



Senate Fiscal Agency
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BILL



ANALYSIS

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House Bill 5187 (Substitute H-6 as reported without amendment)
House Bill 5188 (Substitute H-6 as reported without amendment)
House Bill 5223 (Substitute H-3 as reported without amendment)
House Bill 5224 (Substitute H-2 as reported without amendment)
House Bill 5256 (Substitute H-3 as reported without amendment)
House Bill 5611 (Substitute H-2 as reported without amendment)

Sponsor: Representative Michael Hanley (House Bill 5187)
Representative Greg Kaza (House Bill 5188)
Representative Roland Jersevic (House Bill 5223)
Representative William Bobier (House Bill 5224)
Representative Liz Brater (House Bill 5256)
Representative Alvin H. Kukuk (House Bill 5611)

House Committee: Urban Policy (House Bills 5187, 5188, 5223, 5224, and 5256)
Local Government (House Bill 5611)

Senate Committee: Financial Services (House Bills 5187, 5188, 5223, 5224, and 5256)
Local, Urban and State Affairs (House Bill 5611)

Date Completed: 6-20-96

RATIONALE

A situation in Independence Township, Oakland County, has led some people to believe that there is a need for increased public scrutiny of governmental investment practices, particularly in regard to derivative investments. (A derivative investment essentially is an arrangement that allows an investor or institution to speculate on the movement of a market; the rate of return is based on, or derived from, the movement in value of an underlying asset.) Between 1993 and 1994, according to an article in *The Detroit News* (3-24-95), the township invested almost \$6 million in several types of investments that derived their value from mortgage interest rates. Apparently, the value of the township's investment in collateralized mortgage obligations declined dramatically when interest rates began to rise in 1994. According to an August 1995 article in *The Oakland Press*, the township had irretrievably lost about \$200,000 and the value of the rest of its derivative investments had declined by nearly \$3.7 million.

While the situation in Independence Township resembles that of Orange County, California--which lost some \$1.7 billion in the derivative market--evidently the township officials had no idea of the risk they were taking. Reportedly, the

township treasurer relied on the advice of a Houston, Texas, investment firm, and township leaders did not know of the rapid drop in the market value of their investment until it was brought to their attention by township auditors. Although Independence Township appears to be the only local unit in Michigan to experience serious derivative losses, there is a concern that other governmental units might have made similar risky investments, or might do so in the future. To protect public assets and pension funds, it has been suggested that State and local government should be required to report on the nature and amount of their investments.

CONTENT

House Bills 5187 (H-6), 5223 (H-3), and 5256 (H-3) would amend various acts to require local units of government and State departments, institutions, and offices annually to report the cost and fiscal year end market value of derivative instruments or products in their pension and nonpension investment portfolios, and make this information available to the public. Additional categories of investments in the State pension system's

investment portfolio also would have to be reported and made available. House Bill 5611 (H-2) would amend the uniform system of accounting Act to require that audit reports for State offices include any fiscal irregularities.

House Bill 5224 (H-2) would create the “Financial Investment Clearinghouse Act” to require the Library of Michigan to serve as the clearinghouse to assist securities brokers and dealers, maintain information about municipal securities offerings in this State, and maintain the annual financial reports of local units. House Bill 5188 (H-6) would create the “Good Government Financial Report Disclosure Act” to require local units and State departments, institutions, and offices to retain copies of financial reports pertaining to them and make the reports available for public inspection.

House Bills 5187 (H-6), 5188 (H-6), and 5256 (H-3) would define “derivative instrument or product” as either of the following: 1) “a contract or convertible security that changes in value in concert with a related or underlying security, future, or other instrument or index; or obtains much of its value from price movements in a related or underlying security, future, or other instrument or index; or both”; or 2) “a contract or security, such as an option, forward, swap, warrant, or a debt instrument with 1 or more options, forwards, swaps, or warrants embedded in it or attached to it, the value of which contract or security is determined in whole or in part by the price of 1 or more underlying instruments or markets”.

House Bill 5187 (H-6) is tie-barred to House Bill 5224. House Bills 5224 (H-2), 5223 (H-3), and 5256 (H-3) are tie-barred to House Bill 5187.

