

**CITY OF COSTA MESA**  
**STATEMENT OF INVESTMENT POLICY**  
**2021-2022**

I. GENERAL INTRODUCTION

Under the laws of the State of California, it is the responsibility of the City Treasurer, at the direction of the City Council, to secure and protect the public funds of the City, and to establish proper safeguards, controls, and procedures to maintain these funds in a lawful, rational and auspicious manner. Said maintenance shall include the prudent and secure investment of idle funds, in a manner anticipated to provide additional benefit to the people of the City of Costa Mesa. The City's Finance Director serves as the City Treasurer.

On an annual basis, this Statement of Investment Policy will be reviewed by the Finance and Pension Advisory Committee and approved by the City Council in an open public meeting. It will be provided to securities dealers, banks, and brokers currently approved for conducting investment transactions with the City Treasurer's office in the ongoing effort to manage the investment portfolio; to other affected persons or entities; and to any members of the public wishing to review this document upon request. The Treasurer reserves the right to provide these documents on a cost basis.

II. SCOPE

This Statement of Investment Policy pertains to those idle funds under the control of the Treasurer, designated for the daily ongoing operations of the City; and concerns the deposit, maintenance, safekeeping, and preservation of all such funds, and the investments made with these funds. This Policy does not apply to pension trust funds, deferred compensation funds, and certain other trust or non-operating funds.

III. PURPOSE

The purpose of this Statement of Investment Policy is to provide the City Council, the Finance and Pension Advisory Committee, those involved in servicing the investment requirements of the City, and any other interested party, a clear understanding of the regulations and internal guidelines that will be observed in maintaining and investing City funds. This statement is intended to provide guidelines for the prudent investment of the City's temporary idle cash, and outline the procedures for maximizing the efficiency of the City's cash management system. The ultimate goal of the Investment Policy is to enhance the economic status of the City while safeguarding its assets.

IV. OBJECTIVE

The City's cash management system is designed to accurately monitor and forecast revenues and expenditures, thus enabling the City to invest funds to the fullest extent possible only after the criteria established for safety and liquidity have been met.

The basic premise underlying the City's investment philosophy is and continues to be, to insure that surplus funds are always safe and available when needed. The City strives to invest all idle funds as near 100 percent as possible, through daily and projected cash flow determinations. Idle cash management and investment transactions are the responsibility of the City Treasurer or his/her designee.

Criteria for selecting investments and the order of priority are:

1. Safety: The safety and risk associated with an investment refers to the potential loss of principal, interest, or a combination of these amounts. The City only operates in those investments that are considered prudent and allowable under current legislation of the State of California Government Code Section 53600 *et seq.* and the general laws of the City of Costa Mesa.
2. Liquidity: This refers to the ability to “cash in” at any moment in time with a minimal chance of losing some portion of principal or interest.
3. Yield: Yield is the potential dollar earnings an investment can provide, and sometimes is referred to as the rate of return.

#### V. DELEGATION OF INVESTMENT AUTHORITY

Authority to manage the City of Costa Mesa's investment program is derived from City of Costa Mesa Council Resolution No. 21-xx. Management responsibility for the investment program is hereby delegated for Fiscal Year 2021-2022 to the City Treasurer or his/her designee, who shall establish written procedures for the operation of the investment program consistent with this Investment Policy. Procedures should include references to: safekeeping, repurchase agreements, wire transfer agreements, banking service contracts, and collateral/ depository agreements. Such procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the City Treasurer or his/her designee. The City Treasurer or his/her designee shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials.

The City may engage the services of an external investment manager to assist in the management of the City's investment portfolio in a manner consistent with the City's objectives. Such an external manager may be granted discretion to purchase and sell investment securities in accordance with this Investment Policy. Such a manager must be registered under the Investment Advisers Act of 1940.

## VI. STANDARD OF PRUDENCE

The Treasurer shall perform the investment function in conjunction with the Prudent Investor Standard as set forth in the California Government Code Section 53600.3: "...all governing bodies of local agencies or persons authorized to make investment decisions on behalf of those local agencies investing public funds pursuant to this chapter are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the City, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the City. Within the limitations of this section and considering individual investments as part of an overall strategy, investments may be acquired as authorized by law."

## VII. AUTHORIZED AND SUITABLE INVESTMENTS

All investments will be made in accordance with Sections 53600 *et seq.* of the Government Code of California and as described within this Investment Policy. Permitted investments under this policy include:

1. **Municipal Securities.** These include obligations of the City, the State of California, any other states, and any local agency within the State of California, provided that:
  - a. Long-term obligations are rated "A" or higher, or the equivalent by at least one nationally recognized statistical rating organization (NRSRO);
  - b. The maximum maturity is five years; and
  - c. No more than 5 percent per issuer.
2. **U.S. Treasury** and other government obligations for which the full faith and credit of the United States are pledged for the payment of principal and interest. There are no limits on the dollar amount or percentage that the City may invest in U.S. Treasuries.
3. **Federal Agency** or United States government-sponsored enterprise obligations, participations, or other instruments, including those issued by or fully guaranteed as to principal and interest by federal agencies or United States government-sponsored enterprises. There are no limits on the dollar amount or percentage that the City may invest in government-sponsored enterprises. No more than 35 percent of the portfolio may be invested in any one issuer.
4. **Banker's acceptances** provided that:
  - a. They are issued by institutions with short term debt obligations rated "A-1" or higher, or the equivalent, by at least one NRSRO; and have long-term debt obligations which are rated "A" or higher, or the equivalent by at least one NRSRO;
  - b. The maturity does not exceed 180 days; and
  - c. No more than 40 percent of the total portfolio may be invested in banker's acceptances and no more than 5 percent per issuer.

