



**House  
Legislative  
Analysis  
Section**

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**LOCAL GOVERNMENT DISCLOSURE**

**House Bill 5187 (Substitute H-5)  
Sponsor: Rep. Michael Hanley**

**House Bill 5188 (Substitute H-5)  
Sponsor: Rep. Greg Kaza**

**House Bill 5223 (Substitute H-2)  
Sponsor: Rep. Roland Jersevic**

**House Bill 5256 (Substitute H-2)  
Sponsor: Rep. Liz Brater**

**Committee: Urban Policy**

**First Analysis (2-27-96)**

House Bills 5187, 5188, 5223 and 5256 (2-27-96)

***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, 5188, 5223, 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 whose value is determined in whole or in part by the price of one or more underlying instruments or markets.

House Bills 5223 and 5187 would amend the same sections of 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. The bills would specify that the fiscal officer of each local unit would make the report, and

would require that the reports contain information on the cost and fiscal year end market value of derivative products, itemized by issuer and type, on certain investments in the local units portfolio. The information required under the bills would have to be reported on both an itemized and aggregate basis. House Bill 5223 would require reporting of derivative investments in a local unit's nonpension portfolio, while House Bill 5187 would require such reporting regarding a local unit's pension portfolio (with the exception of investments of defined contribution plans and deferred compensation plans that are chosen by employees). (Note: The two bills contain conflicting definitions of "local unit".)

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 State Information Depository 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 State Information Depository 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 bills would also specify that they did not provide any authority for any local unit to make any investments not otherwise allowed by law.

Finally, the bills 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, (under House Bill 5223) or allowed (under House Bill 5187), 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. House Bill 5187, on the other hand, would require the local unit to notify the state treasurer, through resolution of its legislative body, of the corrective action taken.

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 provide monthly billings.

Both bills 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.

In addition, House Bill 5223 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. (This repeal, together with House Bill 5611 [currently before the House Local Government Committee] and House Bill 5256, would have the effect of placing county financial oversight functions under the Department of Treasury, rather than the auditor general.)

House Bills 5187 and 5223 are tie-barred to House Bill 5224, which would create the State Information Depository Act. (That bill is currently pending before the House Urban Policy Committee.)

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 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, however, and the bill would add to that by requiring additional information in the required year end fiscal reports for each state pension system. Specifically, the bill would 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. The bill would require the investments 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 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.

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 require that a copy of the report be forwarded to the Attorney General's Office, if the investigation or examination revealed "any fiscal irregularity". 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. Finally, the bill would clarify language requiring the governor to remove officers of any branch of state government or county government if they had been found guilty of refusal or willful neglect in the maintaining of accounts as required by either the auditor general (in the case of state officials) or the Department of Treasury (in the case of county officials), and also language requiring the auditor general (in the case of state officials) and the Department of Treasury (in the case of county officials) to promptly report such refusal or neglect to the governor.

(Note: House Bill 5611, which is part of this package but is still in committee, would amend the same sections of the Uniform System of Accounting Act and contains language conflicting with House Bill 5256.)

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 as (regarding pension and nonpension investments in derivatives as described in House Bills 5223 and 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, itemized by issuer and type, and cumulatively (as required by House Bill 5611).

House Bill 5188 is tie-barred to House Bills 5187, 5223, 5256 and 5611.

### ***FISCAL IMPLICATIONS:***

According to the House Fiscal Agency, House Bill 5187 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. House Bill 5188 has no fiscal impact, according to the HFA. House Bill 5223 would have a negligible fiscal impact on state, and the impact on local governments would be indeterminate. The HFA has not yet completed its analysis of House Bill 5256. (2-27-96)

### ***ARGUMENTS:***

#### ***For:***

Currently, if a county or 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?

#### ***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.

#### ***Against:***

There are some significant conflicts in the language of the bills, particularly between House Bills 5223 and 5187. These conflicts would have to be resolved before the legislation becomes law.

### ***POSITIONS:***

The Michigan Municipal League supports House Bills 5223 and 5187. (2-26-96)

The Michigan Township Association does not oppose the substitutes. (2-23-96)

The Michigan Association of Counties opposes the bills.  
(2-23-96)

The Michigan Association of County Treasurers  
opposes House Bill 5256, and has no official position  
on the other bills at this time. (2-27-96)

House Bills 5187, 5188, 5223 and 5256 (2-27-96)

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