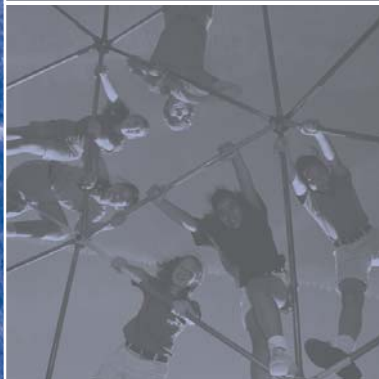


Investment of Bond Proceeds



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Michigan Association of School Boards
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Executive Summary

The Revised School Code expressly limits the investments available to general powers, first class, and intermediate school districts, as well as the availability and management of funds eligible for such investments. Although the types of investments are limited, school districts are allowed to invest as much as they choose in any permitted investment and, therefore, should be acutely aware of the risks involved with each. Varying levels of sophistication may find some school districts comfortable with conducting their own investment functions and others in need of advice from an Investment Advisor. However pursued, school districts must ensure that investment activities comply with all applicable legal requirements and board policies.

School districts are not required under Michigan law to competitively bid individual investments; however, school districts may, and often do, seek bids as a matter of good public policy. In addition to assisting school districts in determining the best investments for their unique needs, competitive bidding helps to ensure that school districts will not unknowingly engage in “yield burning” practices (i.e., the purchase of a security, other than state and local government series securities, at below market yield) for bond proceeds subject to yield restrictions. If competitive bidding is pursued, school districts should strongly consider comparing bids within investment models, rather than collectively among all investment options. Following another course could lead to comparisons of “apples to oranges,” and ultimately unnecessary confusion and misleading conclusions.

School districts may obtain professional advice on a myriad of financial issues relevant both before and after the acquisition of bond proceeds. A Financial Advisor typically provides services relating to the structuring, timing, and issuance of bonds. An Investment Advisor provides advice on the investment of bond proceeds and other school funds. The scope of services an Investment Advisor may perform depends on whether the Investment Advisor is registered, either with the Securities and Exchange Commission or the Michigan Department of Labor and Economic Growth, Office of Financial and Insurance Services. A Registered Investment Advisor is authorized to give advice on a broad range of investments subject to regulatory oversight and statutorily imposed fiduciary obligations. Absent registration, an Investment Advisor must limit advice to areas deemed exempt from registration requirements. An outstanding issue is whether an Exempt Investment Advisor is acting outside this specific exemption if it recommends that a school district invest only in exempt securities or advises school districts against investing in other permissible investments. Each school district should carefully consider its needs, goals, and investment

philosophies before determining whether a Registered Investment Advisor or an Exempt Investment Advisor is wise and/or necessary for its particular purposes.

After determining which type is most appropriate for its needs, a school district should gather information about the various advisors vying to provide services in order to compare and contrast their attributes and ensure an effective and cost-efficient business relationship. A Request for Information (“RFI”) is a good tool for acquiring such information. An RFI can be tailored to discover both general and specific information about an Investment Advisor’s financial health, investment strategies, performance history, and any other information that may be relevant to a school district’s particular needs.

Once a school district has settled on a particular entity or individual to act as Investment Advisor, it should ensure that the resulting contract clearly defines the services to be provided and the applicable law and standards, especially in light of the registered or exempt status of the Investment Advisor. School districts should have any proposed contracts reviewed by legal counsel prior to execution.

School districts should also be wary of potential conflicts of interest relating to services of Investment Advisors. Particularly, school districts should prevent Investment Advisors from acting in multiple capacities that could create the potential for self-interested decisions. For example, it may not be appropriate from a policy perspective to allow a person or entity to simultaneously act as Investment Advisor and a custodian bank, or to bid on a financial matter and assist the school district in awarding the corresponding contract(s). Similarly, subject to limited exceptions, school personnel and board members are prohibited by statute from entering into, negotiating, soliciting, or representing a party in any contract between the school district and himself/herself or certain affiliated entities. Intermediate school districts are also prohibited by law from entering into contracts when a board member or administrator has “a substantial conflict of interest.”

Introduction

This document presents a general outline of laws and policy considerations relevant to the investment of bond proceeds by Michigan school districts. Although bond proceed investments are generally governed by the same restrictions and limitations pertinent to the investment of any school district funds, given the infrequency of bond issues and the typically larger sums involved, school districts should exercise great caution both to ensure legal compliance and to understand the important consequences of their investment decisions.

I. Definitions

A. Investment Professionals

1. Broker-Dealer

A Broker-Dealer is an individual or entity engaged in the business of buying and selling securities for others and for itself. A Broker facilitates transactions for others and typically charges a commission for executing investors' buy/sell orders. A Dealer buys and sells securities for its own account (usually to modify its own holdings or to subsequently sell the securities to others). The term "Broker-Dealer" is commonly used because most brokerages act as both broker and dealer. Broker-Dealers are generally required to register with the Securities and Exchange Commission. Broker-Dealers typically charge fees based on: (1) commission, (2) a mark-up on securities bought or sold, or (3) both.

2. Financial Advisor

For purpose of this document, a Financial Advisor means a financial consultant providing services relating to the structuring, timing and issuance of bonds. In Staff Legal Bulletin No. 11 dated September 19, 2000, the staff of the U.S. Securities and Exchange Commission clarified several issues concerning Financial Advisors, including the circumstances under which Financial Advisors may be investment advisors. On that issue, the staff opined that a Financial Advisor may not routinely provide advice for compensation regarding the investment of assets in non-governmental securities without being deemed to be an investment advisor.