5. **Federally insured time deposits** (Non-negotiable certificates of deposit) in state or federally chartered banks, savings and loans, or credit unions, provided that:
  - a. The amount per institution is limited to the maximum covered under FDIC; and,
  - b. The maturity of such deposits does not exceed five years.
  
6. **Time deposits (Non-negotiable certificates of deposit)** in state or federally chartered banks, savings and loans, or credit unions in excess of FDIC insured amounts which shall be fully secured in accordance with California Government Code Section 53652, provided that:
  - a. No more than 20 percent of the portfolio will be invested in a combination of federally insured and collateralized time deposits;
  - b. No more than 5 percent per issuer;
  - c. They are issued by institutions which have long-term debt obligations which are rated “A” or higher, or the equivalent by at least one NRSRO; and/or have short term obligations rated “A-1” or higher, or the equivalent, by at least one NRSRO; and
  - d. The maturity of such deposits does not exceed five years.
  
7. **Certificate of Deposit Placement Service (CDARS)**
  - a. No more than 30 percent of the total portfolio may be invested in a combination of certificates of deposit including CDARS; and
  - b. The maturity of CDARS deposits does not exceed five years.
  
8. **Negotiable certificates of deposit (NCDs)** provided that:
  - a. They are issued by institutions which have long-term obligations which are rated “A” or higher, or the equivalent by at least one NRSRO; and/or have short term debt obligations rated “A-1” or higher, or the equivalent, by at least one NRSRO;
  - b. The maturity does not exceed five years; and
  - c. No more than 30 percent of the total portfolio may be invested in NCDs and no more than 5 percent per issuer.
  
9. **Repurchase agreements** collateralized with securities authorized under the City’s Authorized and Suitable Investments (Section VII) of this policy maintained at a level of at least 102 percent of the market value of the repurchase agreements, provided that:
  - a. The maximum maturity of repurchase agreements will be one year;
  - b. No more than 30 percent of the total portfolio may be invested in repurchase agreements;
  - c. Securities used as collateral for repurchase agreements will be delivered to the City’s custodian bank (See Section X); and
  - d. The repurchase agreements are the subject of a master repurchase agreement between the City and the provider of the repurchase agreement. The master repurchase agreement will be substantially in the form developed by the Securities Industry and Financial Markets Association (SIFMA).

10. **Commercial paper** provided that:
  - a. The maturity does not exceed 270 days from the date of purchase;
  - b. The issuer is a corporation organized and operating in the United States with assets in excess of \$500 million;
  - c. They are issued by institutions whose short term obligations are rated “A-1” or higher, or the equivalent, by at least one NRSRO; and whose long-term obligations are rated “A” or higher, or the equivalent by at least one NRSRO; and
  - d. No more than 25 percent of the portfolio is invested in commercial paper and no more than 5 percent per issuer.
  
11. **State of California Local Agency Investment Fund (LAIF)**, provided that:
  - a. The City may invest up to the maximum permitted amount in LAIF; and,
  - b. LAIF’s investments in instruments prohibited by or not specified in the City’s policy do not exclude it from the City’s list of allowable investments, provided that the fund’s reports allow the Finance Director/Treasurer to adequately judge the risk inherent in LAIF’s portfolio.
  
12. **Orange County Treasurer’s Pool** is a special fund in the County Treasury which local agencies may use to deposit funds for investment. The City may not invest more than 35 percent of its surplus money with the Orange County Treasurer’s Pool. The County Treasurer charges investment administration fee to all pool participants. Investment earnings are distributed to the pool participants on a monthly basis, net of the administration fee. The earnings are credited to the participant’s accounts on either the last day of the month or the first day of the subsequent month.
  
13. **Corporate medium term notes (MTNs)**, provided that:
  - a. Such notes have a maximum maturity of five years;
  - b. Are issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States;
  - c. Are rated “A” category or better, or the equivalent by at least one NRSRO; and
  - d. Holdings of medium-term notes may not exceed 30 percent of the portfolio and no more than 5 percent per issuer.
  
14. **Mortgage pass-through securities, collateralized mortgage obligations, and asset-backed securities**, provided that such securities:
  - a. Have a maximum stated final maturity of five years;
  - b. Be issued by an issuer having an “A” or higher rating, or the equivalent for the issuer’s debt as provided by an NRSRO;
  - c. Be rated in a rating category of “AA” or better, or its equivalent by an NRSRO; and
  - d. Purchase of securities authorized by this subdivision may not exceed 20% of the portfolio and no more than 5 percent per issuer.

15. **Money market mutual funds** that are registered with the Securities and Exchange Commission under the Investment Company Act of 1940:
  - a. Provided that such funds meet either of the following criteria:
    1. Attained the highest ranking or the highest letter and numerical rating provided by not less than two NRSRO; or
    2. Have retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience investing in the securities and obligations authorized by California Government Code Section 53601 (a through j) and with assets under management in excess of \$500 million.
  - b. Purchase of securities authorized by this subdivision may not exceed 20 percent of the portfolio.
  
