees should discuss the Pool at every review including exception reports covering all significant closed and remaining open items in the front, middle and back office operations of the SBA. Members of the Investment Advisory Council stated that for six years leading up to the most recent meeting, quarterly reports from the SBA only covered the FRS plans and the Lawton Chiles Endowment, further underscoring the step-child status of the Pool at the SBA.

⁵ The monthly memorandum provided to the Trustees by the SBA Executive Director consistently refers to the FRS Pension Plan, the FRS Investment Plan and the Lawton Chiles Endowment as "the SBA's three key mandates".

Recommendation 10: Require consistent information.

The February 29, 2008 memorandum to Trustees includes mentions of the Pool and reports a “Managed Return” of 5.43% for the past 12 months for the combined Fund A and Fund B and a “Value Added” of 0.15% compared to its benchmark. Such reporting to Trustees does not reflect the mark-to-market losses reported Participants on the website in Fund B (9.3% of principal) or Fund A (0.2% of principal).

Recommendation 11: Review SBA compensation practices.

SBA managers and Wilshire Associates⁶ suggest total compensation levels are too low to properly attract and retain talent, thereby subjecting the Pool to key person risk. In addition, current incentive compensation practices (less than 10% of base pay) encourage a focus on the FRS retirement plans to the exclusion of the Pool and do not apply to all employees who would normally be included (many non-trading functions in the private market). The SBA is a large money-management organization and the reoccurring misperception that the SBA is a state agency whose employees are engaged in government service is an impediment to adequate compensation.⁷

Recommendation 12: Perform an operational audit of SBA.

The SBA last performed an operational audit in March 2004. While the SBA did not implement all of the recommendations of the audit in the areas of operations, procedures, policies and controls, the functions of internal audit and enterprise risk management were created as a result of such audit. These along with the SBA’s other operations and compliance functions should be reassessed as to the adequacy of staff⁸, reporting lines⁹ and independent checks and balances.

Recommendation 13: Return Pool to SBA internal management.

Return the Pool trading to internal management at the expiration of Federated’s contract¹⁰, provided the controls are in place. If a new pool is created, install the SBA from the outset as the complete manager, including trading. There are significant tangible and intangible public service benefits to the Pool being run internally by the SBA rather than by an external manager. A \$30 billion dollar pool with a more than 10-year 19.7 basis point¹¹ benefit (the

⁶ “Wilshire Associates is a leading global investment technology, investment consulting and investment management firm with four distinct business units including Wilshire Analytics, Wilshire Consulting, Wilshire Funds Management and Wilshire Private Markets. With nine offices on four continents, Wilshire Associates and its affiliates are dedicated to providing clients with the highest quality counsel, solutions and services.” Source: www.wilshire.com.

⁷ The SBA retains a substantial advantage relative to private money managers in that it does not need to incur expenses for marketing its products

⁸ Internal audit has a strapped staff yet juggles many projects across the front, middle and back office activities of SBA and performs “one off” projects for Senior Management as well. In addition, the historical budget has not facilitated hiring professionals highly experienced in all aspects of SBA investments. Some additional staff may facilitate security and change management issues cited in the Auditor General’s Information Technology Preliminary and Tentative Audit Findings dated February 27, 2008 and the securities valuation issues cited in the SBA internal audit report number 2008-01 dated February 14, 2008.

⁹ The head of enterprise risk management is junior in the organization chart relative to best market practice and reports along with travel services, the records manager, the office services manager, the procurement manager, a contract analyst and a policy and planning analyst to the Senior Officer for planning, policy and administrative services who then reports to the Chief Operating Officer of SBA.

¹⁰ Federated was hired as the external manager for the Pool effective March 1, 2008

¹¹ One hundred basis points equal one percent.

Pool's historical record) translates into \$600 million in extra earnings for Participants. The current budget realities make this more important than ever.

Recommendation 14: Educate Participants in the Pool.

Ensure that the chief investment officer or authorized officer of a local government unit who elects to participate in any pool offered by the SBA is aware that such pool and its securities are not registered with the SEC but operated under an exemption, that investments in the pool are not insured or guaranteed and that substantial losses have occurred in local government investment pools in the past. Such disclosures are consistent with the recommended practices by the Government Finance Officers Association.¹²

Recommendation 15: Expand the Number of Trustees for the SBA.

Currently there are three Trustees for the Pool: the Governor, CFO and Attorney General of Florida. Add a minimum of four Trustees, two who are substantial stakeholders in SBA mandates and two who are experienced financial professionals.¹³ For example, the State of Wisconsin Investment Board (“SWIB”) has nine members meeting specific membership requirements, and SWIB runs both retirement systems and local government investment pools.¹⁴

Recommendation 16: Address communications challenge.

The advisory board noted the extreme difficulty in its ability to raise and to discuss potential issues related to the SBA because of the restrictions posed by the state's Sunshine Law.

¹²See Government Finance Officers Association Recommended Practice “Use of Local Government Investment Pools (LGIPs) (2007) (CASH)” as approved by the GFOA's Executive Board on March 2, 2007. These may be found at www.gfoa.org.

