BEST PRACTICES REVIEW OF THE LGIP

Independent
advice for
the institutional
investor

June 2009

(This page left blank intentionally)

CONTENTS

(This page left blank intentionally)

Executive Summary of Recommendations

Based on our review of the Local Government Investment Pool (LGIP), as described on the following pages, we believe that the LGIP is managed and operated according to best practices for pools of its nature. We note that the LGIP is in line with, or compares favorably to, its peers, in virtually all areas. We also note that, based on information from the LGIP's investment manager (Federated Investors), the LGIP currently operates in a manner consistent with most or all of the best practices recommended by the Investment Company Institute (ICI) Money Market Fund Working Group, a group of industry leaders convened to address money market fund practices in light of the events of 2007 and 2008 (though it is not currently constrained to do so through its Investment Policy Guidelines).

Below, we present recommendations for enhancements in some elements of the LGIP's operation and management.

- Maintain the current "2(a)7-like" nature of the fund. We believe that, given the strict risk controls attendant in the current management practices of the LGIP, SEC registration (a very rare practice among the LGIP's peers) would add (yield-reducing) cost and complexity without corresponding significant gains to participants.

- Amend the LGIP's Investment Policy Guidelines to require compliance with the Investment Company Institute Money Market Working Group's recommendations as a matter of policy, not just current practice.

- Explore the possibility of expanding the lineup of pools available to participants. Currently one pool, with one attendant level of risk, is available to participants. The SBA might consider adding a second option which is restricted to government securities, and avoids all forms of credit risk, for participants who desire such an option.

- Arrange for Bank of New York Mellon, the LGIP's custodian and book of record, to calculate the yield on the LGIP based on the SEC's yield calculation rules. This includes having BNY Mellon calculate a 7-day yield to be posted to the LGIP's website in order for investors to be able to compare the LGIP yield to other like products.

- Consider extending the daily transaction deadline. The LGIP 11:00 AM ET deadline is relatively early compared with some peer and competing funds. If feasible, extending the transaction deadline to 1:00 PM ET or later would increase the convenience of participants. We understand that staff is currently working to change the transaction deadline by July 1, 2009 and therefore, has already adopted our recommendation.

- As a longer-term future consideration, explore using a third-party web interface for participant transactions. Currently a proprietary SBA system (SPLASH) is used. Federated's offerings in this area would be one candidate for consideration.

- Continue to improve the look and feel of the LGIP's website, which we understand is part of a current rebranding initiative. The LGIP website offers a wealth of information and disclosure, which we recognize as highly valuable. Streamlining the way this information is presented may help participants readily find the information they seek.

- Consider formalizing the process of monitoring communication (conference attendance, meetings, calls) between Federated and LGIP participants, to help evaluate their effectiveness and document any frequently arising issues.

- Change the primary benchmark from the gross S&P GIP benchmark to the corresponding net of fees benchmark given that the yield is calculated net of fees.

Comparison with Peer Funds[1]

We compared the LGIP's structure and practices with those of a broad group of peers (other LGIPs). We make the following broad observations about the characteristics of the LGIP. In general, we find that the LGIP is comparable or compares favorably to peers in nearly all areas.

- *Low Fees and Expenses:* Total effective fees are low by any measure, compared with pools of both similar and different structures.
- *Typical Structure:* Current structure (money market fund) is the most common among peers.
- *Risk-Controlled Investment Objective:* The LGIP operates under strict risk controls as a "2a-7-like" fund. Like the vast majority of similar funds, the LGIP is not registered with the SEC as a money market mutual fund.
- *Use of External Adviser:* The use of an external adviser, as does LGIP (Federated), is common among similar pools. While there are investment managers with a larger share of LGIP business, Federated is the adviser to other similar large pools (TexPool and TexPool *Prime*).
- *Highest Credit Rating:* The LGIP has a AAAm principal stability fund rating from S&P, a common circumstance among peers. A small minority of pools are rated by more than one agency.
- *Commonly-Used Custodian:* The LGIP's custodian, BNY Mellon, is commonly used among peer funds.
- *Reasonable Benchmark:* There is no universally accepted practice for benchmarking, but the S&P GIP benchmark used by the SBA is commonly used.
- *Relatively Early Transaction Deadline:* The LGIP's transaction deadline (11:00 AM) is relatively early compared to some peers.

