



**House
Legislative
Analysis
Section**

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LOCAL GOVERNMENT DISCLOSURE

**House Bill 5187 as passed by the House
Sponsor: Rep. Michael Hanley**

**House Bill 5188 as passed by the House
Sponsor: Rep. Greg Kaza**

**House Bill 5223 as passed by the House
Sponsor: Rep. Roland Jersevic**

**House Bill 5224 as passed by the House
Sponsor: Rep. William Bobier**

**House Bill 5256 as passed by the House
Sponsor: Rep. Liz Brater**

**House Bill 5611 (Substitute H-2)
Sponsor: Rep. Alvin Kukuk**

Committee: Urban Policy

Second Analysis (5-9-96)

THE APPARENT PROBLEM:

Most local governmental units have to make investment decisions regarding the money they receive or retain. When money is received through taxes or other forms of revenue, and particularly when money is held for pensions or retirement plans for governmental employees, it is expected that the governmental unit will invest the money in a manner that will, at the very least, retain the money's value against inflation and/or increase the value, if possible.

Unfortunately, investment practices and decisions can lead to significant losses where the money is unwisely invested in risky ventures. Independence Township in Michigan, Orange County in California, Escambia County in Florida, and the State of Wisconsin have all taken significant losses due to unwise investments in one of the more volatile forms of investment, that known as derivatives. Derivatives are broadly defined as any investment whose rate of return is based on the movement in value of an underlying asset; futures contracts and stock options are forms of derivatives. Investment in derivatives allows investors to speculate on the movement of a particular market. The value of a derivative investment is "derived" from the underlying assets, such as currencies, equities, or commodities; an

index, like the stock market; or an indicator, such as interest rates. If the investor predicts correctly which way the market will move, the value of the investment goes up. If the investor is wrong, the value of the investment decreases.

Given the significant losses taken by some governmental entities due to investments in derivatives, legislation has been introduced, in the interest of keeping the public fully informed, to require governmental units to report the amount and nature of their investments in derivatives.

THE CONTENT OF THE BILLS:

The package of bills would require reporting of information concerning the nature and amount of state and/or local governments' investments in derivative instruments or products. House Bills 5187 and 5256 contain identical definitions which would describe a derivative instrument or product as either: a) a contract or convertible security that changes value in concert with a related or underlying security, or obtains much of its value through price movements in a related or underlying security, or both; or b) a contract or security

House Bills 5187, 5188, 5223, 5224, 5256, and 5611 (5-9-96)

whose value is determined in whole or in part by the price of one or more underlying instruments or markets.

House Bills 5187 and 5223 would amend the Uniform Budgeting and Accounting Act (MCL 141.422b et al.), which establishes reporting requirements for local units of government. Among other provisions, the act requires local units of government to file annual financial reports with the state treasurer. House Bill 5187 would change the definition of local unit to include counties. (Currently, a local unit is a village, city, township or an authority or commission created by a county, village, city, or township ordinance or charter.) The bill would also require the fiscal officer of each local unit to make the annual financial report. The reports would still be required to be uniform for local units of the same class and the forms for the reports would still be prescribed by the state treasurer. In addition to the current requirement that the report contain a summary of all the unit's revenues, expenditures, indebtedness, fund balances, and any other information required by law, the bill would require that the reports include information on the cost and fiscal year end market value of derivative products in both the local unit's nonpension portfolio and the local unit's pension portfolio (with the exception of investments of defined contribution plans and deferred compensation plans that are chosen by employees). The information required would have to be reported on both an aggregate basis and itemized by issuer and type of derivative investment.

Upon receiving an annual financial report from a local unit, the state treasurer would be required to file the appropriate number of copies of the report with Library of Michigan so that one copy could be retained by the library and the others could be placed in each designated depository library under the Financial Investment Clearinghouse Act (which would be established by House Bill 5224). The Library of Michigan and the designated depository libraries would be required to make the annual financial reports available to the public as provided by the Financial Investment Clearinghouse Act. Further, local units of government would also be required to retain copies of the annual reports submitted under the act, and would be required to make the reports available for public inspection under the Freedom of Information Act. The bill would also specify that it did not provide any authority for any local unit to make any investments not otherwise allowed by law.

In addition, House Bill 5187 would repeal a section of the Executive Organization Act of 1965, which transferred the powers, duties, and functions of the elected auditor general relating to uniform system of

accounts for county offices to the Department of Treasury by way of a type II transfer.