3. Financial Institution

A Financial Institution is defined by Sections 622(7) and 1221(4) of the Revised School Code to mean "a state or nationally chartered bank or a state or federally chartered savings and loan association, savings bank, or credit union whose deposits are insured by an agency of the United States government and which maintains a

principal office or branch office located in this state under the laws of this state or the United States." MCL 380.622(7); MCL 380.1221(4). Financial institutions include depository banks, which accept and safeguard deposits, and custodian banks, which also accept and safeguard deposits, but have the additional legal responsibility to manage the deposits. Financial Institutions are further addressed herein in Paragraph II-C.

4. Investment Advisor

For purposes of this document, an Investment Advisor is a broad term used to describe one engaged in the business of providing professional advice on a myriad of financial issues relevant after the acquisition of investable funds, such as bond proceeds. Investment Advisors often assist others in managing their financial resources, advise others regarding the value of investments, and/or issue or promulgate analyses or reports concerning investments. The scope of services that may be lawfully provided by an Investment Advisor depends on whether the Investment Advisor is registered, either with the Securities and Exchange Commission or the Michigan Department of Labor and Economic Growth, Office of Financial and Insurance Services. A registered Investment Advisor, referred to in this document as a "Registered Investment Advisor," is authorized to give advice on a broad range of investments and is subject to regulatory oversight and increased ethical and fiduciary obligations. Absent registration, an Investment Advisor must limit advice to areas deemed exempt from registration requirements, such as the investment of U.S. government securities. This type of limited-scope Investment Advisor exempt from registration is referred to in this document as an "Exempt Investment Advisor." Registered Investment Advisors and Exempt Investment Advisors are further addressed herein in Paragraph III-C.

5. Underwriter

An Underwriter guarantees the purchase of all securities from an issuing entity, typically pursuant to an agreement to buy all remaining securities not otherwise purchased by the public. In essence, underwritten securities have a form of insurance that guarantees their purchase even if the market shuns such securities. As insurers, Underwriters charge a fee for the protection they provide.

B. Investment Options

1. Investment Agreement

a. Full Flex Repurchase Agreement

A Full-Flex Repurchase Agreement (“Flex Repo”) is an option with full flexibility to draw funds as needed and that is collateralized by U.S. Treasury and/or Agency securities.²

b. Guaranteed Investment Contract

A Guaranteed Investment Contract (“GIC”) is a funding agreement, typically involving the deposit of bond proceeds with highly rated financial or insurance institutions, that provides a guaranteed fixed rate of interest throughout the term of the agreement and allows for flexibility in accessing and withdrawing necessary funds. For Michigan school districts, GICs must be secured, such as by the ability to acquire specified assets in the event of default or the creation of withdrawal options upon the downgrading of the institution’s credit rating.

2. Laddered Portfolio

A Laddered Portfolio is a portfolio of fixed income holdings each having a successively longer term to maturity. Typically, holdings in the portfolio are sized to meet projected draws for construction. Holdings reaching maturity and not otherwise needed to fund expenses of a project are usually reinvested to keep the ladder going. By laddering a portfolio, fluctuations in yield are reduced and generally “averaged up” by the higher interest rates earned on longer maturities. Also, if interest rates increase, the shorter maturities allow for reinvestment of funds at the higher rates, an option unavailable to holdings not yet reaching maturity.

3. Money Market Fund

A Money Market Fund is a type of Mutual Fund that invests in short-term, low-risk debt obligations of governments and attempts to maintain a constant price per share of \$1.00. The return on a Money Market Fund depends on the yields of the underlying investments. Money Market Funds are often used to hold cash between investments.

4. Mutual Funds Investment Pool

A Mutual Fund is an open-ended company that allows a group of investors to pool their money together to invest in a variety of stocks, bonds, and other securities with a predetermined investment objective. Investments are managed by a fund administrator, often an Investment Advisor. When investing in a Mutual Fund, one buys shares (or portions) of the Mutual Fund, not the actual

securities invested therein. Mutual Funds are a popular investment tool because they create an easy and cost-efficient method to diversify one’s portfolio. Investors are not required to individually select or wholly pay for the Mutual Fund’s investments. The Michigan Liquid Asset Fund (MILAF+) is an example of a local government Investment Pool permitted by law. MILAF+ invests only in those investments that are authorized by statute for school districts.

II. Permitted School District Investments

The Revised School Code expressly limits the investments available to general powers, first class, and intermediate school districts, as well as the availability and management of funds eligible for such investments. Although the types of investments are limited, school districts are allowed to invest as much as they choose in any or all of the permitted investments. Obviously, school districts need to be aware of the risks involved in various investments. Simply because a school district may be permitted to purchase certain investments does not mean that those investments are suitable for its particular needs. Prudent investment involves more than merely choosing the legally permissible. An Investment Advisor can provide advice regarding investment options and their suitability for a district’s needs, goals, and investment philosophy. The scope of such advice depends on whether the Investment Advisor is a Registered Investment Advisor or an Exempt Investment Advisor.

A. General Powers/First Class School Districts

Permitted Investments. General powers/first class school districts are authorized by statute³ to invest in the following types of investments:

1. Bonds, bills, or notes of the United States.
2. Obligations, the principal and interest of which are fully guaranteed by the United States; or obligations of the State of Michigan.⁴
3. Certificates of deposit issued by a financial institution or share certificates of a State of Michigan or federal credit union that is a financial institution.⁵
4. Commercial paper rated prime at the time of purchase and maturing not more than 270 days after the date of purchase.⁶
5. Securities issued or guaranteed by agencies or instrumentalities of the United States government.
6. United States government or federal agency obligation repurchase agreements.
7. Bankers’ acceptances issued by a bank that is a member of the federal deposit insurance corporation (“FDIC”).
8. Mutual funds composed entirely of investment vehicles that are legal for direct investment by a school district.