[1] Comparative information provided by iMoney Net Special Report: Government Investment Pools: Investment Strategies, Facts, Figures, and Trends; February 2009

In the table below, we show a comparison of both performance and fees of the top 25 local government investment pools in the country, including the Florida LGIP, as of June 30, 2008. While the Florida LGIP falls on the lower end of the total return range, the LGIP's fee of 3.3 basis points also falls near the low end of the range of the fees that are charged by the country's largest local government investment pools. These fees range from less than a basis point to over 20 basis points. The lower return for the Florida LGIP was a result of a conscious investment management decision to keep the weighted average maturity extremely short over the past year due to uncertainty surrounding participant cash flows.

Name of Pool[2]	State	Assets ($ mm)	12 Mo. TR (%)	Total Fee (bps)
Local Agency Investment Fund	CA	$25,161	4.29%	0.70
TexPool	TX	19,071	4.05	4.85
State of New Jersey Cash Management Fund	NJ	18,800	4.10	10.00
Georgia Fund 1	GA	11,666	4.13	3.30
Utah Public Treasurers Investment Fund	UT	10,702	4.60	0.23
Local Government Investment Pool	TN	8,687	4.08	5.00
Mass Municipal Depository Trust-Cash Portfolio	MA	8,067	4.48	9.00
Local Government Investment Pool	WA	7,162	4.08	0.84
Local Government Surplus Funds Trust Fund	FL	7,050	3.92	3.32
State Treasury Asset Reserve of Ohio	OH	6,570	3.83	8.40
North Carolina Capital Management Trust: Cash Portfolio	NC	6,399	4.32	22.00
TexSTAR Cash Reserve Fund	TX	5,450	4.03	5.00
(Riverside) Treasurer's Pooled Investment Fund	CA	5,336	4.50	10.00
The Illinois Funds – Money Market Fund	IL	5,084	3.42	9.00
San Diego County Treasurer's Pooled Money Fund	CA	5,063	4.61	13.00
State Treasurer's Short-Term Investment Fund	CT	5,036	4.13	3.00
Local Gov't Investment Pool	OR	4,397	4.49	3.60
San Bernardino County Investment Pool	CA	4,335	4.53	5.00
King County Investment Pool	WA	4,100	4.35	15.00
Colotrust PLUS+	CO	4,069	--	16.10
Commonwealth of Virginia LGIP	VA	4,024	4.21	6.00
Local Gov't Investment Pool	WI	3,734	3.99	18.00
PFM Funds: Prime Series/SNAP Fund	VA	3,622	4.48	8.00
Arizona Pool 5 LGIP	AZ	3,218	4.06	6.00
Sacramento County Pooled Investment Fund	CA	3,103	--	10.00

[2] Data provided by iMoney Net Special Report: Government Investment Pools: Investment Strategies, Facts, Figures, and Trends; February 2009

Recommendations of the Investment Company Institute Money Market Working Group

In 2009, representatives of many leading participants in the money market fund industry convened in a working group to develop recommendations as to best practices for that industry. The impetus for the working group was the difficulties experienced by money market funds in conjunction with the market conditions of 2007 and 2008. The group's recommendations span numerous areas of money market fund operations and management, and include actions that could be taken by money market funds themselves as well as the SEC and other regulatory and governmental agencies. We understand that the funds and agencies are giving serious consideration to implementing many of the group's recommendations.

Based on our review of the group's comprehensive report, our knowledge of the LGIP, and a discussion with representatives of Federated regarding the matter, we believe that the current management practices of the LGIP are consistent with most or all of the working group's recommendations that could be acted on by money market funds themselves (as opposed to those which involve policies and actions of regulatory agencies.) We would note that this is a matter of practice, not policy: the LGIP's Investment Policy Guidelines do not require compliance with all of the Working Group's recommendations. As discussed in the next section, we recommend that compliance with the Working Group's recommendations be written into the LGIP's Investment Policy Guidelines.