¹³ An expansion of the Trustees also was recently recommended by Florida CFO Alex Sink.

¹⁴ See <http://www.swib.state.wi.us/trustees.pdf>

History of the Pool

The Pool was established “to provide local governments a low cost, low risk, fully transparent investment option for their surplus funds”.¹⁵ The Pool is open to all units of local government in Florida and has been operated by the SBA since January 1982. As of June 30, 2007, the SBA managed approximately \$31 billion in assets in the Pool serving almost 1000 participants. The SBA’s Trustees are the Governor who serves as Chairman, the CFO who serves as Treasurer and the Attorney General who serves as Secretary.

Confidence in the Fund began to erode as a result of the Pool’s July and August 2007 purchase of four securities, Ottimo, KKR Pacific, KKR Atlantic and Axon (the “Securities”) discussed below with a par value at time of purchase of \$947.8 million. These Securities were downgraded in late summer and early fall 2007 below the Pool’s investment guidelines. See Table 1 on the following page. Knowledge of these downgrades, primarily from financial news accounts and rumors that in July and August one or more of the Securities had defaulted, all against the backdrop of the national sub-prime mortgage crisis, spooked Participants into withdrawing \$14 billion from the Pool in mid- to late- November 2007 (the “Run”).

As a result of this Run, on November 29, 2007, the SBA Trustees suspended withdrawals from the Pool and on December 4, 2007, split the Pool into two funds, Fund A and Fund B. The four downgraded Securities with a then-par value of approximately \$867 million together with additional securities with a par value of approximately \$1.2 billion deemed by an investment manager, BlackRock, hired by the SBA, to have an unacceptable level of risk, were placed in Fund B and frozen. Additionally, the Trustees transferred to Fund B the Pool’s entire \$22 million in accumulated, unspecified reserves and \$96 million representing the Pool’s interest earned in November 2007 by all Participants in the Pool. The \$96 million was transferred to Fund B in the form of \$82 million in cash and \$14 million in securities.

The Pool’s remaining securities were placed in Fund A and rated by Standard and Poor’s as AAA. It should be noted that the two funds are, in fact, simple accounting entries in the Pool’s original trust and are not separate legal entities. New money investment in Fund A after it reopened on December 6, 2007, was posted to a separate account number, different from its old Pool number. Fund B Participants had an accounting entry of “B” added to their account number to indicate their position in Fund B. This accounting entry is not a legal vehicle to isolate the problems in Fund B.

When Fund A was reopened, the SBA established withdrawal limitations based upon the Fund’s liquidity and imposed a 2% fee on Participants which elected to withdraw more than they were allowed under the liquidity restrictions on redemptions. The 2% fee was based upon an assessment by the SBA staff that a complete liquidation of Fund A would result in a 2% shortfall.

¹⁵ http://sbafla.com/fund_pool.aspx

The Four Troublesome Securities

In search of higher yields, the Pool, by July 31, 2007, had invested in 28 collateralized debt obligations and structured investment vehicles and seven extendable asset-backed commercial paper (ABCP) issued by seven ABCP programs that chose to extend.¹⁶

The Pool's investment guidelines effective July 1, 2006, to October 31, 2007, permitted the purchase of first-tier securities, which are, as defined by SEC Rule 2a-7, those receiving the highest short term rating for debt obligations from two of the nationally recognized statistical rating organizations. If only one service rated the security, only one was required. The first tier rating for the three major agencies are:

Standard and Poor's	A-1+ and A-1
Moody's	P-1
Fitch	F1+ and F1

KKR Pacific and KKR Atlantic, sponsored by KKR Financial Holdings, and Ottimo, sponsored by Aladdin Capital Management, three ABCP issues, extended their maturities and chose to negotiate with their investors to meet a mutually agreed-upon liquidation plan for the assets collateralizing the securities. Axon, a SIV sponsored by Axon Financial Funding, is also in restructuring. All of these Securities were first-tier rated.

The following table sets forth the history and status of the rating of these four Securities with their original par value totaling \$947.8 million.

Table 1
The Troublesome Securities

Securities	Par (\$MM)	Seller	Purchase Date	Rating at Purchase	Downgrade Date and Rating
Ottimo	52.8	Lehman	7/3/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
Ottimo	100	Lehman	7/9/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
KKR Pacific	125.1	Lehman	7/26/2007	A-1+/P-1/F1+	10/29/2007 Fitch B
KKR Pacific	200	Lehman	7/27/2007	A-1+/P-1/F1+	10/29/2007 NP (Moody)
Ottimo	30.7	JP Morgan	7/27/2007	A-1+/P-1	NA
Axon	175	JP Morgan	7/27/2007	A-1+/P-1/F1+	10/29/2007 F3 (Fitch)
KKR Pacific	64.3	Lehman	8/1/2007	A-1+/P-1/F1+	8/15/2007 B (Fitch)
KKR Atlantic	200	Lehman	8/1/2007	A-1+/P-1/F1+	10/24/2007 A-2 (S&P)

¹⁶ See *Observations on Risk Management Practices During the Recent Market Turbulence*, March 6, 2008 for definitions and discussions of collateralized debt obligations, structured investment vehicles and extendable asset-backed commercial paper <http://www.occ.treas.gov/ftp/release/2008-29a.pdf>.