16. **Supranational securities** of United States dollar denominated senior unsecured unsubordinated obligations issued or unconditionally guaranteed by the International Bank for Reconstruction and Development, International Finance Corporation, or Inter-American Development Bank, with remaining maturity up to five years, and eligible for purchase and sale within the United States. Investment under this section shall be rated "AA" or higher, or the equivalent by an NRSRO and shall not exceed 15 percent of the portfolio. No more than 5 percent of the portfolio shall be invested in one issuer.

#### VIII. INVESTMENT OF BOND PROCEEDS

When investing proceeds from the issuance of bonds, the City of Costa Mesa will follow this Investment Policy when determining allowable investments. Should the trust agreement of a particular bond issue be more restrictive than the City's policy on permitted investments, then the trust agreement will take precedence.

#### IX. CITY CONSTRAINTS

The City Treasurer or his/her designee will evaluate local banks and savings institutions and may invest idle cash funds with such institutions when the criteria for prudent investment previously stated are met. The City operates its investment pool according to State and self-imposed constraints. Any investment extending beyond a five-year period requires prior City Council approval. Additionally, a minimum of 20 percent of the outstanding investments must mature within a one-year time period.

#### X. SAFEKEEPING AND COLLATERALIZATION

All security transactions, including collateral for repurchase agreements, entered into by the City shall be conducted on a delivery-versus-payment (DVP) basis. Securities purchased shall be held in third party safekeeping in the Trust Department of a financial institution, in the City's name and control. The account established shall be protected from seizure by creditors should the financial institution holding the City's securities file for bankruptcy protection.

Collateralization will be required on two types of investments: certificates of deposit and repurchase agreements. In order to anticipate market changes and provide a level of security for all funds, a minimum collateralization level is required.

Surplus funds must be deposited in State or national banks, State or Federal savings and loan associations, or State or Federal credit unions within the State of California. The deposits cannot exceed the amount of the bank's or savings and loan's paid-up capital and surplus.

The bank or savings and loan must secure public funds deposits with eligible securities having a market value of 110 percent of the total amount of the deposits. State law also allows as an eligible security, first trust deeds having a value of 150 percent of the total amount of the deposits. A third class of collateral is 105 percent in the form of a letter of credit drawn on the Federal Home Loan Bank.

The City Treasurer or his/her designee may waive security for that portion of a deposit, which is insured pursuant to Federal law. Currently, the first \$250,000 of a deposit is federally insured and deposits in excess of \$250,000 are collateralized as previously indicated.

## XI. PORTFOLIO RISK MANAGEMENT

### A. Prohibited investment vehicles and practices

1. State law notwithstanding, any investments not specifically described herein are prohibited, including, but not limited to futures and options, or stocks.
2. In accordance with Government Code Section 53601.6, investment in inverse floaters, range notes, or mortgage derived interest-only strips is prohibited.
3. Investment in any security that could result in a zero interest accrual if held to maturity is prohibited.
4. Trading securities for the sole purpose of speculating on the future direction of interest rates is prohibited.
5. Purchasing or selling securities on margin is prohibited.
6. The use of reverse repurchase agreements, securities lending or any other form of borrowing or leverage is prohibited.
7. The purchase of foreign currency denominated securities is prohibited.

### B. Mitigating credit risk in the portfolio

Credit risk is the risk that a security or a portfolio will lose some or all of its value due to a real or perceived change in the ability of the issuer to repay its debt. The City will mitigate credit risk by adopting the following strategies:

1. The diversification requirements included in Section VII are designed to mitigate credit risk in the portfolio;
2. No more than 5 percent of the total portfolio may be invested in securities of any single issuer, other than the U.S. Government, its agencies and enterprises;
3. The City may elect to sell a security prior to its maturity and record a capital gain or loss in order to improve the quality, liquidity or yield of the portfolio in response to market conditions or City's risk preferences; and

4. If securities owned by the City are downgraded by an NRSRO to a level below the quality required by this Investment Policy, it will be the City's policy to review the credit situation and make a determination as to whether to sell or retain such securities in the portfolio.
  - a. If a security is downgraded, the Finance Director/Treasurer will use discretion in determining whether to sell or hold the security based on its current maturity, the economic outlook for the issuer, and other relevant factors.
  - b. If a decision is made to retain a downgraded security in the portfolio, its presence in the portfolio will be monitored and reported monthly to the City Council.

C. Mitigating market risk in the portfolio

Market risk is the risk that the portfolio value will fluctuate due to changes in the general level of interest rates. The City recognizes that, over time, longer-term portfolios have the potential to achieve higher returns. On the other hand, longer-term portfolios have higher volatility of return. The City will mitigate market risk by providing adequate liquidity for short-term cash needs, and by making longer-term investments only with funds that are not needed for current cashflow purposes. The City further recognizes that certain types of securities, including variable rate securities, securities with principal paydowns prior to maturity, and securities with embedded options, will affect the market risk profile of the portfolio differently in different interest rate environments. The City, therefore, adopts the following strategies to control and mitigate its exposure to market risk:

1. The City will maintain a minimum of three months of budgeted operating expenditures in short term investments to provide sufficient liquidity for expected disbursements;
2. The maximum percent of callable securities (does not include "make whole call" securities as defined in the Glossary) in the portfolio will be 20 percent;
3. The maximum stated final maturity of individual securities in the portfolio will be five years, except as otherwise stated in this policy; and
4. The duration of the portfolio will at all times be approximately equal to the duration (typically plus or minus 20 percent) of a Market Benchmark Index selected by the City based on the City's investment objectives, constraints and risk tolerances. The City's current Benchmark will be documented in the investment guidelines.