We believe that compliance in practice is a positive state of affairs, and we recommend that the SBA continue to operate in a manner consistent with the recommendations. We recommend that the SBA consider incorporating some or all of the recommendations in the LGIP statement of investment policy. We list these in more detail on the following page.

Investment Guidelines

In November 2008, EnnisKnupp completed a review of the investment guidelines for the Local Government Investment Pool (LGIP). While the majority of the rules set out in the investment guidelines are more conservative than those suggested by the SEC's Rule 2a-7, we did make a few recommendations to ensure that risk would be appropriately mitigated. Below are the recommendations from the 2008 investment guideline review of the LGIP, which we believe follows best practices with regards to conservative guidelines for money market funds.

- VI. Investment Strategies: We suggest specifying the rating category separately for short-term (i.e. commercial paper) and longer-term obligations.
- VI. Investment Strategies: The maximum exposure to a single industry sector should be explicitly stated instead of stating that the manager will "generally limit exposure".
- VI. Investment Strategies: The IPS states a limit of not more than 25% to a single industry sector; however, investing in the financial services sector is an exception to this limit. The IPS should specify the reason for the investment manager to be able to invest more than 25%.
- VIII. Principal Risks Associated with the LGIP. Interest Rate Risks: Specific maturity limits should be set for single securities.
- VIII. Principal Risks Associated with the LGIP. Credit Risks: The IPS should set exposure limits to single issuers such as no more than 5% can be invested in a single issuer.
- IX. Controls and Escalation Procedures: We suggest that the IPS include more detail on the membership of the Investment Oversight Group.
- Appendix A. Special Transactions. Delayed Delivery Transactions: This type of special transaction is concerning to us and is not standard in our experience for this type of investment fund.

In addition, the Investment Company Institute Money Market Working Group has proposed some changes to investment guidelines of 2a-7 registered money market funds. While we note that the LGIP is in compliance with most of these guidelines in practice through Federated's conservative investment management process, we also propose that these additional guidelines be incorporated into the investment policy statement.

- Minimum of 5% of the assets should be held in securities accessible within one day.
- Minimum of 20% of the assets should be held in securities accessible within seven days.
- The SBA should regularly stress test the LGIP to assess the portfolio's ability to meet levels of credit risk, shareholder redemptions, and interest rate changes.
- Weighted average maturity limit of 75 days.
- Spread weighted average maturity should not exceed 120 days.
- Require the SBA to post monthly website disclosures of client concentration levels by type of client.
- Note that the SBA expects Federated's credit committee to specifically analyze new structures prior to them being invested in by the LGIP.
- Note that the SBA expects that Federated will consider and, when appropriate, follow best practices in connection with minimal credit risk determination.

(This page left blank intentionally)

Communications

Communication with participants, both existing and prospective, is an important and critical part of the services provided by local government investment pools (pools). Prospective participants need access to information to determine if investing in a pool is appropriate for them and existing participants need access to their account information in order to manage their liquidity, understand the yield they are earning, and generally track purchase and redemption activity. All parties, including the general public, ought to be provided access to general information, including a pool's governance and oversight structure, as transparency is important in building public trust. Additionally, participants need to have opportunities to provide feedback on the services provided and be informed of their rights.

The SBA recognizes the importance of adopting and adhering to prudent communications and governance policies and practices as it relates to the LGIP and has made significant legislative and operational efforts to better communicate with current participants, prospective participants, and the general public.

All relevant information, including LGIP performance, applicable statutes and rules, investment policy, enrollment information, orientation material for PLGAC, and meeting information for both PLGAC and IAC, is available to all participants and the general public on the LGIP website. We believe this practice to be consistent with best practices and one that builds transparency.