9. Investment pools authorized by the Surplus Funds Investment Pool Act and composed entirely of instruments that are legal for direct investment by a school district.⁷

Investable Funds. General powers/first class school districts are limited in the funds that may be invested. Particularly, boards of general powers and first class school districts may authorize their treasurers to invest: (1) debt retirement funds; (2) building and site funds; (3) building and site sinking funds; and/or (4) general funds.⁸

Commingling of Funds. Generally, money from different school funds may not be commingled when making investments.⁹ However, commingling is permitted in two circumstances: (1) if a school board authorizes the establishment of one common debt retirement fund for bond issues of a similar character, or (2) if a school board, by resolution, authorizes the treasurer to combine money for the purpose of investing in an authorized investment pool.¹⁰

Investment Earnings. All earnings from an investment become a part of the fund from which the investment was made.¹¹ If money is combined in an investment pool, however, the money is to be accounted for separately, and the earnings from the investment must be separately and individually computed, recorded, and credited to the fund or the district, as the case may be, for which the investment was acquired.¹²

Investment Security. As a general rule, security in the form of collateral, surety bond, or another form may be taken for the deposits or investments of a school district in a financial institution. Security is required, however, for investments in United States government or federal agency obligation repurchase agreements, whether such agreements are separately procured or included in an authorized investment pool.¹³ Moreover, while collateralized repurchase agreements generally require the delivery of government securities from the provider to a third-party custodian to be held for the benefit of the investor/school district, Michigan requires transfer of custody and title to the government securities and a pledge to the investor/school district of an undivided interest in the obligations. It is important that this obligation be expressly incorporated into any repurchase agreements permitted by the Revised School Code.

Additional Funds. Additional funds of a school district shall not be deposited or invested in a financial institution which is not eligible to be a depository of surplus funds for the State of Michigan under MCL 21.146.¹⁴

Investment of Deferred Compensation Funds. The treasurer of a school district, if authorized by resolution of the board, may also deposit upon approval of the employee, funds accumulated under a deferred compensation program in a federally insured financial institution authorized by law to do business in this state. If authorized by a resolution of the

board, the treasurer of a school district, with the prior consent of the employee, may use funds accumulated under a deferred compensation plan to purchase from a life insurance company authorized to do business in this state an annuity contract or life insurance policy in the manner and for the purposes described in section 457 of the internal revenue code.¹⁵

B. Intermediate School Districts

Permitted Investments. As with general powers/first class school districts, intermediate school districts are limited in their investments by statute.¹⁶ Permissible investments for intermediate school districts include:

1. Bonds, bills, or notes of the United States or obligations of this state.
2. Certificates of deposit issued by a financial institution.
3. Commercial paper rated prime at the time of purchase and maturing not more than 270 days after the date of purchase.¹⁷
4. Securities issued or guaranteed by agencies or instrumentalities of the United States government.
5. United States government or federal agency obligation repurchase agreements.
6. Bankers' acceptances issued by a bank that is a member of the federal deposit insurance corporation.
7. Investment pools authorized by the Surplus Funds Investment Pools Act and composed entirely of instruments that are legal for direct investment by an intermediate school district.
8. Mutual funds composed entirely of investment vehicles that are legal for direct investment by an intermediate school district.

Investable Funds. An intermediate school board can authorize the treasurer of the school board to invest: (1) general operating funds; (2) special education funds; (3) area vocational-technical education funds; (4) building and site funds; (5) cooperative education funds; or (6) debt retirement funds of the intermediate school district.¹⁸

Investment Earnings. Any investment earnings become part of the fund from which the investment was made. However, if money from more than 1 fund of a single intermediate school district or money from more than 1 intermediate school district is combined for investment in an authorized investment pool, the money shall be accounted for separately, and the earnings from the investment shall be separately and individually computed, recorded, and credited to the fund or intermediate school district, as the case may be, for which the investment was acquired.¹⁹

Investment Security. Intermediate school districts are limited in the types of security that can be obtained to guarantee investments. Assets that may be pledged to secure deposits of funds are limited by statute²⁰ to any of the following:

1. Assets considered acceptable to the state treasurer under MCL 21.143, to secure deposits of state surplus funds.
2. Any of the following:
 - a. Securities issued by the federal home loan mortgage corporation.
 - b. Securities issued by the federal national mortgage association.
 - c. Securities issued by the government national mortgage association.
3. Securities considered acceptable to the intermediate school board and the financial institution.

Additional Funds. Funds of an intermediate school district shall not be deposited or invested in a financial institution which is not eligible to be a depository of surplus funds belonging to this state under MCL 21.146.²¹

C. Financial Institutions

“Financial institutions” are important in many aspects of school district finance and investment. School districts are required to deposit funds into “financial institutions.”²²

A similar requirement applies to intermediate school districts.²³ “Financial institutions” are also addressed in the Revised School Code’s provisions relating to the deposit of various investments.²⁴

The definition of “financial institution” has undergone a significant change within the last ten years. A “financial institution” is now defined as:

[A] state or nationally chartered bank or a state or federally chartered savings and loan association, savings bank, or credit union whose deposits are insured by an agency of the United States government and which maintains a principal office or branch office located in this state under the laws of this state or the United States.²⁵

Significantly, a “financial institution” includes state and nationally-chartered banks, S&L associations, savings banks, and credit unions either: (1) maintaining a principal office in Michigan, or (2) maintaining a branch office in Michigan. Prior to this definition, “financial institutions” only included entities with their principal office in Michigan. Accordingly, public bodies were not permitted to deposit funds in entities having a branch in Michigan if their principal office was in another state.