Loss of Trust

As we stated at the beginning of this Review, we do not question the purchase of the Securities. We do not question the decision to continue to hold the downgraded Securities in light of the market, as long as the Participants in Fund B are able to wait to receive their monies. We do, however, question the lack of meaningful internal controls and the lack of timely disclosure to the Trustees and to the Participants of the events following the downgrades. We question the lack of communication of the almost certainty that proceeds from the Securities will not be available to Participants for the 2008 budget year. Participants' surprise, if not shock, may have turned to anger and led to demands upon the Florida Legislature to make good on the losses when the Participants learned that the Pool paid par to those Participants who withdrew their funds before the Pool was closed on November 29, 2007 thus leaving a potential loss embedded in Fund B and reduced liquidity in Fund A on the shoulders of those left in the Pool. It is unknown whether the SBA's delay for months in disclosing material adverse events and the timely installation of liquidity protections might have avoided a "run," the creation of Fund B and the decision to outsource the trading desk to Federated.

Several senior managers at the SBA suggested that disclosure was delayed through November 2007 because of the fear that such disclosure would cause a "run". Ironically, the decision to not communicate these events timely to the Participants may have undermined the Participants' trust in the Pool.

The 2007 material events not timely disclosed by the prior administration are as follows:

Table 2
2007 Material Events

July	Ottimo	Missed maturity payment (July); missed maturity and interest payments (August)
August	Ottimo	Missed maturity payment (July); missed maturity and interest payments (August)
August	Ottimo	Conference calls with senior note holder with goal to preserve collateral for liquidation – August 13, 2007. Downgraded August 30, 2007
	KKR Atlantic and Pacific	Conference calls with senior note holder with goal to preserve collateral for controlled liquidation – August 21, 2007
October	Axon	Downgraded October 24, 2007
	KKR Atlantic	Downgraded October 24, 2007
	KKR Pacific	Downgraded October 29, 2007

Meaningful disclosures of the above events and related Investment Oversight Committee¹⁷ workout activities began at the earliest on October 31, 2007, when the Pool mailed Participants a copy of the Pool's third quarter newsletter dated September 30, 2007. Disclosure, however, has been improved under the new administration through the

¹⁷ The Oversight Committee of the SBA was restructured in December 2007 and currently consists of the Deputy Executive Director, the Head of Fixed Income Trading and the Enterprise Risk Manager.

publication on February 6, 2008, of the “Significant Events Timeline” and recent postings to the SBA’s website.

According to the publication *S&P Rated Local Government Investment Pools Weathering Storm* published November 30, 2008, there were other state pools with exposure to the same types of investments:

“In the past four months, Standard and Poor's has taken just one rating action on a LGIP, on Oct. 22 when it placed the King County, Wash. Investment Pool's 'AAA' rating on CreditWatch with negative implications. We currently maintain public ratings on 75 LGIPs from 26 states. As of mid November, only 17 rated LGIPs held investments in asset backed commercial paper (ABCP), with an average exposure 13.5%. Only nine held investments in structured investment vehicles (SIVs), with the average exposure of approximately 3%. During the past few days, we have received numerous inquiries on recent events surrounding the Florida Local Government Investment Pool, operated by State Board of Administration of Florida. Standard and Poor's does not rate the Florida LGIP and therefore is not in a position to comment on the pool's investments.¹⁸”

¹⁸ Source: *S&P Rated Local Government Investment Pools Weathering Storm*, November 30, 2007.

The Value of Pools to Local Governments

Local government investment pools (“pools”) have existed for more than 100 years. Today, 45 of the fifty states have such pools and the funds run by these pools exceed \$200 billion.¹⁹ There are significant tangible and intangible public service benefits related to these pools.

Tangible benefits typically are lower fees, diversification and access to professional management. Table 3 sets forth the average historical fees paid by participants if funds are managed by a private sponsor rather than by a government-sponsored internal manager pool such as at the SBA (as much as 34.58 basis points). Fees paid by Participants to the Fund averaged a very, very favorable 1.5 basis points from the Pool’s inception in 1982 through June, 2007, a savings of over 73% relative to the average fees paid. Under the recent contract with Federated Investors that switches the management of the Pool to Federated, Participants lose the fee advantage and will pay two or three times as much.

Table 3
Average Total Effective Fees by Type of LGIP Sponsor (in basis points)²⁰

<u>Category</u>	<u>Private Sponsor</u>	<u>Government Sponsor</u>	
		<u>Internal Manager</u>	<u>External Manager</u>
Money Market Fund	34.58	5.62	12.12
Money Market Fund Plus	16.75	12.19	15.72
Ultrashort Bond Pools	22.67	8.92	18.60
Florida Pool		1.5²¹	4.2 or higher²²

Wilshire Associates provided an assessment on February 4, 2008 that commented on the SBA’s “proven successful track record for managing both longer term and short term portfolios”. It also provided a comparison of the historical gross absolute returns for the Pool versus the 2a-7 money market funds²³ of the three finalist firms in the SBA process that

¹⁹ Source: iMoneyNet, “Government Investment Pools: 2007 Update of Investment Strategies, Facts, Figures and Trends”.