House Bill 5187 (H-6)

The Uniform Budgeting and Accounting Act requires each local unit of government to make an annual financial report, which must contain an accurate statement of specific information for each fiscal year. House Bill 5187 (H-6) would amend the Act to require an annual financial report also to include the cost and fiscal year end market value of derivative investments or products in the local unit’s nonpension investment portfolio and pension investment portfolio at fiscal year end. This information would have to be reported on an aggregate basis and itemized by issuer and type of derivative instrument or product. Investments of

defined contribution plans and deferred compensation plans that were chosen by a participating employee would be excluded from the information reported for pension investment portfolios.

Under the Act, copies of an annual financial report must be filed with the State Treasurer within 120 days after the end of the local unit’s fiscal year, unless the State Treasurer grants an exception. The bill would require the State Treasurer promptly to file with the Library of Michigan a sufficient number of copies of an annual financial report for deposit of one copy in the Library of Michigan and one copy in each designated depository library under the proposed Financial Investment Clearinghouse Act.

The bill would require a local unit to obtain a copy of an annual financial report submitted under the Uniform Budgeting and Accounting Act. A local unit or the State Treasurer would have to make an annual financial report prepared, owned, used, in the possession of, or retained by the local unit or State Treasurer available for public inspection under the Freedom of Information Act. The Library of Michigan and any designated depository libraries would have to make an annual financial report available to the public as provided under the Financial Investment Clearinghouse Act.

The bill specifies that these provisions would not authorize a local unit to make investments not otherwise authorized by law.

Under the Act, “local unit” generally refers to a village, city, or township, or an authority or commission established by a county, village, city, or township ordinance or charter. The bill would include a county in this definition.

The bill would repeal a section that transferred to the Department of Treasury all powers and duties of the elected auditor general “relating to uniform system of accounts for county offices and examination thereof” (MCL 16.180).

House Bill 5223 (H-3)

The bill would amend the Uniform Budgeting and Accounting Act to provide that, if a local unit failed to report investments in derivative instruments or products as required under House Bill 5187, the State Treasurer could determine that the local unit could not report the investments without his or her assistance, advice, or instruction. The State

Treasurer would have to submit a written statement of the findings and recommendations to the legislative body of the local unit. Within 90 days after receiving this statement, the local unit would have to retain a certified public accountant or the State Treasurer to report the investments and would have to notify, by resolution of the legislative body, the State Treasurer of this action. If the local unit failed to respond within the 90-day period, the State Treasurer would have to report the investments.

The State Treasurer could charge reasonable and necessary expenses, including per diem and travel expenses, to the local unit for services performed under these provisions, and the local unit would have to pay the State Treasurer for these expenses. The Treasurer would be required either to execute a contract with the local unit or to bill the local unit on a monthly basis.

Under the Uniform Budgeting and Accounting Act, every audit report must disclose any fiscal irregularities, defalcations, misfeasance, nonfeasance, or malfeasance that came to the auditor's attention. The bill specifies that the irregularities would include, but not be limited to, any deviations from the requirements of the Act concerning annual financial reports.

Senate Bill 5256 (H-3)

Annual Financial Report

The bill would amend the uniform system of accounting Act (Public Act 71 of 1919), which requires each State department, institution, and office, and each county office to make an annual financial report and file a copy with the Auditor General and the Governor. The bill would delete county offices from these requirements. In addition to the currently required information, the bill would require a report to contain the cost and fiscal year end market value of derivative instruments or products in the department's, institution's, or office's nonpension investment portfolio at fiscal year end. This information would have to be reported on an aggregate basis and itemized by issuer and type of derivative instrument or product.

A report also would have to include, for each State pension system, the cost and fiscal year end market value for each item in each of the following categories of pension investments in the State pension system's investment portfolio at fiscal year end:

- U.S. government or agency obligations, itemized by type of security.
- Commercial paper, itemized by issuing bank.
- U.S. government or agency repurchase agreements, itemized by institution with type of security specified.
- U.S. bank bankers' acceptances, itemized by issuing bank.
- Mutual funds, itemized by mutual fund name.
- Common stock, itemized by issuing corporation.
- Corporate bonds, itemized by issuing corporation and type of security.
- Real estate, itemized by separately described holding.
- Mortgages, itemized by mortgagor.
- Derivative instruments or products, itemized by issuer and type.
- Other pension investments not listed above itemized by type of investment.