## XII. POLICY COMPLIANCE REGULATIONS

Should the portfolio, for any reason, fall out of compliance with this Investment Policy, immediate liquidation of securities in order to bring the portfolio back into compliance is not required. However, the Treasurer must take action to bring the portfolio into compliance within 12 months from the date the portfolio was determined to be in non-compliance with the provisions of this Investment Policy so long as the action is deemed to be prudent under then current market conditions. Additionally, adequate disclosure as to all instances of noncompliance, and the efforts undertaken to bring the portfolio into compliance, must be made on the monthly Treasurer's Report.



### XIII. REPORTING

Under provisions of Section 53646 of the California Government Code, the Treasurer or his/her designee shall render a quarterly investment report to the City Council, the City Manager, and the City Attorney within 30 days following the end of the quarter covered by the report. However, as a matter of practice, a monthly report shall be submitted listing the type of investments, institution, date of maturity, par value, amount of deposit, rate of interest, current market value for all securities, and such other data as may be required by the City Council on a monthly basis. Furthermore, a Finance and Pension Advisory Committee comprised of the following individuals will meet quarterly to review the City's portfolio and investment strategy.

- Mayor, or his/her designee
- City Treasurer
- Assistant Finance Director
- Revenue Supervisor
- Eleven Committee Members appointed by City Council who are either residents or conduct business within the City and have experience in banking, securities trading, or financial planning.

#### Monthly reports

Monthly investment reports will be submitted by the City Treasurer or his/her designee to the City Council members, the City Manager and the Finance and Pension Advisory Committee. These reports will disclose, at a minimum, the following information about the risk characteristics of the City's portfolio:

1. An asset listing showing par value, cost and accurate and complete market value of each security, type of investment, issuer, and interest rate;
2. Monthly transactions for the period;
3. A one-page summary report that shows:
  - a. Average maturity of the portfolio and modified duration of the portfolio;
  - b. Maturity distribution of the portfolio;
  - c. Average portfolio credit quality; and,
  - d. Time-weighted total rate of return for the portfolio for the prior one month, three months, twelve months, year to date, and since inception compared to the Benchmark Index returns for the same periods;
4. A statement of compliance with investment policy, including a schedule of any transactions or holdings which do not comply with this policy or with the California Government Code Section 53600 *et seq.*, including a justification for their presence in the portfolio and a timetable for resolution; and,
5. A statement that the City has adequate funds to meet its cash flow requirements for the next six months.

#### XIV. AUTHORIZED FINANCIAL INSTITUTIONS, DEPOSITORIES, AND BROKER/DEALERS

A list will be maintained of financial institutions and depositories authorized to provide investment services. In addition, a list will be maintained of approved security broker/dealers selected by conducting a process of due diligence described in the investment procedures manual. These may include “primary” dealers or regional dealers that qualify under Securities and Exchange Commission (SEC) Rule 15C3-1 (uniform net capital rule).

- A. The City Finance Director/Treasurer will determine which financial institutions are authorized to provide investment services to the City. Institutions eligible to transact investment business with the City include:
  - 1. Primary government dealers as designated by the Federal Reserve Bank and non-primary government dealers;
  - 2. Nationally or state-chartered banks;
  - 3. The Federal Reserve Bank; and,
  - 4. Direct issuers of securities eligible for purchase.
- B. Selection of financial institutions and broker/dealers authorized to engage in transactions with the City will be at the sole discretion of the City.
- C. All financial institutions which desire to become qualified bidders for investment transactions (and which are not dealing only with the investment adviser) must supply the Finance Director/Treasurer with a statement certifying that the institution has reviewed the California Government Code Section 53600 *et seq.* and the City’s Investment Policy.
- D. Selection of broker/dealers used by an external investment adviser retained by the City will be at the sole discretion of the investment adviser.
- E. Public deposits will be made only in qualified public depositories as established by State law. Deposits will be insured by the Federal Deposit Insurance Corporation, or, to the extent the amount exceeds the insured maximum, will be collateralized in accordance with State law.

#### XV. POLICY REVIEW

This Statement of Investment Policy shall be reviewed at least annually to ensure its consistency with the overall objectives of preservation of principal, liquidity and return, and its relevance to current law, financial and economic trends.

Should conditions change or legislation become effective that behooves subsequent changes or a liberalization of terms within the policy during the next fiscal year, the revised policy will be submitted to both the Finance and Pension Advisory Committee and Council for adoption of the recommended action.

## XVI. INVESTMENT OBJECTIVES (PERFORMANCE STANDARDS AND EVALUATION)

- A. **Overall objective:** The investment portfolio will be designed with the overall objective of obtaining a total rate of return throughout economic cycles, commensurate with investment risk constraints and cash flow needs.
  
- B. **Specific objective:** The investment performance objective for the portfolio will be to earn a total rate of return over a market cycle which is approximately equal to the return on the Market Benchmark Index as described in the City's investment guidelines.

**CITY OF COSTA MESA**

**INVESTMENT GUIDELINES AND STRATEGY**

I. GUIDELINES - Guidelines are established to direct and control activities in such a manner that previously established goals are achieved.