While this definition change is certainly intended to broaden the number of entities that can be “financial institutions,” the Revised School Code does not define a “branch” for purposes of specifically determining whether an entity is a “financial institution.” Any questions about whether a particular out-of-state bank is operating as a “financial institution” for purposes of accepting public funds should be directed to the OFIS

Commissioner. Information about OFIS may be accessed via their website or by telephone at (517) 373-0220.²⁶

D. Limitations on Amount of Deposit

Even if an entity qualifies as a “financial institution” authorized to receive deposits of public funds, the amount of school district deposits the bank can receive may be restricted in accordance with the bank’s capital and unimpaired surplus. The Revised School Code provides that:

A bank whose combined capital and surplus exceeds \$50,000.00 may receive deposits of funds in an amount not more than double the combined capital and unimpaired surplus of the bank.²⁷

III. Policy Considerations

A. Generally

There is no “one size fits all” approach to investing school district funds. Not only do the needs of individual school districts vary, but needs change even within the same school district over time. Moreover, a school district’s level of sophistication may rise or fall depending on the knowledge and experience of individuals within the school district. Each school district should conduct an internal analysis of its business office’s ability to manage and oversee current or proposed investment functions. Based on this analysis, school districts may find themselves comfortable and competent to manage their own investments, or in need of assistance from one or more Investment Advisors.

Furthermore, while this document outlines various statutory requirements concerning school district investments, it does not address individual school district policies that may additionally govern investment options and procedures. School districts must review all applicable board policies prior to making investment decisions and ensure compliance therewith. School districts may choose, however, to revisit and modify investment policies. The intricacies of school district finance and investment may dictate review by legal counsel and/or an Investment Advisor.

B. Bidding Investments

School districts are not required under Michigan law to competitively bid individual investments; however, school districts may, and often do, seek bids as a matter of good public policy. In addition to assisting school districts in determining the best investments for their unique needs, competitive bidding helps to ensure that school districts will not unknowingly engage in “yield burning” practices (i.e., the purchase of a security, other than state and local government series securities, at below market yield) for bond proceeds subject to yield restrictions. If competitive bidding is pursued, school districts should strongly consider comparing bids within the various investment models, rather than collectively

among all investment models. As identified above, each investment model has unique attributes that make it difficult to perform a meaningful comprehensive comparison across investment models. It is far more effective to first determine which investment models suit the school district's individual investment goals, needs, and timelines, and to thereafter competitively compare attributes within each desired model. Following another course could lead to comparisons of "apples to oranges," and ultimately unnecessary or misleading confusion.

A school district's Investment Advisor, if any, can provide invaluable assistance in ascertaining the most appropriate and cost-effective investments. Selecting the best investments involves more than merely choosing those with the highest current yields. Again, the scope of assistance that may be given from an Investment Advisor will depend on whether the Investment Advisor is Registered Investment Advisor or an Exempt Investment Advisor.

C. Investment Advisor Options

Whether a Registered or Exempt Investment Advisor is preferable will necessarily depend on the individual circumstances, needs, and objectives of the investing school district. An Exempt Investment Advisor can provide advice on certain investments that school districts commonly utilize for bond proceeds. Nevertheless, Registered Investment Advisors are legally authorized to advise on all investment types that an Exempt Investment Advisor may consult upon, in addition to many others. If a school district feels that a broader analysis of its investment options is needed, a Registered Investment Advisor may be required. Further, since Registered Investment Advisors are subject to strict federal and state licensing requirements and regulatory oversight, school districts may feel that their investment advice is better suited from a Registered Investment Advisor.

1. Scope of Authorized Investment Advisor

The federal Investment Adviser Act ("Act") defines an "investment adviser"²⁸ as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ..."²⁹ The Act generally requires "investment advisers" to register with the Securities and Exchange Commission.³⁰ The Act goes on to state, however, that the following persons or entities are not considered "investment advisers":

a. a bank, or any bank holding company, as defined in the Bank Holding Company Act,³¹ which is not an investment company;

- b. any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession;
- c. any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore;
- d. the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation;
- e. any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest designated by the Secretary of the Treasury as exempted securities;³² or
- f. such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.³³

If a person or entity falls within one of the foregoing exceptions, that person or entity is not an "investment adviser" under the Act and, consequently, is not required to register under the Act. For example, the most notable exception for purposes of school district investments is found in Clause E, which excludes from the definition of "investment adviser" those persons or entities limiting their investment advice to certain U.S.-backed securities. One could provide investment advice on those U.S.-backed securities identified in Clause E without registering under the Act (i.e., an Exempt Investment Advisor); however, providing advice on any other securities³⁴ would require registration (i.e., a Registered Investment Advisor).³⁵ A flow chart, attached hereto as Attachment A, identifies many of the important distinctions between a Registered Investment Advisor and an Exempt Investment Advisor with respect to the exemption set forth in Clause E.

The definition of "investment adviser" provided in Michigan's Uniform Securities Act³⁶ is substantially the same as the definition provided in the Act.

School districts should be cognizant of an Exempt Investment Advisor's consulting limitations as some Exempt Investment Advisors may be unaware of applicable securities laws and could inadvertently give advice that can only be provided by a Registered Investment Advisor.³⁷ School districts are advised to consult legal counsel if they have any questions whether their Investment Advisors are subject to state and federal licensing and registration laws and, if so, whether they are complying with same. School districts

should also consider obtaining written confirmation from their Investment Advisors that they are in full compliance with all such applicable laws.