²⁰ Source for non-Florida SBA LGIP information: GFOA Public Investor, Volume 24, Number 2, February 23, 2006. This table appears in the article “Government Investment Pool Report by Michael Krasner, Senior Editor, iMoneyNet. Florida information provided by SBA. Money market funds are defined as “stable net asset values and maximum weighted average maturities of 90 days.” Money Market Fund Plus are defined as “striving to maintain NAVs of \$1.00 with weighted average maturities generally extending from 90 days to one year.” Ultrashort bond pools are defined as “variable net asset value with investment horizons from one to three years”.

²¹ Average fees borne by Pool participants through June 30, 2007

²² Current planned fees total \$3.7 million and include charges passed on to Pool participants from the external manager Federated, the rating agency Standard and Poor’s, the new custodian Mellon, the new independent audit, Bank of America wire and banking services plus SBA charges. The range is driven by Participants’ assets in Fund A and the pro rata effective increase in fees as the size of Fund A decreases.

²³ As defined in Wikipedia, “Money market funds, also known as principal stability funds, seek to limit exposure to losses due to credit, market, and liquidity risks. Money market funds in the United States are regulated by the Securities and Exchange Commission’s (SEC) Investment Company Act of 1940. Rule 2a-7 of the act restricts investments in money market funds by quality, maturity and diversity. Under this act, a money fund mainly buys the highest rated debt which matures in under 13 months. The portfolio must maintain a Weighted Average Maturity (WAM) of 90 days or less and not invest more than 5% in any one issuer, except for government and repurchase agreement securities. Money market funds seek a stable \$1.00 Net Asset value

led to the selection of Federated Investors. This comparison is reproduced below as Table 4 and illustrates the historical competitive performance of the Pool:

Table 4
Cumulative Gross Returns (%)
Comparison for Periods Ending 9/30/2007

	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>
BlackRock - MMkt	4.12	5.55	4.40	3.15	N/A
Dreyfus- MMkt	4.11	5.54	4.38	3.14	4.08
Federated - MMkt	4.12	5.55	4.40	3.18	4.06
Florida Pool	4.26	5.71	4.53	3.37	4.23

Source: Wilshire Associates

The tangible benefits are real. Each extra 10 basis points earned by a local government investment pool – whether achieved through lower fees or higher returns – translates into \$1 million in savings for each \$1 billion managed. Using Table 4, over a 10-year period the Fund Achieved better gross performance of 17 basis points relative to the new manager Federated (4.23% compared to 4.06%) Combining this with Table 3, SBA achieved a 10-year net return benefit of 19.7 basis points (4.215% compared to 4.018%). The implied tangible benefit to Participants is about \$2 million per year for each \$1 billion under management. For a \$30 billion dollar pool over a 10-year period this translates into a total of about \$600 million in potential lost earnings for Participants.

Intangible benefits include the ability of a State’s Auditor General and other oversight and control functions to perform reviews of a single entity, the Pool, to enhance protection of Participants, rather than reviews of numerous entities.

(NAV). Since the 2a-7 rule was adopted only one fund "broke the buck" in 1994, paying investors \$0.96 per share. That fund was the Community Bankers US Government Fund and had invested a large percentage of its assets into adjustable rate securities. As interest rates increased, these floating rate securities lost value.”

Why a New Pool

We strongly feel the business, legal and accounting basis for splitting the Pool into Funds A and B, the two “reserve” transfers and the suspension of redemptions is very problematic and will hamper the ability to attract new funds to the Pool. We have referred these items to the SBA’s forensic accountants for further examination and to address their impact on the Pool’s June 30, 2008 independent audit.

Accordingly, we recommend that a new pool in the form of a new trust be created by the Legislature and the current Pool, both Funds A and B, be allowed to self-liquidate. This recommendation is explicitly conditioned upon the implementation of the risk and control safeguard we find missing in the Pool’s current operation.