1. Investment Transactions. Investment transactions will be periodically reviewed by the Treasurer or his/her designee.
2. Pooled Cash. Whenever practical, City cash is consolidated into one bank account and invested on a pooled concept basis. Interest earnings are allocated monthly according to month-end cash and investment balances for each fund.
3. Competitive Bids. Purchase and sales of securities are made on the basis of competitive offers and bids when practical.
4. Cash Forecast. The cash flow for the City is analyzed with the receipt of revenues and maturity of investments scheduled so that adequate cash will be available to meet disbursement requirements.
5. Investment Limitations. Security purchases and holdings are maintained within statutory limits imposed by the California Government Code. Current limits are:

Bankers' Acceptances	40% Section 53601(g)
Commercial Paper	25% Section 53601(h)
Negotiable Certificates of Deposit	30% Section 53601(i)
Medium Term Notes	30% Section 53601(k)
Money Market Mutual Funds	20% Section 53601(l)
Asset-Backed/Mortgage-Backed Securities	20% Section 53601(o)
Federal Agency restriction	35% per Agency Section VII of Policy
Local Agency Investment Fund	<u>Maximum permitted amount \$65,000,000</u>
<del>maximum allowed per Section</del>	<del>VII of Policy</del>
Orange County Treasurer's Pool	35% per Section VII of Policy
Supranational Securities	15% per Section VII of Policy
Portfolio Maturing within one year	20% per Section IX of Policy

6. Liquidity. The marketability of a security is considered at the time of purchase, as the security may have to be sold at a later date to meet unanticipated cash demands.
7. Diversification. The portfolio should consist of a mix of various types of securities, issuers, and maturities.

## CITY OF COSTA MESA

### INVESTMENT GUIDELINES AND STRATEGY

(Continued)

8. Evaluate Certificates of Deposit
  - (a) Certificates of Deposit shall be evaluated in terms of FDIC coverage. For deposits in excess of the FDIC insured maximum, approved collateral at full market value shall be required. (California Government Code Section 53652)
  - (b) Negotiable Certificates of Deposit shall be evaluated in terms of the credit worthiness of the issuer, as these deposits are uninsured and uncollateralized promissory notes.
9. Benchmark Index. The portfolio has a performance index of ICE BofAML 1-5 Year US Treasury & Agency Index. This index includes all securities with a remaining term to final maturity less than five years.

#### II. STRATEGY - Strategy refers to the ability to manage financial resources in the most advantageous manner.

1. Economic Forecasts. Economic Forecasts are obtained periodically from economists and financial experts through bankers and brokers to assist the Treasurer or his/her designee with the formulation of an investment strategy for the local agency.
2. Implementing Investment Strategy. Investment transactions are executed which conform with anticipated interest rate trends and the current investment strategy plan.
3. Rapport. A close working relationship is maintained with large vendors of the City. The objective is to pinpoint when large disbursements will clear the City's bank account. It is essential for good cash control that such large expenditures be anticipated, estimated as to dollar amount, and communicated to the Treasurer or his/her designee for liquidity planning purposes.
4. Preserve Portfolio Value. Field standards are developed in order to maintain earnings near the market and to preserve the value of the portfolio.

**CITY OF COSTA MESA**  
**INVESTMENT PROCEDURES**  
**INTERNAL CONTROL - GUIDELINES**

OBJECTIVES OF INTERNAL CONTROL

Internal control is the plan of organization and all the related systems established by the management's objective of ensuring, as far as practicable:

- The orderly and efficient conduct of its business, including adherence to management policies.
- The safeguarding of assets.
- The prevention or detection of errors and fraud.
- The accuracy and completeness of the accounting records.
- The timely preparation of reliable financial information.

LIMITATIONS OF INTERNAL CONTROL

No internal control system, however elaborate, can by itself guarantee the achievement of management's objectives. Internal control can provide only reasonable assurance that the objectives are met, because of its inherent limitations, including:

- Management's usual requirement that a control be cost-effective.
- The direction of most controls at recurring, rather than unusual, types of transactions.
- Human error due to misunderstanding, carelessness, fatigue, or distraction.
- Potential for collusion that circumvents controls dependent on the segregation of functions.
- Potential for a person responsible for exercising control abusing that responsibility; a responsible staff member could be in a position to override controls which management has set up.

**CITY OF COSTA MESA**  
**INVESTMENT PROCEDURES**  
**INTERNAL CONTROL - GUIDELINES**  
**(Continued)**

ELEMENTS OF INTERNAL CONTROL

Elements of a system of internal control are the means by which an organization can satisfy the objectives of internal control. These elements are:

1. ORGANIZATION  
Specific responsibility for the performance of duties should be assigned and lines of authority and reporting clearly identified and understood.
2. PERSONNEL  
Personnel should have capabilities commensurate with their responsibilities. Personnel selection and training policies together with the quality and quantity of supervision are thus important.
3. SEGREGATION OF FUNCTIONS  
Segregation of incompatible functions reduces the risk that a person is in a position both to perpetrate and conceal errors or fraud in the normal course of duty. If two parts of a transaction are handled by different people, collusion is necessary to conceal errors or fraud. In particular, the functions that should be considered when evaluating segregation of functions are authorization, execution, recording, custody of assets, and performing reconciliations.
4. AUTHORIZATION  
All transactions should be authorized by an appropriate responsible individual. The responsibilities and limits of authorization should be clearly delineated. The individual or group authorizing a specific transaction or granting general authority for transactions should be in a position commensurate with the nature and significance of the transactions. Delegation of authority to authorize transactions should be handled very carefully.
5. CONTROLS OVER AN ACCOUNTING SYSTEM  
Controls over an accounting system include the procedures, both manual and computerized, carried out independently to ascertain that transactions are complete, valid, authorized, and properly recorded.