2. Additional Regulation of Registered Investment Advisors

Registration under the Act subjects Registered Investment Advisors to ethical and fiduciary obligations that may not be applicable to Exempt Investment Advisors. School officials may desire to use Registered Investment Advisors due to this increased regulatory oversight, including the following obligations and restrictions applicable to those registered under the Act:

- a. Registered Investment Advisors have a fiduciary obligation to place the interests of their clients ahead of their own interests.³⁸
- b. Registered Investment Advisors must prepare and provide to clients and prospective clients a registration form including information about the Registered Investment Advisor's business location, ownership structure, basic operations, past disciplinary events, fees, investment style, potential conflicts of interest, and brokerage practices.³⁹
- c. Registered Investment Advisors are required to maintain written policies and procedures to prevent trading based on material, non-public information.⁴⁰
- d. Registered Investment Advisors must adopt and enforce codes of ethics that establish standards of conduct and reflect the advisor's fiduciary duties. Clients of Registered Investment Advisors may request and view a copy of the code of ethics at any time.⁴¹ Registered Investment Advisors are also required to adopt and implement policies and procedures to prevent violations under the Act.⁴²
- e. Registered Investment Advisors must maintain various books and records relating to its business, including personal trading records of its employees.⁴³
- f. Registered Investment Advisors must notify clients when they experience an impaired financial situation or become involved in certain legal or disciplinary matters.⁴⁴

Several other requirements also apply to Registered Investment Advisors.⁴⁵ Exempt Investment Advisors are not mandated by the Act or the SEC to comply with these requirements; however, similar requirements may be applicable under common law or could be incorporated into advisory contracts. A flow chart, attached hereto as Attachment A, identifies many of the important regulatory oversight distinctions between a Registered Investment Advisor and an Exempt Investment Advisor.

3. Investment Advisor Agreements

Once a school district has settled on an Investment Advisor, it should enter into a contract that clearly delineates the services to be performed. A careful examination of the proposed services is necessary to ascertain whether the Investment Advisor (especially if an Exempt Investment Advisor) is legally capable of performing those services and to ensure that the school district is receiving the advisory assistance it desires.

For example, contracts with Investment Advisors may or may not include services relating to compliance with arbitrage restrictions. Given the important monetary and practical value of such services, if desired, it is important that the arbitrage services are described in the contract. Other important contractual provisions include ensuring that Michigan law governs the parties' relationship and identifying the Investment Advisor's standard of care. It is recommended that school districts have any proposed consulting contracts reviewed by legal counsel prior to execution.

D. Arbitrage

School districts issuing bonds must be cognizant of arbitrage restrictions that may limit yields on bond proceeds. Because interest on a municipal bond is exempt from federal income tax, investors will typically accept a lower rate of return to purchase the bonds. In essence, school districts receive a financial benefit of lower interest cost due to the federal government's decision to exempt interest from taxation. Restrictions have been placed on a school district's ability to acquire low-cost bond proceeds at the federal government's expense and to thereafter reinvest those proceeds in higher yielding ventures. Earning higher yields from the investment of low-cost bond proceeds triggers the law of arbitrage.

Arbitrage is the simultaneous purchase and sale of identical or equivalent securities, commodities, contracts, insurance or foreign exchange in order to profit from a price discrepancy.⁴⁶ Generally speaking, arbitrage is the practice of using a market imbalance to realize profits at little or no risk. The federal government places restrictions on the yield from bond proceed investments depending on the type of bond being issued. School districts should consult their bond counsel and/or Investment Advisor(s) to calculate and ensure compliance with exact arbitrage yield restrictions.

One method of staying below applicable yield restrictions would be to buy at an artificially inflated price or sell at an artificially reduced price in order to show a return that falls just within allowable levels. Of course, transactions at artificially-determined prices only mask the arbitrage issue. To prevent such transactions, the federal government requires that the purchase or sale of investments be conducted at "fair

market value,” adjusted to take into account qualified administrative costs which may be allocated to the investment.⁴⁷ Compliance with various safe harbor rules ensure that permissible “fair market value” transactions have occurred. Safe harbors generally regard trading on an established securities market, certificates of deposit, and sales according to minimum bidding requirements. For more information on arbitrage and applicable safe harbors, school districts should contact their bond counsel and/or Investment Advisor(s).

E. Conflicts of Interest

1. Dual Roles

As a matter of policy, school districts may wish to avoid perceived conflicts of interest even though they are not expressly prohibited by law. Particularly, school districts should be wary of parties acting in multiple capacities that could create the potential for self-interested decisions. For example, it may not be appropriate from a policy perspective to allow a person or entity to simultaneously act as an Investment Advisor and a custodian bank, or as an Investment Advisor and a bidder for financial services. The latter could raise many policy concerns, especially if the individual or entity is permitted to analyze bids and recommend contract awards, to selectively distribute requests for proposals, to access information not available to all bidders (such as revised architectural draw-down schedules), or to answer questions of prospective bidders.

2. School Personnel/Board Members

School districts should be aware of potential conflicts of interest when selecting an Investment Advisor to perform consulting services. School districts should pay particular attention to potential conflicts involving board members, administrators, and other employees. Subject to limited exceptions, Michigan law prevents soliciting, negotiating, or entering into contracts when a conflict of interest exists with a board member, officer, or employee.

Michigan’s Contracts of Public Servants with Public Entities Act states that a public servant, which broadly includes any person serving a public entity, shall not be a party, directly or indirectly, to any contract between himself or herself and the public entity of which he or she is an officer or employee.⁴⁸ A public servant is also prohibited from directly or indirectly soliciting, negotiating, or representing a party in any contract between the public entity of which he or she is an officer or employee and either himself or herself individually or certain other affiliated entities.⁴⁹

Limited exceptions to the conflict prohibitions apply to contracts between public entities, certain contracts awarded via competitive bidding, and contracts with public servants paid for no more than 25 hours per week if the conflict is disclosed and the contract is approved by at least 2/3 of the remaining board members.⁵⁰ School districts should address any specific concerns about conflicts of interest under this statute with legal counsel.

3. Intermediate School Districts

The Revised School Code requires each intermediate school board to adopt and implement a conflict of interest policy designed to avoid conflicts of interest by intermediate school district officials and employees.⁵¹ The Revised School Code also states that, subject to certain exceptions,⁵² if an ISD board member or administrator has a “substantial conflict of interest” in a proposed contract, the ISD board shall not enter into that contract.⁵³

The ISD reform legislation also seeks to avoid conflicts of interest by requiring any board member, administrator, or employee with authority to recommend, negotiate, or authorize the signing of a contract on behalf of an ISD to disclose whether he or she, or one of his or her family members, is either employed by, or under contract with, a business enterprise with which the ISD is considering entering into a contract.