House Bill 5187 is tie-barred to House Bill 5224, which would create the Financial Investment Clearinghouse Act.

House Bill 5223 would provide that if a local unit failed to report its investments in derivatives as required, the state treasurer would be allowed to make a determination that the local unit was unable to complete its report without assistance. The state treasurer could then submit a written statement of findings and recommendations to the local unit's legislative body. The local unit would then be required to retain a certified public accountant or the state treasurer to complete the report on its investments within 90 days of receipt of the state treasurer's statement. House Bill 5223 would require the local unit to notify the state treasurer, through resolution of its legislative body, of its action.

If the local unit failed to respond to the state treasurer's statement within 90 days, the state treasurer would be required to complete the report on the local unit's investments. The state treasurer would be allowed to charge the local unit for reasonable and necessary expenses required to complete the report, including travel and per diem expenses. The local unit would be required to reimburse the state treasurer for these expenses, and the state treasurer would be allowed to either execute a contract with the local unit or bill the local unit on a monthly basis. The bill would also require audit reports to include, among other things, information regarding any deviations in the reporting of the local unit's investments in derivatives.

House Bill 5223 is tie-barred to House Bill 5187.

House Bill 5256 would amend the Uniform System of Accounting Act (MCL 21.44 et al.). The bill would remove the requirement for county offices to make annual financial reports (similar to those required of local units under the Uniform Budgeting and Accounting Act) to the auditor general at the end of each fiscal year. State departments, offices, and institutions would still be required to make annual financial reports to the auditor general, and the bill would require that the reports contain additional information. Specifically, the bill would require reporting of the cost and fiscal year end market value of derivative instruments in the office's nonpension investment portfolio at the end of the fiscal year. This information would have to be reported both on an aggregate basis and itemized by issuer and type of derivative instrument. The bill would also require

reporting of the cost and fiscal year end market value of each item in the pension system's investment portfolio at the end of the fiscal year. These investments would be required to be listed by category and itemized. United States Government or agency obligations would be itemized by type of security; commercial paper would be itemized by issuing bank; United States Government or agency repurchase agreements would be itemized by institution with the type of security specified; United States Bank bankers' acceptances would be itemized by issuing bank; mutual funds would be itemized by fund name; common stock would be itemized by issuing corporation; corporate bonds would be itemized by issuing corporation and type of security; real estate would be itemized by separately describing each holding; mortgages would be itemized by mortgagor; derivative instruments or products would be itemized by issuer and type; and all other types of pension investment would be itemized by type of investment. However, information concerning investments in defined contribution plans and deferred compensation plans where the employee participating in the plan chooses the nature of the investments would not have to be included in the reports. The annual financial reports would also have to contain the total cost and total fiscal year end market value of all of the previously listed types of investments, both by category and combined total of all of the categories.

Each department, office, and institution of state government would be required to retain a copy of its annual financial report and would be required to make such report available for public inspection under the Freedom of Information Act. The auditor general would continue to be required to publish copies of the substance of the reports in an annual volume of comparative statistics. However, this annual comparative report would no longer have to include information regarding county governments and copies for county offices would no longer be required.

The bill would also provide that if a department, institution, or office of state government failed to report its nonpension investments in derivatives and its pension investments as required, the auditor general could make a determination that the department, institution, or office was unable to complete its report without assistance from the auditor general. The auditor general could then submit a written statement of findings and recommendations to the office, department, or institution. The institution, department, or office would then be required, within 90 days of receipt of the auditor general's statement, to either retain the auditor general to report the investments, or retain a certified public accountant report on the investments and notify the auditor general of the action. If the office,

department, or institution failed to respond to the auditor general's statement within 90 days, the auditor general would be required to complete the investment report. The auditor general would be required to charge for reasonable and necessary expenses required to complete the report, including travel and per diem expenses, and the office, institution, or department would be required to pay for these expenses. The auditor general would be required to execute a contract with the office, institution, or department or to provide monthly billings if a contract is not executed.

House Bill 5256 is tie-barred to House Bill 5187.