## CITY OF COSTA MESA

### CASH CONTROLS

#### PROCEDURES PERFORMED BY EXTERNAL AUDITORS WITH RESPECT TO CASH RECEIPTS

- A. City procedures and controls are reviewed. Some of the system strengths are:
1. Receipts are controlled upon receipt by proper registration devices.
  2. Receipts are reconciled on a daily basis.
  3. Amounts are deposited intact.
  4. All bank accounts are authorized by City Manager.
  5. Cash counts are done by two or more individuals.
  6. Bank reconciliations are reviewed.
  7. Prompt posting of cash receipt entries in books.
  8. Receipt forms are prenumbered, accounted for, and physically secured.
  9. Proper approval required for write-off's of customer accounts.
  10. Checks are restrictively endorsed upon receipt or when run through cash register.
  11. Adequate physical security over cash.
  12. Individuals that handle cash do not post to customer account records or process billing statements.
  13. Adequate supervision of Finance Department operations.
- B. Significant revenues are confirmed directly with payor and compared with City books to make sure amounts are recorded properly.
- C. Cash balances are substantiated by confirming all account balances recorded in books. Bank reconciliations are reviewed for propriety and recalculated by the auditor. All significant reconciling items on bank reconciliations are verified as valid reconciling items by proving to subsequent bank statements.



**CITY OF COSTA MESA**

**SEGREGATION OF RESPONSIBILITIES OF  
THE TREASURY FUNCTIONS**

<u><b>Function</b></u>	<u><b>Responsibility</b></u>
1. Authorization of investment transactions:  Formal investment policy should be:  * Prepared by:  * Submitted to:  Investment transactions should be approved by	City Treasurer  City Council  City Treasurer and/or External Investment Manager
2. Execution of investment transactions	Assistant Finance Director and/or Revenue Supervisor and/or External Investment Manager
3. Investment transactions approved for compliance with investment policy and/or State law	Assistant Finance Director and/or External Investment Manager
4. Timely recording of investment transactions:  Recording of investment transactions in the Treasurer's records  Recording of investment transactions in the accounting records	Revenue Supervisor  Accounting Supervisor and/or Accountant
5. Verification of investment, i.e., match broker confirmation to Treasurer's records	Assistant Finance Director and/or Revenue Supervisor and/or External Investment Manager
6. Safeguarding of assets and records:  Reconciliation of Treasurer's records to the accounting records  Reconciliation of Treasurer's records to bank statements and safekeeping records	Revenue Supervisor  Accounting Supervisor and/or Accountant

**CITY OF COSTA MESA**

**SEGREGATION OF RESPONSIBILITIES OF  
THE TREASURY FUNCTIONS  
(Continued)**

<u><b>Function</b></u>	<u><b>Responsibility</b></u>
6. Safeguarding of Assets and Records (continued):  Annual review of (a) financial institution's financial condition, (b) safety, liquidity, and potential yields of investment instruments.	Assistant Finance Director with Treasurer's approval
7. No less than an annual review of investment portfolio as prepared by Treasurer including: <ul style="list-style-type: none"><li>• Investment types</li><li>• Purchase Price</li><li>• Par values</li><li>• Market values</li><li>• Maturity dates</li><li>• Investment yields</li><li>• Conformance to stated investment policy</li><li>• Safekeeping reports</li></ul>	External Independent Auditors
8. Periodic review of investment portfolio and strategies.	Finance and Pension Advisory Committee

## Glossary of Investment Terms

**AGENCIES.** Shorthand market terminology for any obligation issued by a *government-sponsored entity (GSE)*, or a *federally related institution*. Most obligations of GSEs are not guaranteed by the full faith and credit of the US government. Examples are:

**FFCB.** The Federal Farm Credit Bank System provides credit and liquidity in the agricultural industry. FFCB issues discount notes and bonds.

**FHLB.** The Federal Home Loan Bank provides credit and liquidity in the housing market. FHLB issues discount notes and bonds.

**FHLMC.** Like FHLB, the Federal Home Loan Mortgage Corporation provides credit and liquidity in the housing market. FHLMC, also called “FreddieMac” issues discount notes, bonds and mortgage pass-through securities.

**FNMA.** Like FHLB and FreddieMac, the Federal National Mortgage Association was established to provide credit and liquidity in the housing market. FNMA, also known as “FannieMae,” issues discount notes, bonds and mortgage pass-through securities.

**GNMA.** The Government National Mortgage Association, known as “GinnieMae,” issues mortgage pass-through securities, which are guaranteed by the full faith and credit of the US Government.

**PEFCO.** The Private Export Funding Corporation assists exporters. Obligations of PEFCO are not guaranteed by the full faith and credit of the US government.

**TVA.** The Tennessee Valley Authority provides flood control and power and promotes development in portions of the Tennessee, Ohio, and Mississippi River valleys. TVA currently issues discount notes and bonds.

**ASKED.** The price at which a seller offers to sell a security.

**ASSET BACKED SECURITIES.** Securities supported by pools of installment loans or leases or by pools of revolving lines of credit.

**AVERAGE LIFE.** In mortgage-related investments, including CMOs, the average time to expected receipt of principal payments, weighted by the amount of principal expected.

**BANKER’S ACCEPTANCE.** A money market instrument created to facilitate international trade transactions. It is highly liquid and safe because the risk of the trade transaction is transferred to the bank which “accepts” the obligation to pay the investor.