IV. Recommended Information From Investment Advisors

School districts should obtain as much information as possible about potential Investment Advisors. The following is a list of questions that a school district may utilize as part of an RFI or otherwise to obtain this information:

1. Are you registered with the SEC? If yes, please state the date(s) your company and each individual that will be providing advice became licensed.
2. Are you operating under an exemption for SEC registration? If yes, please state the specific exemption and the authority you rely on for this exemption.
3. What is the legal name of your company?
4. What form of legal entity is your company?
5. Who are the principals and/or shareholders of your company?
6. How long has your company been in existence?
7. Who are the personnel that would be assigned the school district’s account?

8. Has your company or any of its principals, shareholders or employees ever been involved in litigation, arbitration or other legal disputes or regulatory proceedings, in the last ten (10) years? If yes, please explain the circumstances surrounding the dispute, the remedies sought, and how the dispute was resolved.
9. Do you have a recommended management approach and adequate financial controls? If yes, please explain.
10. What is the company's target market in terms of portfolio size?
11. What is the company's primary source of new clients?
12. Do you have a reference list? If so, please provide a copy.
13. Do you have insurance? If yes, please identify the amount of the insurance(s) and the name of the insurer(s).
14. How are the company's investment projections derived?
15. Does the company have investment in strategic planning philosophies? If yes, please explain.
16. Do you have a list of, and/or contact information for, similar type clients for which you have performed some or all of the services being proposed? If yes, please indicate the client name, contact information and services rendered.
17. Do you have any unusual expertise, experience, understanding or ability to perform the services proposed? If yes, please explain.
18. Have you received any recognition, awards and/or certifications? If yes, please explain.
19. Have any surveys been conducted relative to the company's performance, reputation and/or skill level? If yes, please provide a copy.
20. Do you have proposed fee and compensation schedules for the performance of the proposed services? If yes, please provide a copy.
21. Do you have a sample agreement? If yes, please provide a copy.
22. Are arbitrage services included as part of the fees being proposed?
23. If arbitrage services are provided, are they performed in-house or by a third-party? If by a third-party, please state the name of the third-party.
24. How often do you provide reports to your customers?
25. Do you have a non-discrimination policy? If yes, please provide a copy.
27. Do you have a conflicts of interest policy? If yes, please provide a copy.

Furthermore, state and federal registration agencies provide opportunities for investors to research a Registered Investment Advisor. For a detailed report on how to investigate a Registered Investment Advisor, visit the SEC's report entitled "Investment Advisers: What You Need to Know Before Choosing One," which is available online at <http://www.sec.gov/investor/pubs/invadvisers.htm>. No similar research tool is available for Exempt Investment Advisors.