Restoring confidence in the current Pool will be difficult because of past events, related adverse press, missing control and risk safeguards, the threat of management establishing additional “reserves” from earned interest to cover expected losses, and litigation risk, with its attendant cost and possible interference with the operation of the current Pool. The major business, litigation and accounting questions these issues will raise in the Pool’s year-end audit are:

1. The potential claims that may arise from the decision to allow Participants from July, 2007 through November 29, 2007 to redeem their investments at par -- not at a price based on marking the Securities to market.
2. The decision to transfer to Fund B the Pool’s entire \$22 million reserve.
3. The decision to transfer to Fund B an additional \$96 million representing the interest earned on Participants’ investments for November 2007. 100 percent of the November interest was transferred to Fund B even though Fund B accounted only for fourteen percent of the Pool’s assets at the time of the Pool’s division into Funds A and B. The SBA staff initially divided the November 2007 interest in accordance with the percentage of the Fund Assets placed in each Fund, i.e. Fund A - 86 percent, Fund B - 14 percent. One week later however, Senior Management of the SBA reversed the staff decision and ordered all \$96 million placed in Fund B to protect against “losses.” The transfer was made in the form of \$82 million in cash and \$14 million in securities. Our inquiry reveals that no opinions of counsel were obtained to support the transfer of the \$22 million and the \$96 million to Fund B and that the definition of “reserve” as set forth in Florida Statutes, relied upon by the SBA to create and to transfer these funds, permits the use of earned interest as a “reserve” to cover potential losses in Fund B. Furthermore, the Pool’s Senior Management believes it has the right to use Participants’ earnings to create reserves to cover Fund B losses. In light of the potential losses facing Fund B, this is not a meaningless threat. In theory, if 90% of the par value of the Securities are recovered, an excellent outcome in the eyes of many, Fund B will lose approximately \$85 million in principal alone. At February 29, 2008, Fund B had \$10 million in cash on hand. Will SBA Senior Management again use reserves in the form of interest earned to cover the balance? If not, why was the November 2007 interest used as a reserve? The point is, use of interest as a “reserve” is a dangerous precedent that might further invite litigation.

4. The fear that the 2% withdrawal fee can be increased.

If the recommended controls are adopted and a new Pool created, we further recommend that the new Fund be entirely managed by the SBA staff and not under a management agreement with an external manager (Federated Investors) as is currently the case. Interviews with SBA staff reveal that under the Federated agreement the SBA transfers the desk trading to Federated²⁴, but retains all the mid- and back-office functions and related cost of the operation of the Pool.

²⁴ Federated also will perform some non-administrative investor relations relating to the Pool.

Due Diligence For a New Investor in the Pool

Due diligence for a potential investor in a fund has both quantitative and qualitative elements and often begins with the question, “What is the track record of the manager?” With respect to the Pool, the answer is that the performance through the fiscal year ended June 30, 2007 was competitive based on a combination of good investment results and low fees. Subsequent performance requires careful evaluation:

- Why did the fund post performance of “0” in November?
- Why did the Pool’s fees change? Can they change again?
- Why did reserves and liquidity change? Can they change again?
- What performance is attributable to the SBA, to Blackrock and to Federated?
- What transparency exists in the Pool’s current performance?
- What fiduciary protections exist?

There is a serious disconnect between how the SBA publicly describes the Fund as compared to its rules. In addition, there are conflicts in terminology. For example, the mission statement says, “The Local Government Investment Pool (LGIP) was established to provide local governments a low cost, low risk, *fully transparent* investment options for their surplus funds” and the home page for the LGIP further states, “*Actual income is distributed* at month end based on the average daily balances of participating accounts” (emphasis added).²⁵ Discussions with SBA Management and a review of materials made available by the SBA including those on the website since July 2007²⁶ reveal a lack of transparency and that a Participant’s actual income is subject to:

- a) higher management fees because of to the introduction of Blackrock and Federated;
- b) the imposition of new redemption fees for withdrawals beyond certain amounts;
- c) potential charges because of legal or other costs related to the Fund B assets; and
- d) SBA Senior Management’s right to set a monthly pool rate of return that may not be linked and may be lower than actual income earned during the period.

The ability to set a rate divorced from actual income is demonstrated by the monthly pool rate of “0” posted for November 2007 for Fund A. When posed the question of whether SBA Management may divorce future pool rates from actual income distributed to pool participants, Senior Management answered, “Yes, we have that right”. The lack of transparency in how monthly pool rates may be set is of concern to investors from a due diligence perspective. These due diligence concerns would be reduced substantially by establishing total transparency of the calculation for Participants’ Pool rate of return and by forming a new legal vehicle that does not inherit the cost and return uncertainties of the current Pool.

Several activities of the Fund are not in accord with best market practice. In particular:

²⁵ <https://www.sbafla.com/pool/>

²⁶ A search on the website for “fees” produced 32 results, only four of which are dated prior to July 2007. The first mention of redemption fees, higher management fees, deductions for reserves and the ability of SBA Management to determine the rate of return for the Pool do not appear as part of this search.