Legislative Changes

Due to the 2007 liquidity issues, legislative changes were passed in 2008 that impacted many of the LGIP's policies and procedures, including those related to communication and governance. Previously, the Board, along with the Executive Director and the Investment Advisory Council (IAC), were the key parties involved in the decision-making process for the LGIP. The IAC's role continues to be to make recommendations to the Board on investment related issues affecting the LGIP. A similarly dedicated entity did not exist to address the various administrative issues, including communication with participants, for the LGIP. In addition, there were not policies or procedures in place that dictated the manner with which or how frequently to communicate with participants in the LGIP. We describe two key changes that were made in 2008 to remedy these issues.

Participant Local Government Advisory Council

One major initiative created the six-member Participant Local Government Advisory Council (PLGAC). Its main purpose is to make recommendations on administrative issues related to the LGIP. The PLGAC's members are appointed by the Board and confirmed by the Senate and have to "possess special knowledge, experience, and familiarity obtained through active, long-standing, and material participation in the dealings of the trust fund."[3] We strongly support this governance change as a significant step toward improving services to the participants.

Having the PLGAC is consistent with the best practices of having both investment and administrative aspects of an LGIP addressed by a high-level governing body, either directly by the board or indirectly through an advisory council. Since the LGIP's Board is composed of the Governor, Chief Financial Officer, and Attorney General and each Board

---

[3] Florida State Board of Administration, Participant Local Government Advisory Council Member Handbook, Section II: PLGAC Draft Operating Procedures, February 2009.

member has other significant responsibilities that demand their time, we find that having councils vet certain issues and make recommendations is useful and prudent.

Since PLGAC was created, one meeting has taken place and the next meeting is scheduled for June 18th. The first meeting was a detailed orientation. We reviewed the material provided to the PLGAC and found it to be comprehensive. We commend the LGIP staff for their effort to provide education to the PLGAC and for exhibiting best practices in this regard. It is our understanding that the PLGAC will be defining its roles and responsibilities in more detail and prioritizing administrative issues in the next few meetings. A facilitated session could be helpful in setting priorities. This session can be led by a neutral outside party (such as a consultant) or SBA human resources staff to strategically brainstorm about the role and functions of the PLGAC. After the functions that are under the purview of the PLGAC are solidified, the group can prioritize the issues it would like to address in the upcoming meetings through consensus.

If the PLGAC decided to create a detailed list of its responsibilities in conjunction with the Board, monitoring and assessing the quality and appropriateness of communications to prospective and existing participants could be one of the duties listed. In our experience, some funds also adopt communications policy as a means to provide appropriate and consistent information to relevant parties and show their commitment to adhering to best practices.

Investment Policy Guidelines

In addition to the creation of the PLGAC, the Investment Policy Guidelines were updated and improved, along with other policies and procedures, including those related to communications.

The SBA articulates its commitment to providing “clear up-front communication”[4] to prospective and existing participants in the LGIP, ensuring transparency, and adhering to best practices. The recent legislative changes that were proposed in Senate Bill 2422 include provisions related to each of these goals in the form of mandatory enrollment materials to communicate risks and rights to prospective participants, mandatory disclosure statement to ensure transparency, and annual best-practice certification to address best practices.

Enrollment of Prospective Participants

As a means to better communicate the objectives and risks of the LGIP to prospective participants, the law now requires that they receive “a fund profile containing impartial educational information describing the administration and investment management of the fund, including but not limited to: rights and conditions of participants; investment policy; historical performance; holdings information; administrative rules; any fees, charges, or deductions that apply; recently published financial statements; and a disclosure statement for signature by the appropriate local government official.”[5]

To adhere to this requirement, the LGIP provides prospective participants: a 32-page new participant enrollment guide; operating procedures statement; audited financial statements; historical performance; expense analysis; apportionment subsystem description; Florida governing statutes for the LGIP; and Florida governing rules for the LGIP. A disclosure statement and an authorizing resolution are also provided to the prospective participants and

[4] Florida Local Government Investment Pool Newsletter, Q2 2008
[5] Florida Local Government Investment Pool Newsletter, Q2 2008

have to be signed by the authorized person to acknowledge receipt. Together, these forms explain the investment objectives and risks multiple times and are overall, extremely comprehensive.