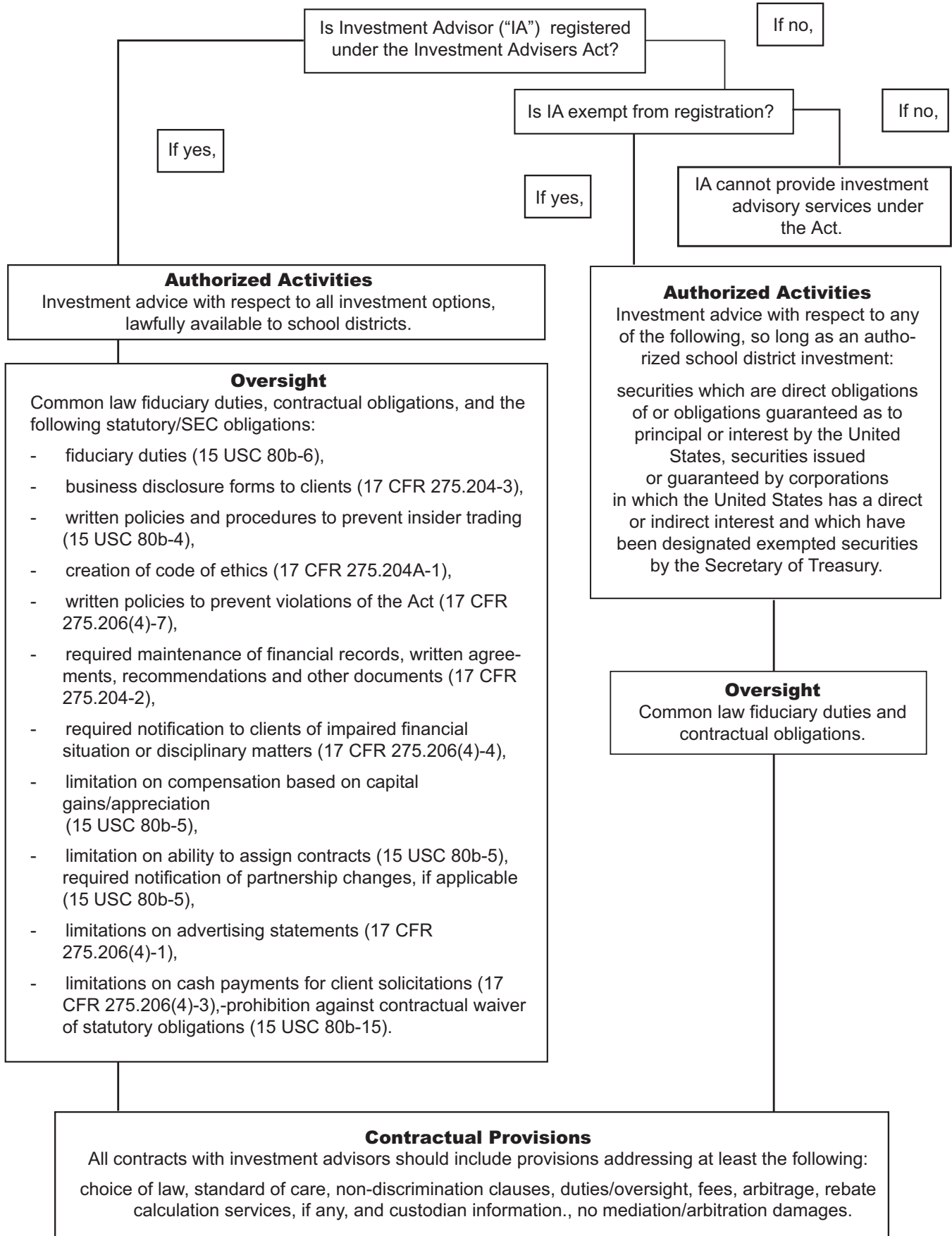
Endnotes

1. The federal Investment Advisers Act, 15 USC 80b-1, et seq., defines “investment adviser” to exclude those that limit investment advice to certain exempt areas (i.e., “Exempt Investment Advisers,” as that term is used in this document, are not “investment advisers” within the meaning of that statute). 15 USC 80b-2(11). In an effort to reduce confusion, this document refers to all professionals giving investment advice as “Investment Advisors,” and specifically identifies whether the Investment Advisor is “Registered” or “Exempt.”
2. Generally, a Flex Repo is a short-term investment vehicle whereby a provider sells government securities with a simultaneous obligation to buy back the securities with a fixed rate of interest at a fixed maturity date. A Flex Repo permits withdrawals (or the repurchase of the securities by the provider) for any purpose stated in the agreement and, accordingly, provides for a high rate of liquidity to meet fluctuating capital needs, such as modifications to construction draw-down schedules. Any remaining funds are returned on the final maturity date. Funds invested in Flex Repos are typically collateralized by the delivery of government securities to a third-party custodian valued in excess of the investment. In Michigan, school district investments must be secured by transferring title to and custody of collateral securities, and an undivided interest in such collateral securities must be pledged to the school district. Flex Repos should be competitively bid.
3. MCL 380.1223.
4. When an obligation is received by the school district’s treasurer, it must be deposited with the financial institution having the deposit of money of the particular fund from which the obligation was purchased. MCL 380.1223(2).
5. A certificate of deposit is a special type of deposit account whereby a fixed sum of money is deposited for a fixed period of time and a fixed rate of interest accrues at regular intervals. Principal and accrued interest is payable when the CD is redeemed; however, a penalty may apply if the CD is redeemed before maturity. CDs feature federal deposit insurance up to \$100,000.
6. Commercial paper is an unsecured, short-term debt that matures within two hundred seventy (270) days of the date it is purchased. Because commercial paper is unsecured (i.e., it is not protected by the ability to acquire specified assets in the event of default), commercial paper is typically issued only by major companies with sufficient credit ratings to pique market interest even in the absence of security. Rates of return on commercial paper tend to be conservative given the confidence afforded the issuing companies. Moreover, “rated prime” is not defined by federal or state statute; accordingly, it is recommended that the propriety of commercial paper investments be discussed and determined with the assistance of an Investment Advisor. School districts should consider developing standards and parameters to assist in due diligence investigations and determinations regarding the appropriateness of specific commercial paper investments.
7. The Surplus Funds Investment Pool Act (MCL 129.111, et. seq) sets forth certain requirements that school districts must follow when entering into a contract with a financial institution to place surplus funds in an investment pool. At a minimum the contract must include the following: (a) the minimum amount of money which may be deposited in the investment pool; (b) the procedure for the deposit and withdrawal of the money; (c) the amount of the fee for managing the investment pool, if a management fee is to be charged to the participant school district by the financial institution; and (d) the terms for distribution of earnings in excess of any management fee, and for the allocation of losses, to participant school districts, in a manner which equitably reflects the differing amounts of their respective investments and the differing periods of time for which such amounts were in custody of the investment pool. MCL 129.114. The Surplus Funds Investment Pool Act also requires that the depository (which signifies the department of the financial institution which is responsible for managing, investing, and reinvesting funds placed in an investment pool) shall maintain a separate account showing all deposits, earnings, withdrawals, or any fees paid. Each participant school district must receive a monthly statement and upon request be furnished with a report showing the investment holdings of the pool. MCL 129.115.
8. MCL 380.1223(1).
9. MCL 380.1223(3).
10. Id.
11. MCL 380.1223(3), (4).
12. Id.
13. MCL 380.1223(6).
14. MCL 21.146 prohibits state surplus funds from being deposited in a financial institution if the institution has committed illegal discriminatory lending practices as determined by a state or federal agency.
15. MCL 380.1223(5).
16. MCL 380.622.
17. As with general powers/first class school districts, intermediate school districts should utilize an Investment Advisor to help determine whether commercial paper is “rated prime.”
18. MCL 380.622(2).
19. MCL 380.622(3).
20. MCL 380.622(5).
21. MCL 21.146 prohibits state surplus funds from being deposited in a financial institution if they have committed illegal discriminatory lending practices.
22. Section 1221 of the Revised School Code states that, “The treasurer of a board of a school district or board of directors of a public school academy shall deposit the funds of the school district or public school academy in a financial institution or in a joint investment authorized by section 1223.” MCL 380.1221.
23. Section 622 of the Revised School Code provides that, “The intermediate school board shall select financial institutions for the deposit of school funds.” MCL 380.622.
24. MCL 380.622; MCL 380.1223.
25. MCL 380.622(7); MCL 380.1221(4).
26. The statutory amendments to the definition of “financial institution” were intended to conform with the federal Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub. L. No. 103-328, 108 STAT. 2338 (1994), which allowed the formation of larger banks with interstate branch networks by eliminating many geographic restrictions. The federal law sought to create more efficient banking and, ultimately, to enhance the competitiveness of U.S. banks both domestically and globally. 21 J. Legis. 255 (1995). The Riegle-Neal Interstate Banking and Branching Efficiency Act allowed states to “opt-in” or “opt-out” of interstate banking. Michigan chose to “opt-in.” Accordingly, the 1997 amendments to the Revised School Code and other state statutes were intended to remove potential conflicts between state and federal law with respect to the use of interstate branches located in Michigan for the deposit of public funds. It is now clear that school districts and intermediate school districts can deposit funds into financial institutions maintaining a branch office in Michigan, but having their principal office in another state.