**BENCHMARK.** A comparison security or portfolio. A performance benchmark is a partial market index, which reflects the mix of securities allowed under a specific investment policy.

**BID.** The price at which a buyer offers to buy a security.

**BROKER.** A broker brings buyers and sellers together for a transaction for which the broker receives a commission. A broker does not sell securities from his own position.

**CALLABLE.** A callable security gives the issuer the option to call it from the investor prior to its maturity. The main cause of a call is a decline in interest rates. If interest rates decline since an issuer issues securities, it will likely call its current securities and reissue them at a lower rate of interest. Callable securities have reinvestment risk as the investor may receive its principal back when interest rates are lower than when the investment was initially made.

**CERTIFICATE OF DEPOSIT (CD).** A time deposit with a specific maturity evidenced by a certificate. Large denomination CDs may be marketable.

**CERTIFICATE OF DEPOSIT ACCOUNT REGISTRY SYSTEM (CDARS).** A private placement service that allows local agencies to purchase more than \$250,000 in CDs from a single financial institution (must be a participating institution of CDARS) while still maintaining FDIC insurance coverage. CDARS is currently the only entity providing this service. CDARS facilitates the trading of deposits between the California institution and other participating institutions in amounts that are less than \$250,000 each, so that FDIC coverage is maintained.

**COLLATERAL.** Securities or cash pledged by a borrower to secure repayment of a loan or repurchase agreement. Also, securities pledged by a financial institution to secure deposits of public monies.

**COLLATERALIZED MORTGAGE OBLIGATIONS (CMO).** Classes of bonds that redistribute the cash flows of mortgage securities (and whole loans) to create securities that have different levels of prepayment risk, as compared to the underlying mortgage securities.

**COMMERCIAL PAPER.** The short-term unsecured debt of corporations.

**COST YIELD.** The annual income from an investment divided by the purchase cost. Because it does not give effect to premiums and discounts which may have been included in the purchase cost, it is an incomplete measure of return.

**COUPON.** The rate of return at which interest is paid on a bond.

**CREDIT RISK.** The risk that principal and/or interest on an investment will not be paid in a timely manner due to changes in the condition of the issuer.

**CURRENT YIELD.** The annual income from an investment divided by the current market value. Since the mathematical calculation relies on the current market value rather than the investor's cost, current yield is unrelated to the actual return the investor will earn if the security is held to maturity.

**DEALER.** A dealer acts as a principal in security transactions, selling securities from and buying securities for his own position.

**DEBENTURE.** A bond secured only by the general credit of the issuer.

**DELIVERY VS. PAYMENT (DVP).** A securities industry procedure whereby payment for a security must be made at the time the security is delivered to the purchaser's agent.

**DERIVATIVE.** Any security that has principal and/or interest payments which are subject to uncertainty (but not for reasons of default or credit risk) as to timing and/or amount, or any security which represents a component of another security which has been separated from other components ("Stripped" coupons and principal). A derivative is also defined as a financial instrument the value of which is totally or partially derived from the value of another instrument, interest rate, or index.

**DISCOUNT.** The difference between the par value of a bond and the cost of the bond, when the cost is below par. Some short-term securities, such as T-bills and banker's acceptances, are known as discount securities. They sell at a discount from par, and return the par value to the investor at maturity without additional interest. Other securities, which have fixed coupons, trade at a discount when the coupon rate is lower than the current market rate for securities of that maturity and/or quality.

**DIVERSIFICATION.** Dividing investment funds among a variety of investments to avoid excessive exposure to any one source of risk.

**DURATION.** The weighted average time to maturity of a bond where the weights are the present values of the future cash flows. Duration measures the price sensitivity of a bond to changes in interest rates. (See modified duration).

**FEDERAL FUNDS RATE.** The rate of interest charged by banks for short-term loans to other banks. The Federal Reserve Bank through open-market operations establishes it.

**FEDERAL OPEN MARKET COMMITTEE.** A committee of the Federal Reserve Board that establishes monetary policy and executes it through temporary and permanent changes to the supply of bank reserves.

**LEVERAGE.** Borrowing funds in order to invest in securities that have the potential to pay earnings at a rate higher than the cost of borrowing.

**LIQUIDITY.** The speed and ease with which an asset can be converted to cash.

**LOCAL AGENCY INVESTMENT FUND (LAIF).** A voluntary investment fund open to government entities and certain non-profit organizations in California that is managed by the State Treasurer's Office.

**LOCAL GOVERNMENT INVESTMENT POOL.** Investment pools that range from the State Treasurer's Office Local Agency Investment Fund (LAIF) to county pools, to Joint Powers Authorities (JPAs). These funds are not subject to the same SEC rules applicable to money market mutual funds.

**MAKE WHOLE CALL.** A type of call provision on a bond that allows the issuer to pay off the remaining debt early. Unlike a call option, with a make whole call provision, the issuer makes a lump sum

payment that equals the net present value (NPV) of future coupon payments that will not be paid because of the call. With this type of call, an investor is compensated, or "made whole."

**MARGIN.** The difference between the market value of a security and the loan a broker makes using that security as collateral.

**MARKET RISK.** The risk that the value of securities will fluctuate with changes in overall market conditions or interest rates.