In addition, an annual financial report would have to include the total cost and fiscal year end market value for each category of investments described above in the State pension system's investment portfolio at fiscal year end; as well as the total cost and fiscal year end market value on an aggregate basis.

Investments of defined contribution plans and deferred compensation plans that were chosen by a participating employee would be excluded from the information that would have to be reported under these provisions.

A State department, institution, or office would have to obtain and retain, subject to the Management and Budget Act, a copy of an annual financial report submitted under Public Act 71. A State department, institution, or office, including the Auditor General, would have to make an annual financial report prepared, owned, used, in the possession of, or retained by the department, institution, or office available for public inspection under the Freedom of Information Act.

The bill specifies that these provisions would not authorize a department, institution, or office of State government to make investments not otherwise authorized by law.

Failure to Report

If a State department, institution, or office failed to report nonpension investments in derivative

instruments or products or pension investments as required above, the Auditor General could determine that the department, institution, or office could not report the investments without his or her assistance, advice, or instruction. The Auditor General would have to submit a written statement of the findings and recommendations to the department, institution, or office. Within 90 days after receiving this statement, the department, institution, or office would have to retain the Auditor General to report the investments or retain a certified public accountant to report them and notify the Auditor General of that action. If the department, institution, or office failed to respond within the 90-day period, the Auditor General would have to report the investments.

The Auditor General would have to charge reasonable and necessary expenses, including per diem and travel expenses, to the department, institution, or office for services performed under these provisions, and the department, institution, or office would have to pay the expenses. The Auditor General would have to execute a contract with the department, institution, or office or bill it on a monthly basis.

House Bill 5611 (H-2)

The bill would amend the uniform system of accounting Act to require that a report of an examination, among other things, disclose any fiscal irregularities, including but not limited to any violations of the requirements of Section 4 (which concerns annual financial reports), malfeasance, misfeasance, nonfeasance, or gross neglect of duty by an officer or employee of a State department, institution, or office.

The Act requires the Auditor General to examine the accounts of State departments, institutions, and offices, and of county offices, and to make reports of examinations. If an examination discloses any malfeasance, misfeasance, nonfeasance, or gross neglect of duty, for which a criminal penalty is provided by law, a copy of the report must be filed with the Attorney General, who is required to institute criminal proceedings or direct criminal proceedings to be instituted by a county prosecutor. Under the bill, these provisions also would apply if an examination disclosed any fiscal irregularity.

The bill would delete references to county offices from provisions of the Act concerning a uniform system of accounting; examination and reporting

by the Auditor General; the use of books, forms, records, and systems prescribed by the Auditor General; and the removal from office of an officer who refuses to keep accounts as prescribed by the Auditor General.

House Bill 5224 (H-2)

The bill would create the "Financial Investment Clearinghouse Act" to require that the Library of Michigan serve as the financial investment clearinghouse in this State for the purpose of assisting brokers and dealers, including municipal securities dealers, in complying with certain Federal regulations (17 C.F.R. 240.15c2-12). (The terms "broker", "dealer", "municipal securities", and "municipal securities dealer" would be defined as they are in the Federal Securities Exchange Act.)

The Library of Michigan would have to maintain current, accurate information about municipal securities offerings of issuers of municipal securities located 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" (defined below), and notices of failure to provide annual financial information by obligated persons under Federal regulations at no charge to the issuers or obligated persons. The Library would have to accept the information described in this provision from any issuer located in Michigan and any obligated person for the municipal securities offerings of such an issuer. The Library would not have to verify the accuracy of this information.

The Library also would be required to maintain the annual financial reports of local units filed with it by the State Treasurer under the Uniform Budgeting and Accounting Act.

The Library would have to make the information about municipal securities offerings and obligated persons, and the annual financial reports, available promptly to the public on a contemporaneous basis upon payment of any applicable fee. Any fee would have to be reasonable and set to defray the costs of operating under the proposed Act.

In addition, the Library would have to deposit copies of the information and reports in each designated depository library on a basis substantially contemporaneous with the acceptance of that information. The State Librarian would have to designate the depository

libraries. Each depository library would have to comply with the requirement that information be made available to the public.

The State Treasurer could require the State Library to supply any information or reports relative to its function under the bill that the Treasurer considered appropriate. The information or reports would have to be provided at no charge.