While the Revised School Code does not define “branch” for purposes of determining whether a specific financial institution is a permitted custodian of public funds, Section 1201 of the Banking Code of 1999 broadly defines “branch” to mean, with various listed exceptions, “a branch bank, a branch office, branch agency, additional office, or a branch place of business at which deposits are received, checks paid, or money lent.” MCL 487.1201(j). The Banking Code of 1999 also provides that the Commissioner of the Office of Financial and Insurance Services (“OFIS”) has various rights concerning the authorization of bank branches in Michigan. MCL 487.13711. In particular, Section 13711 of the Banking Code of 1999 provides that:

- An out-of-state bank may apply to organize a branch in this state under this act by providing to the commissioner proof that its deposits are insured by an agency of the United States government. If the commissioner determines that the out-of-state bank is safe and sound, that the out-of-state bank is subject to regulation, and that there exists an agreement for exchange of supervisory information between the bureau and the out-of-state bank's regulator, the commissioner shall provide to the out-of-state bank a certificate of organization and eligibility to accept deposits and investments of public funds of the state and local units of government. MCL 487.13711(8).
- Any questions regarding the status of an out-of-state bank as a "financial institution" should be directed to the OFIS Commissioner.
27. MCL 380.1222.
 28. See, Endnote No. 1.
 29. 15 USC 80b-2(a)(11).
 30. 15 USC 80b-3.
 31. 12 USC 1841, et seq.
 32. Exempted securities are designated by the Secretary of the Treasury as exempt for purposes of the Securities and Exchange Act of 1934, 15 USC 78, et seq., in accordance with Section 3(a)(12) of that Act. 15 USC 78c(a)(12).
 33. 15 USC 80b-2(a)(11).
 34. A "security" is broadly defined under the Investment Advisers Act to mean "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing." 15 USC 80b-2(a)(18). The Supreme Court has noted that Congress' definition of "security" is "sufficiently broad to encompass virtually any instrument that might be sold as an investment." *Reves v Ernst & Young*, 494 US 56, 57 (1990).
 35. The Securities and Exchange Commission, Division of Investment Management: Staff Legal Bulletin No. 11 (200), further examines the circumstances under which an Investment Advisor must be registered.
 36. MCL 451.501 et seq.
 37. Applicability of Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as an Integral Component of Other Financially Related Services, SEC Release No. IA-1092, codified at 17 CFR 276 (1987).
 38. The Supreme Court in *SEC v Capital Gains Research Bureau, Inc*, 375 US 180, 191 (1963), states that the Investment Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship." (Emphasis added).
 39. 17 C.F.R. 275.204-3(a).
 40. 15 USC 80b-4.
 41. 17 C.F.R. 275.204A-1.
 42. 17 C.F.R. 275.206(4)-7.
 43. 17 C.F.R. 275.204-2.
 44. 17 C.F.R. 275.206(4)-4.
 45. For example, Investment Advisors are also regulated with respect to bookkeeping and record retention, performance-based fee structures, the assignment of advisory contracts, advertising, and client referral payments. 15 USC 80b-5; 17 C.F.R. 275.204-2; 17 C.F.R. 275.206(4)-1; 17 C.F.R. 275.206(4)-3.
 46. Black's Law Dictionary 31 (5th ed. 2003); see also 12 C.F.R. § 220.7 (2005).
 47. 26 C.F.R. 1.148-6(c) (2005).
 48. MCL 15.322.
 49. A public servant may not directly or indirectly solicit, negotiate, or represent a party in a contract between the public entity he or she serves and either: (1) himself or herself, (2) any firm, meaning a co-partnership or other unincorporated association, of which he or she is a partner, member, or employee, (3) any private corporation in which he or she is a stockholder owning more than 1% of the total outstanding stock of any class if the stock is not listed on a stock exchange, or stock with a present total market value in excess of \$25,000.00 if the stock is listed on a stock exchange or of which he or she is a director, officer, or employee, or (4) any trust of which he or she is a beneficiary or trustee. MCL 15.322(2), (3).
 50. MCL 15.323(1); MCL 15.324.
 51. MCL 380.634.
 52. A "substantial conflict of interest" does not exist in contracts between ISDs and any of the following: (1) a corporation in which the ISD board member or administrator is a stockholder or a beneficiary of a trust owning 1% or less of the total stock outstanding in any class if the stock is not listed on a stock exchange; or owns stock or is a beneficiary of a trust that owns stock that has a present market value of \$25,000 or less if the stock is listed on a stock exchange; (2) a professional limited liability company organized under the laws of the state of Michigan, if the ISD board member or administrator is an employee but not a member of the company; (3) corporations in which the ISD board member or administrator is not a partner, member or employee; (4) a firm, partnership, or other unincorporated association in which the ISD board member or administrator is not a partner, member or employee; (5) a corporation or firm that has an indebtedness owed to an ISD board member or administrator; and (6) the constituent school districts. *Id.*
 53. "Substantial conflict of interest" means a conflict of interest on the part of an ISD board member or administrator that "is of such substance as to induce action on his or her part to promote the contract for his or her own personal benefit."

Investment Advisor Flowchart



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