- Instruments in the Pool should be valued independently and not determined or influenced by a trader or portfolio manager whose compensation is tied to the performance of those instruments.²⁷ In addition, appropriate safeguards should be in place to ensure that traders do not have access to any systems that would allow them to alter the prices of positions. In the fixed income area, traders are permitted to designate positions as “manual mark-to-market.” Within the SBA, this means that even if prices are available from an independent third party, the manual prices sourced by the trader may be used. These manual mark-to-market prices then provide the basis for the portfolio accounting system (EagleSTAR), the general ledger (PeopleSoft Financials) and may impact the performance data provided to the independent performance measurement provider (Mellon Analytical Solutions), which calculates metrics that relate to performance and incentive compensation.
- Checks and balances should be increased so that individuals or areas of the SBA do not check on themselves. There is a large onus on people to do the right thing, leading, at a minimum, to the possibility for unintended errors or lack of follow-up to close out pending items. Risk oversight practices should be conducted by individuals who do not report to the area that assume the risk. Examples are procedures for monitoring investment exposure versus guidelines and benchmarks, assuming new types of investment risk, dealer/counterparty credit evaluation, and benchmark selection.
- Standard risk controls should be fully implemented by the Pool. Examples are implementation of standard quantitative risk measures (risk budgeting, scenario analysis and stress testing) and documentation of the risk policy.
- Exception reporting and escalation procedures should be created. Senior Management, the Trustees and the Investment Advisory Council should receive ongoing reports regarding open items or reports that “all is well” and that all exceptions have been cleared in a timely fashion.
- Ensure an audit trail exists for critical portfolio activities and changes thereto. A special focus should be placed on manual activities at the SBA such as how decisions are made to accrue or not to accrue interest on troubled investments; the use of spreadsheets to track owed but unpaid interest and principal, and manual pricing records, among others.
- Ensure when higher performance is being reported that the attendant questions have been asked:
 - What risks are being taken to achieve the higher performance?
 - What can go wrong?
 - If something goes wrong, how much will Participants lose?

We conclude that these failures appear to be because of a failure of Senior Management to implement changes suggested by staff and to timely provide material information to the Trustees and Investment Advisory Council. In July 2005, after 6 months of research and due diligence to implement a comprehensive risk management program, the SBA established

²⁷ For a discussion of best market practices, see “*Valuation Concepts for Investment Companies and Financial Institutions and Their Stakeholders*” published by the International Association of Financial Engineers Investor Risk Committee, June 8, 2004: <http://iafe.org/upload/IAFEValuationConcepts0604.pdf>.

an enterprise-risk function. Strategic Objective 1.11 was created in November 2005: “Establish an Enterprise Risk Management function and consider various overall risk management frameworks for the SBA before making final recommendations to the Executive Director by December 2006.” As of February 2008, the Enterprise Risk Management function did not cover the Pool.

An internal audit of the Fixed Income Trading Activities (the area that invests on behalf of the Pool) was completed in March 2007 (Report 2005-02) and provided to Senior Management of SBA (Coleman Stipanovich, then Executive Director of SBA, and Kevin SigRist, Deputy Executive Director of SBA). This internal audit report highlights the failure of SBA senior management to implement many standard components of enterprise-risk management as “high priority audit findings.” The internal audit report number 2008-01, “Operational Audit of the Market Valuation of Securities and Other Financial Instruments Held in Internally-Managed Portfolios” highlights failures in segregation of duties surrounding market valuation among other “high priority audit findings.”

Our due diligence concurred with many of the criticisms in the audit findings, which revealed unacceptable or weak practices relative to common market practice. We encourage the SBA to improve the independence of all oversight risk functions and to complete on schedule all of the items cited in the internal audit. We passed four items to the SBA’s new independent auditors for their review: (i) the quality of the mark-to-market values in the Pool; (ii) whether the rate at which Participants placed or withdrew monies from the Pool should be restated for the period July 1, 2007 to date; (iii) whether intra-Participant²⁸ transfers occurred between accounts and if they occurred, did the transfer favor the liquidity of certain Participant accounts; and (iv) whether the transfers of assets at the time Fund A and Fund B were formed should have been recorded at then current mark-to-market values.

²⁸ Participants may have up to ten separate accounts at the Pool. Transfers between these are “intra-Participant” transfers.

Communication Breakdowns

Improved communication within the SBA and with Participants is critical to reestablishing confidence in the Pool.

Within the SBA

Communication failed at times within the organization, leading to missed opportunities to quickly identify and deal with problems. Unfortunately, no formal mechanism existed within the SBA to escalate the critical problems with the Securities when they first appeared in July in the form of a missed payment to the Pool. While the missed payment represented uncollected amounts, July Participants received payment for these uncollected amounts. Only after additional missed payments in August were the July and August missed payments (defaults on Pool investments) escalated within the SBA. Early escalation of these failed cash flows in combination with escalation of any concerns raised by the SBA senior investment group provided a missed opportunity to take action before the pool Run.

On August 23, 2007, the SBA senior investment group met with consultants from Ennis, Knupp + Associates and Wilshire Associates “to discuss (i) the impact of recent market volatility on asset class performance and portfolio management; (ii) material sectors/instruments that are receiving particular focus from the asset class and/or portfolio managers due to perceptions of heightened risk; and (iii) tactics being used to manage, mitigate, avoid, or exploit the recent market volatility and changes in relative valuations.” Anecdotally, several SBA senior managers noted that rumors of pending, substantial pool withdrawals occurred prior to the Run.

With Participants

There were numerous poor communications with Participants that have led to misunderstandings and created distrust of the SBA.