House Bill 5188 would create the Good Government Financial Report Disclosure Act. The bill would specify that a financial report prepared, owned, used, in the possession of, or retained by a public body (the state and local units of government) must be made available to the public under the Freedom of Information Act (FOIA). Under the bill, a "financial report" would include: a) reports required of local units required to make annual financial reports under the Uniform Accounting and Budgeting Act (regarding pension and nonpension investments in derivatives as described in House Bill 5187); b) any reports from departments, institutions, or offices of state government showing, for each state pension system, the state governmental unit's investments in each pension investment portfolio (as required under House Bill 5256); and c) state governmental units' reports showing the cost and fiscal year end value of the all the unit's investments in derivatives in its nonpension investment portfolio, both on an aggregate basis and itemized by issuer and type.

House Bill 5188 is not tie-barred to any other legislation.

House Bill 5224 would create the Financial Investment Clearinghouse Act, under which certain information pertaining to municipal securities would be maintained by the Library of Michigan as the financial investment clearinghouse as follows:

Financial Investment Clearinghouse. The Library of Michigan would be designated as the financial investment clearinghouse for the purpose of assisting brokers and dealers, including municipal securities dealers, in complying with certain federal regulations (17 CFR 240.15c2-12). The library would have to accomplish all of the following:

** Maintain current, accurate information about the municipal securities offerings of issuers of municipal securities in this state, and about obligated persons with

respect to those securities, including final official statements, annual financial information, audited financial statements, notices of "material events" (see below), and notices of failure to provide annual financial information by obligated persons as required under the Code of Federal Regulations, at no charge to the issuers or obligated persons. The library would not be required to verify the accuracy of the information. The library would also be required to accept the information on municipal securities offerings from any issuer located in this state and any obligated person for the municipal securities offering of such an issuer.

** Maintain the annual financial reports of local units filed with the library by the state treasurer under the Uniform Budgeting and Accounting Act (as amended by House Bills 5187 and 5223).

The library would also be required to deposit copies of the financial reports and the information in each designated depository library. Both the library and the designated depository libraries would be required to make the reports and information available promptly to the public on a contemporaneous basis, upon payment of an applicable and reasonable fee. The fees would be set to defray the operating costs.

Definitions. The terms "annual financial information," "final official statement," "issuer of municipal securities," and "obligated person" would mean those terms as defined in the Code of Federal Regulations (17.CFR 240.15c2-12). The terms "broker," "dealer," "municipal securities," and "municipal securities dealer" would mean those terms as defined in Section 3 of Title I of the federal Securities Exchange Act of 1934.

"Material event" would mean the failure of an issuer of municipal securities to timely file an annual financial report, as required under the Uniform System of Accounting Act or the Uniform Budgeting and Accounting Act, or any of the following occurrences with respect to securities being offered in an offering, if material: principal and interest payment delinquencies; non-payment-related defaults; unscheduled draws on debt service reserves or on credit enhancements reflecting financial difficulties; substitution of credit or liquidity providers, or their failure to perform; adverse tax opinions or events affecting the tax-exempt status of the security; modifications to rights of security holders; bond calls; defeasances; release, substitution, or sale of property securing repayment of the securities; or rating changes.

House Bill 5224 is tie-barred to House Bill 5187.

House Bill 5611, together with House Bill 5256, would have the effect of placing county financial oversight functions under the Department of Treasury, rather than the auditor general. Currently, under the Uniform System of Accounting Act (MCL 21.41 et. al.), each department, institution, and office of state government, and each county office, must file an annual financial report with the auditor general for the fiscal year ending June 30th. House Bill 5611 would amend the act to exclude county offices from the reporting requirements; delete provisions concerning charges collected against counties for the services of examiners; require the reporting of information concerning the nature and amount of state governments' investments in derivative instruments or products; and delete references to county offices from the act.

Further, the bill would require the auditor general, when making a report regarding the results of an investigation or examination, to include, among other things, disclosure of any fiscal irregularities, including violations of the annual financial report requirements, malfeasance, misfeasance, nonfeasance, or gross neglect of duty by an officer or employee of a department, institution, or office of state government or by an officer or employee of a county office.

The bill would also add to the reasons that a copy of such a report would be required to be forwarded to the attorney general's office. Currently, an examination must uncover a malfeasance, misfeasance, nonfeasance, or gross neglect of duty on the part of an officer or employee of either a state or county governmental unit or office, for which there exists a criminal penalty, in order to require that a copy of the report be forwarded to the attorney general's office. The bill additionally would require that a copy of the report be forwarded to the attorney general's office if the investigation or examination revealed "any fiscal irregularity".