**MARKET VALUE.** The price at which a security can be traded.

**MARKING TO MARKET.** The process of posting current market values for securities in a portfolio.

**MATURITY.** The final date upon which the principal of a security becomes due and payable.

**MEDIUM TERM NOTES.** Unsecured, investment-grade senior debt securities of major corporations which are sold in relatively small amounts on either a continuous or an intermittent basis. MTNs are highly flexible debt instruments that can be structured to respond to market opportunities or to investor preferences.

**MODIFIED DURATION.** The percent change in price for a 100 basis point change in yields. Modified duration is the best single measure of a portfolio's or security's exposure to market risk.

**MONEY MARKET.** The market in which short-term debt instruments (T-bills, discount notes, commercial paper, and banker's acceptances) are issued and traded.

**MORTGAGE PASS-THROUGH SECURITIES.** A securitized participation in the interest and principal cash flows from a specified pool of mortgages. Principal and interest payments made on the mortgages are passed through to the holder of the security.

**MUNICIPAL SECURITIES.** Securities issued by state and local agencies to finance capital and operating expenses.

**MUTUAL FUND.** An entity which pools the funds of investors and invests those funds in a set of securities which is specifically defined in the fund's prospectus. Mutual funds can be invested in various types of domestic and/or international stocks, bonds, and money market instruments, as set forth in the individual fund's prospectus. For most large, institutional investors, the costs associated with investing in mutual funds are higher than the investor can obtain through an individually managed portfolio.

**NATIONALLY RECOGNIZED STATISTICAL RATINGS ORGANIZATION (NRSRO).**

A credit rating agency that the Securities and Exchange Commission in the United States uses for regulatory purposes. Credit rating agencies provide assessments of an investment's risk. The issuers of investments, especially debt securities, pay credit rating agencies to provide them with ratings. The three most prominent NRSROs are Fitch, S&P, and Moody's.

**NEGOTIABLE CD.** A short-term debt instrument that pays interest and is issued by a bank, savings or federal association, state or federal credit union, or state-licensed branch of a foreign bank. Negotiable CDs are traded in a secondary market and are payable upon order to the bearer or initial depositor (investor).

**PREMIUM.** The difference between the par value of a bond and the cost of the bond, when the cost is above par.

**PREPAYMENT SPEED.** A measure of how quickly principal is repaid to investors in mortgage securities.

**PREPAYMENT WINDOW.** The time period over which principal repayments will be received on mortgage securities at a specified prepayment speed.

**PRIMARY DEALER.** A financial institution (1) that is a trading counterparty with the Federal Reserve in its execution of market operations to carry out U.S. monetary policy, and (2) that participates for statistical reporting purposes in compiling data on activity in the U.S. Government securities market.

**PRUDENT PERSON (PRUDENT INVESTOR) RULE.** A standard of responsibility which applies to fiduciaries. In California, the rule is stated as "Investments shall be managed with the care, skill, prudence and diligence, under the circumstances then prevailing, that a prudent person, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of like character and with like aims to accomplish similar purposes."

**REALIZED YIELD.** The change in value of the portfolio due to interest received and interest earned and realized gains and losses. It does not give effect to changes in market value on securities, which have not been sold from the portfolio.

**REGIONAL DEALER.** A financial intermediary that buys and sells securities for the benefit of its customers without maintaining substantial inventories of securities and that is not a primary dealer.

**REPURCHASE AGREEMENT.** Short-term purchases of securities with a simultaneous agreement to sell the securities back at a higher price. From the seller's point of view, the same transaction is a reverse repurchase agreement.

**SAFEKEEPING.** A service to bank customers whereby securities are held by the bank in the customer's name.

**STRUCTURED NOTE.** A complex, fixed income instrument, which pays interest, based on a formula tied to other interest rates, commodities or indices. Examples include inverse floating rate notes which have coupons that increase when other interest rates are falling, and which fall when other interest rates are rising, and "dual index floaters," which pay interest based on the relationship between two other interest rates - for example, the yield on the ten-year Treasury note minus the Libor rate. Issuers of such notes lock in a reduced cost of borrowing by purchasing interest rate swap agreements.

**SUPRANATIONAL.** A Supranational is a multi-national organization whereby member states transcend national boundaries or interests to share in the decision making to promote economic development in the member countries.

**TOTAL RATE OF RETURN.** A measure of a portfolio's performance over time. It is the internal rate of return, which equates the beginning value of the portfolio with the ending value; it includes interest earnings, realized and unrealized gains, and losses in the portfolio.

**U.S. TREASURY OBLIGATIONS.** Securities issued by the U.S. Treasury and backed by the full faith and credit of the United States. Treasuries are considered to have no credit risk, and are the benchmark for interest rates on all other securities in the US and overseas. The Treasury issues both discounted securities and fixed coupon notes and bonds.

**TREASURY BILLS.** All securities issued with initial maturities of one year or less are issued as discounted instruments, and are called Treasury bills. The Treasury currently issues three- and six-month T-bills at regular weekly auctions. It also issues "cash management" bills as needed to smooth out cash flows.

**TREASURY NOTES.** All securities issued with initial maturities of two to ten years are called Treasury notes, and pay interest semi-annually.

**TREASURY BONDS.** All securities issued with initial maturities greater than ten years are called Treasury bonds. Like Treasury notes, they pay interest semi-annually.

**VOLATILITY.** The rate at which security prices change with changes in general economic conditions or the general level of interest rates.

**YIELD TO MATURITY.** The annualized internal rate of return on an investment which equates the expected cash flows from the investment to its cost.