Example: Subscription documents for new Participants consist of a cover letter, a page to record banking information and a form of resolution authorizing the investment in the Pool. Contrast these three pages with normal disclosures in a mutual fund subscription document where all cost and fees are set forth together with the investment objective, benchmark of the fund and other material disclosures.

Example: Many of the Pool’s documents use the term “maturity” without explaining that maturity does not equal payment. Currently the website reports that 53.9% of Pool A assets have a maturity beyond August 2008 and 53.2% of the Pool B assets have a maturity of “Under negotiation/Other” beyond June 2008.

Example: Late dissemination of adverse material information. For many months the SBA’s website did not provide a mark-to-market value for the downgraded securities.

With Trustees

The March 28, 2007 memo from Executive Director Coleman Stipanovich to the Trustees, copied to the Investment Advisory Committee members, identified quite early on the potential spillover of credit and liquidity issues into other markets and observed “concerns that sub-prime mortgage woes could mushroom gave equity markets pause in February.” In several of the monthly memos leading up to the Pool’s freeze, the monthly memorandum expressed further concerns. One Investment Advisory Committee member we interviewed recalled a summer presentation by the SBA’s economist which included observations that the SBA mandates were at little risk to the ongoing systemic leverage and macro issues; the discussion by the economist turned to how to the SBA mandates might take advantage of the opportunities created by these.

A review of daily trading activity for the Pool reveals that prior to the Run two substantial changes occurred. First, while normal trading activity had consisted largely of “buy” activity (the purchase of securities) this now included a substantial increase in “sell” activity (the sale of securities). Second, while numerous large withdrawals on a single day had been rare, this now was happening daily. The slow escalation of such events were missed opportunities to take action ahead of the Pool Run.

Communication across the SBA, from the SBA to Participants and from the SBA to the Trustees and Investment Advisory Committee all play critical roles in preventing crises from reoccurring in the future.

Conclusion

The goals of our recommendations are to promote best investment practice, to protect Participants and taxpayer dollars and to restore confidence in future operation of the Pool by the SBA.

Respectfully submitted,

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Appendix²⁹

Subprime Events Timeline: February 2007 – March 2008

2007

February 8: HSBC announces that it has set aside \$1.76 billion because of problems in its US-based subprime lending business.

March 20: The chairman of the Senate Banking Committee, Christopher Dodd (D-CT) writes to the Chairman of the Federal Reserve, Ben Bernanke, and other regulatory officials asking for information on what “steps these agencies took in the face of the growing crisis of subprime mortgage lending.”

April 2: New Century Financial, one of the US's biggest subprime mortgage lenders, files for Chapter 11 bankruptcy after it is forced to repurchase billions of dollars worth of bad loans.

May 17: In a speech, Ben S. Bernanke refers to "recent sharp increases in subprime mortgage loan delinquencies." But he says that "we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."

July 19: Ben Bernanke warns there will be “significant financial losses” from the crisis in the subprime mortgage market.

July 24: US mortgage lender Countrywide Financial reports a sharp fall in profits as increasing numbers of borrowers default on payments. CEO Angelo Mozilo comments: “We are experiencing home-price depreciation almost like never before, with the exception of the great depression.”

July 31: Bear Stearns files for bankruptcy on behalf of two hedge funds and halts clients from withdrawing funds from another. The US's 10th-largest mortgage lender American Home Mortgage Investment faces insolvency as it is unable to pay back its creditors.

August 9: France's largest bank, BNP Paribas, suspends three of its funds with heavy US debt exposure, blaming a drying up of credit. The European Central Bank (ECB) pumps emergency funds into credit markets for the first time since the 9/11 terrorist attacks to increase liquidity. It is followed by the US Federal Reserve and national banks in Japan, Canada, Australia and Hong Kong.

August 10: Central banks continue to inject funds over the next two days. Germany's IKB bank and Deutsche Postbank announce heavy losses from exposure to the subprime market.

²⁹ Source: Algo FIRST database of case studies. For additional information, refer to the following web site: <http://www.algorithmics.com/EN/solutions/casestudies/>

August 13: Goldman Sachs announces that together with CV Starr and Maurice Greenberg, it has injected \$3 billion in its Global Equity Opportunities Fund. Sentinel sends out a letter to clients announcing that it has frozen their accounts. Coventree Inc., a Canadian company specializing in structured finance, announces that it was unable to meet its obligations on maturing short-term debt as a result of market disruption.

August 15: The Dow Jones Industrial Average falls below the 13,000 level. The Federal Reserve adds more cash to the US banking system. Australian hedge fund Basis Capital issues a statement telling investors that losses to one of its funds “could exceed 80%.”

August 17: The Federal Reserve cuts its discount rate -- the rate for borrowing from the Fed, and provides temporary liquidity support to banks -- by 0.50 percent on Aug. 17 to 5.75%. Bernanke says upon cutting the discount rate that “downside risks to growth have increased appreciably.”

August 20: Countrywide Financial experiences a “run on the bank” when customers line up to inquire about the safety of their funds and/or to withdraw money from their accounts.