Finally, the bill would clarify language requiring the governor to remove officers of any branch of state government if they had been found guilty of refusal or willful neglect in the maintaining of accounts as required by the auditor general, and also language requiring the auditor general to promptly report such refusal or neglect to the governor. (The current language also applies to county officials; however, as noted above, the references to county governments would be removed from the act.)

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, House Bill 5188 has no fiscal impact; House Bill 5223 would have a negligible fiscal impact on the state, and the other bills

could result in increased costs to local governments to the extent that penalties were applied for violations, with a corresponding revenue increase to the state. The HFA has not yet completed its analysis of House Bill 5256. (2-27-96)

ARGUMENTS:

For:

Currently, if a local unit or a state governmental entity uses a private money manager for maintaining its investment portfolio, the information on how the money has been invested may be unavailable to members of the public, even if a FOIA request is made. The bills will allow for increased public scrutiny of how local governmental units invest public money. How public money is invested is a matter of some concern to the public; when governmental units lose public money due to poor investments or poor investment strategies, members of the public should be able to find out how and why it happened. The reporting requirements added by the bills would increase the likelihood that members of the public could find out how public money is being invested and as a result could discourage overly risky investments.

The bills are not particularly onerous, as they require only the additional specific reporting on investments in derivative instruments or products. Derivatives are a volatile form of investment and extra scrutiny is necessary to help prevent the type of losses that have occurred due to excessive investments in derivative products.

Response:

If investments in derivatives are so risky, wouldn't it be better to simply restrict the ability of units of government to invest in them?

For:

The Library of Michigan is already designated as the Michigan document depository under the Library of Michigan Act and is responsible for the distribution and maintenance of official Michigan documents; as a result it makes sense to make the library the financial investment clearinghouse. The Library of Michigan already receives 75 copies of all official Michigan documents (those that are printed and intended for general distribution, including statutes, department reports and etc.); the library keeps some copies and distributes the rest to official document depositories under the act. The Library of Michigan has a state-wide network of depository libraries, including 18 state public libraries, 16 academic libraries, 7 county libraries, and 5 public co-operative libraries. Given the existence of this network it makes far more sense to

make use of it than to hire or create a new entity to accomplish what is already being done by the library.

Response:

As long as the library is not forced to attempt to collate the information or otherwise create the documents, it is likely that the retention of certain yearly reports and the distribution of them to the other depository libraries would not significantly increase the library's workload. However, it is difficult to know how much increased work would be involved in maintaining the information on municipal securities offerings required in House Bill 5224. The library could have difficulty coping with a huge influx of information, particularly if the information had to be organized in a fashion to allow for easy access to particular points of information. Additionally, House Bill 5224 would require the library to maintain "accurate information" regarding municipal securities but in the same subdivision also states that the library would not be required to verify the accuracy of the information.

Against:

The reporting requirements added by the bills are unnecessary; there are already laws which limit the type and manner of investments governmental units can make. These laws provide ample protection for investments. Particularly, Public Act 20 of 1943 (MCL 129.91 et al), known as the Investment of Surplus Funds of Political Subdivisions Act, restricts the types of investments made by legislative or governing bodies of political subdivisions. These laws already limit the risks political subdivision may take with public money. Furthermore, merely requiring reporting of the types of investments held at the end of the year will do little to prevent bad investments; without some form of review and/or oversight of the reports there will be little encouragement to change shaky investment practices.

Investment plans which take significant losses usually do so because the investment plan relied too much upon a particular type of investment. Investment in derivatives is not, in and of itself, a bad thing; when invested in wisely, derivatives can offer a hedge against fluctuations in certain markets.

Additionally, it should be noted that the majority of counties in Michigan rely on the Municipal Employees Retirement System (MERS) to invest pension money. It would make more sense for MERS to report on the types of investments made in the counties pension portfolios directly, since MERS is in control of the investments.

Furthermore, many local units of government are already overwhelmed by the reporting requirements added due to Proposal A's passage; the addition of the

requirements of this package will be difficult to meet. The requirement that the local units of government increase their reporting could result in increased costs for the local units. These increased costs should be paid by the state under the Headlee amendment, which limits unfunded state mandates.

POSITIONS:

The Michigan Municipal League supports House Bills 5223 and 5187, but has no position on the other bills. (5-8-96)

The Michigan Township Association does not oppose the bills. (5-8-96)

The Michigan Association of County Treasurers has no position on the bills. (5-9-96)

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.