The purpose of providing these mandatory documents to prospective participants is not just to fulfill a legal requirement, but also to ensure the participants actually understand the risks involved and their rights as participants. It is difficult to assess how many participants read all the documents provided to them and to what degree they understand the terms; and although contact information for a person at the LGIP is provided, most participants complete the enrollment process via the website or by mail, without much in-person or telephone contact. This enrollment method is similar to other LGIPs.

It is our understanding that the new enrollment process with the mandatory documents is only applicable to the new participants. Although the SBA has not made it mandatory for existing participants to fulfill the same protocol, it will consider it once Fund B is closed. In the meantime, we suggest that the SBA proactively send current participants the various fund documents to ensure that all participants have been apprised of fund risks and other characteristics.

Communication with Current Participants

Once enrolled, participants receive comprehensive monthly summary reports, which contain beginning and ending balance, interest, expenses, withdrawals, and deposits for the LGIP as a whole. These reports also include information on upcoming participant outreach events and other meetings. They highlight significant issues, performance, and investment holdings as well as detailed information on compliance with Investment Policy guidelines. Participants also have virtual 24/7 access to daily information through the Florida State Board of Administration's website dedicated to the LGIP and their own individual account information through a secured website. In addition, each participant receives an audited, monthly statement that lists any purchases, redemptions, expense payments, or interest payments made during the month. This statement also reflects the yield the participant earned on their investment during the month. The information provided to participants complies with best practices. Participants can also contact the LGIP staff with inquires via telephone between 7:30 a.m. and 4:30 p.m. ET, Monday through Friday. The majority of the participants choose to get their information from the website, but a few do call. On June 1, 2009, staff implemented a new process that tracks the frequency and results of the calls and documents the issues participants call about. We believe tracking prospective and existing participants' inquires helps to measure and improve customer service.

Communication from Federated Investment Management

The LGIP's investment manager, Federated, also plays a key role in communicating with the participants. There is an individual at Federated, called the Participant Consultant, who is solely dedicated to direct participant communication for the LGIP. This individual is responsible for contacting the current participants on a regular basis, promoting the LGIP through attendance at local conferences and seminars, and in-person meetings with both current and prospective clients. The Participant Consultant is also responsible for understanding the cash flow needs of the participants and communicating this regularly to the portfolio manager with the intention to more efficiently and appropriately manage liquidity in the LGIP throughout the year. In addition to one-on-one communication and conference attendance, Federated also holds quarterly conference calls at which the participants can communicate with and ask questions of Federated's Chief Investment Officer. These calls have been well attended and have provided a forum wherein participants are able to ask critical questions related to the LGIP and voice concerns. We are encouraged by the steps being taken by Federated to increase communication to the participants and feel that these actions are appropriate and meaningful in SBA's efforts to not only retain current participants, but also to gain additional participants. Similarly to what the SBA has recently implemented, we suggest that Federated also log the questions and concerns voiced by participants on the periodic calls and in separate meetings.

During Federated's quarterly meetings and calls, SBA staff is also present. This serves as an informal means of monitoring and assessing information provided by Federated. We recommend formalizing this monitoring process, codifying it in policy, and presenting findings to the PLGAC on a periodic basis. Recording the meeting attendance and frequently asked questions can also help in evaluating the effectiveness of the meetings.

In 2008, a survey of participants was conducted to assess liquidity needs, preferred method and frequency of communications, and overall confidence in the LGIP, among other aspects. Although the sample size of the survey was too small to draw any statistically significant conclusions about participants' liquidity needs, it was valuable in generating feedback from participants. Periodic surveying of participants, and even former participants, can be of great benefit to the LGIP in retaining existing participants and determining ways to re-enroll former participants. In our experience, some LGIPs also assess liquidity needs of their larger participants on a periodic basis since their withdrawal can have the greatest impact on liquidity.

In addition to the communication efforts similar to those provided by Federated, some funds have other practices built in to their governance procedures. Participants of some pools have the authority to call special meetings with a certain percent of the votes from the participant base. This practice is usually in place at pools where the participants vote some or all of the board or council members and is seen as a good way to elicit participant feedback.