August 22: Bank of America announces that it has injected \$2 billion into Countrywide Financial. Bank of America, Citigroup, JPMorgan Chase, and Wachovia announce that they have each borrowed \$500 million from the US Federal Reserve in a symbolic move to reassure the markets that credit is available.

September 1: UK lender Northern Rock is relying solely on the overnight money markets to finance its commitments.

September 6: The Bank of England issues a statement stating that it has “heightened concerns about a variety of asset-backed securities” that have led to “disruption around the world.”

September 13: Northern Rock makes a formal request to the Bank of England for emergency funding. The Bank of England authorizes a lending facility to Northern Rock.

September 14: The legal documents authorizing the Bank of England’s rescue of Northern Rock are signed at 3am. Lines form in front of the bank’s branches in a “run on the bank.” The bank’s share price closes down 33% over the previous day. Due to an unusually high volume, the bank experiences intermittent outages on its web site.

September 18: The Fed lowers interest rates by half a point.

October 15: A consortium of U.S. banks, backed by the U.S. government, announce a "super fund" of \$100 billion to purchase distressed mortgage backed securities.

October 25: Merrill Lynch discloses an \$8.5 billion write-down.

October 26: Countrywide announces a \$1.2 billion loss for the third quarter of 2007. This is the lender’s first loss in 25 years.

October 31: Federal Reserve lowers the federal funds rate by 25 basis points to 4.5%.

November 1: Federal Reserve injects \$41B into the money supply for banks to borrow at a low rate.

November 4: Citigroup discloses that it will take a write-down of \$11 billion on losses in structured finance products held by seven proprietary special investment vehicles (SIVs), due to the crisis in the mortgage securities and credit markets.

November 7: Morgan Stanley announces it will take a write-down of \$3.7bn due to losses incurred in mortgage-related securities, including collateralized debt obligations.

November 29: Florida's State Board of Investments freezes outflows from a state money market fund after over \$16 billion is withdrawn by local schools and municipalities. A lawsuit is filed against Washington Mutual for alleged violations of the US Employee Retirement Income Security Act of 1974 (ERISA).

December 6: President Bush announces a plan to voluntarily and temporarily freeze the mortgages of a limited number of mortgage debtors holding adjustable rate mortgages (ARM).

December 10: UBS announces a write-down of around \$10 billion as a result of its subprime mortgage-related positions, on top of a \$3.4 billion third quarter write-down the bank had disclosed at the end of October.

December 11: The Federal Reserves announces that it has lowered its target for the federal funds rate 25 basis points to 4-1/4 percent.

December 12: Five Central Banks, including the US Federal Reserve and the European Central Bank, agree to inject capital into the global financial market

December 19: SandP places MBIA on negative ratings watch. After the market closes, MBIA posts information on its website which is consistent with the SandP report. It also discloses that \$8.1 billion of its multi-sector CDOs are exposed to RMBS risk.

December 21: MBIA announces that Fitch has informed the company that it will lose its AAA credit rating unless it raises \$1 billion in additional capital.

December 21: Fitch warns Ambac that it will lower its triple-A rating if it does not raise at least \$1 billion by end of January, 2008.

2008

January 11: Bank of America announces that it will purchase Countrywide in a \$4 billion stock transaction.

January 17: Moodys announces that it has put Ambac's AAA credit rating under negative review.

January 18: Ambac announces that it has reversed course and will scrap its \$1 billion capital raising plan. A class action lawsuit is filed on behalf of Ambac shareholders against the company. Fitch downgrades Ambac's credit rating from AAA to AA.

January 21: Societe Generale begins to unwind a \$7.2 billion rogue trade. Global markets are sharply down.

January 22: US Federal Reserve announces a sharp interest rate cut – the largest cut since the early 1980s. The US market opens sharply down, but recovers somewhat by the end of the day. Fitch downgrades 137,000 Ambac-insured municipal bonds.

February 29: Peloton Partners LLP, the stricken London-based hedge fund manager, whose flagship GBP 1 billion (USD \$2 billion) ABS Master Fund imploded at the end of February 2008, is forced to wind up its USD \$1.6 billion Multi-Strategy Fund, after six banks seized and sold some of its assets. Shares of American International Group fall after the insurer reports the biggest quarterly loss in its 89-year history.

March 3: New York State Attorney General Andrew Cuomo's Office and the Office of Federal Housing Enterprise Oversight (OFHEO) reach an agreement with Fannie Mae and Freddie Mac. New standards will prohibit lenders that sell mortgages to the two enterprises from using internal staff or staff from companies that they control for property valuations.

March 7: Trading of shares in Carlyle Capital Corp, a hedge fund based in the Netherlands, is suspended.

March 11: The Federal Reserve announces expansion of its securities lending program. Under this new Term Securities Lending Facility (TSLF), the Federal Reserve will lend up to \$200 billion of Treasury securities to primary dealers secured for a term of 28 days.

March 14: JP Morgan and the Federal Reserve provide emergency funding to Bear Stearns as a result of a "significantly deteriorated" liquidity position. The Federal Reserve announces that it is monitoring market developments closely and will continue to provide liquidity as necessary.