“Material event” would mean the failure of an issuer of municipal securities to file timely an annual financial report under Public Act 71 of 1919 or under 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; nonpayment-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 5188 (H-6)

The bill would create the “Good Government Financial Report Disclosure Act” to require a local unit or a State department, institution, or office to retain a copy of any financial report pertaining to that unit or department, institution, or office. A local unit or State department, institution, or office, including the State Treasurer or Auditor General, would have to make an annual financial report prepared, owned, used, in the possession of, or retained by the local unit or State department, institution, or office available for public inspection under the Freedom of Information Act. Investments of defined contribution plans and deferred compensation plans that were chosen by a participating employee could not be made available to the public. The proposed Act would not authorize a local unit or the State to make investments not otherwise authorized by law.

“Financial report” would include an audit report or other report for a local unit showing the cost and fiscal year end market value of derivative instruments or products in the local unit’s pension investment portfolio or nonpension investment portfolio at fiscal year end reported on an aggregate basis and itemized by issuer and type of derivative instrument or product.

“Financial report” also would include an audit report or other report for a State department, institution, or office showing, for each State pension system, the following:

- The cost and fiscal year end market value for each item in each of the following categories of pension investments in the State pension system’s investment portfolio at fiscal year end (itemized as described in House Bill 5256 (H-3)): U.S. government or agency obligations; commercial paper; U.S. government or agency repurchase agreements; U.S. bank bankers’ acceptances; mutual funds; corporate bonds; real estate; mortgages; derivative instruments or products; and other pension investments.
- The total cost and fiscal year end market value for each category of investments described above in the State pension system’s investment portfolio at fiscal year end, as well as on an aggregate basis.

In addition, “financial report” would include an audit report or other report for a State department, institution, or agency showing the cost and fiscal year end market value of derivative instruments or products in the department’s, institution’s, or office’s nonpension portfolio at fiscal year end reported on an aggregate basis and itemized by issuer and type of derivative instrument or product.

MCL 141.422b et al. (H.B. 5187)
141.428 et al. (H.B. 5223)
21.44 et al. (H.B. 5256)
21.41 et al. (H.B. 5611)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Currently, if a local unit or a State governmental entity uses a private money manager to maintain its investment portfolio, information on how the funds have been invested may be unavailable to members of the public. The bills would allow increased public scrutiny of how governmental units invest public money. Citizens have a right to know whether the government is jeopardizing their funds through risky, if not illegal, investments, and members of the public should be able to find out what happened when a governmental unit loses

public money due to poor investment strategies. Although local units of government and State offices currently are subject to various financial reporting requirements, the bills would ensure that specific categories of investments, including derivatives, were reported. If a governmental entity failed to report as required, it would have to hire a certified public accountant to do so, or the State Treasurer or the Auditor General would have to report the investments. In addition, the bills would create a clearinghouse in the Library of Michigan for information about municipal securities offerings and local units' annual financial reports. These requirements not only would increase public awareness, but also could discourage governmental bodies from making unwise investments.

Opposing Argument

House Bill 5224 (H-2) would impose on the Library of Michigan responsibilities that are outside the scope of its mission and in which it has no expertise. Although retaining and distributing annual financial reports should not be overly burdensome, since the Library already functions as the repository of official State documents, serving as the financial investment clearinghouse for brokers and dealers, as well as maintaining information about municipal securities offerings, could result in a large influx of information and an increased workload.

Legislative Analyst: S. Margules

FISCAL IMPACT

House Bill 5187 (H-6)

Counties currently provide annual financial data; therefore, there would be no fiscal impact.

House Bill 5188 (H-6)

The bill would have no fiscal impact on State or local government.

House Bill 5223 (H-3)

Local units in which the State Treasurer reported the investments would be charged reasonable and necessary expenses for services performed by the State Treasurer.

House Bill 5224 (H-2)

According to the Library of Michigan, costs would depend upon any new responsibilities under the

bill. Requiring the Library to act as a depository for the information under the Michigan Documents Depository System would have a minimal fiscal impact.

House Bill 5256 (H-3)

The Auditor General estimates its costs under the bill for compiling the report at \$12,200.

House Bill 5611 (H-2)

Auditing of county offices would be covered in House Bill 5187 (H-6).

Fiscal Analyst: R. Ross
B. Bowerman

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.