Recordkeeping

The LGIP's recordkeeping practices provide an important service to participants. We have investigated the adequacy of the LGIP recordkeeping practices, specifically focusing on the ability to provide participants with accurate and timely recordkeeping services. A secondary consideration was the ability to provide participants with tools and procedures that allow them to conveniently make required transactions. Overall, we feel that the process is robust, the systems sound and efficient for SBA's purposes, and that participants are supplied with a user-friendly interface to enter transactions and check balances.

Systems Capabilities

The LGIP uses two systems for providing recordkeeping services to participants, SPLASH and Eagle STAR. The SPLASH system is the system for daily participant transactions and is maintained internally by SBA technology staff. Eagle STAR is the primary accounting system that interfaces with BNY Mellon, the LGIP's custodian.

SPLASH

SPLASH is the internally developed system that staff relies on to track and monitor daily transactions by participants. This system includes an internet interface which allows participants to transact individually and monitor account activity. We find that the participant demands on the SPLASH system are somewhat light. The range of transactions that participants utilize is not large; typically deposits, withdrawal requests, and balance inquiries. The daily transaction volume is also low at approximately 100 transactions with a dollar value in the range of $10 to $40 million. Historically, the IT department has been responsive to changes in the operation of the LGIP and have been able to adapt the system quickly to these changes. In addition, the SPLASH system is currently undergoing a significant upgrade. The SPLASH system is also backed up daily to servers provided by the State of Florida for government agencies. This is favorable as daily system back-up is standard and important for all critical information systems. For the LGIP's current purposes, it appears that SPLASH operates with a high degree of accuracy and serves the needs of the participants well.

Eagle STAR

Eagle STAR is used for participant income accrual and monthly comprehensive reporting. This system is commercially supported by Eagle Investment Solution, a subsidiary of BNY Mellon since 2007. Given that Eagle STAR is a commercial system, it is supported by professional programmers and a sophisticated technology staff that completes regular upgrades, as deemed necessary. In addition, the SBA technology staff works closely and frequently with Eagle Investment to provide necessary systems upgrades that are relevant to SBA's specific needs. This system is operated by a BNY Mellon affiliate and receives a high degree of attention given its widespread use across the financial industry. In addition, the monetary support it receives as well as the number and quality of professionals that attend to the system on a daily basis is favorable.

Accounting

We believe ensuring accuracy in participant transactions and integrity of the accounting records is the most important role of the LGIP recordkeeping practices. Staff reported multiple steps are taken on a daily basis to ensure the accuracy of participant transactions.

Staff members manually reconcile total SPLASH transactions, both deposits and withdrawals, to the bank reports at the end of each business day. Any discrepancy between the SPLASH transaction and transactions posted to the Eagle System would be identified via the reconciliation.

At the end of each month, prior to distribution of earnings and fees, additional reconciliation of total cost basis and transactions is performed. Staff reports that participants are also involved in quality control by examining their monthly statements and reporting issues. Staff reports a low volume of participant reported issues for review.

Summary

We believe the recordkeeping practices used by LGIP are adequate in the primary function of providing participants with accurate reports and timely service. Based on our discussions with staff we are satisfied with the accuracy of the systems, manual procedures in place to ensure error-free reconciliations, and high level of participant satisfaction based on the low number of complaints that are filed.

Custodian

The Bank of New York Mellon (BNY Mellon) provides standard custody services for the LGIP. BNY Mellon prices the account daily and performs a detailed reconciliation with the investment advisor, Federated. In addition, BNY Mellon calculates a cost-based return and total return for the LGIP on a monthly basis. Based on our knowledge and experience with BNY Mellon, we feel that this is a fully capable custodian for the LGIP given its current needs.

Custody Capabilities

BNY Mellon is one of the industry's largest custodians with $20 trillion assets under custody and more than 2,400 U.S.-based custody clients. Greater assets allow custodians to benefit from economies of scale and function more efficiently than smaller firms. Further, banks with larger custody businesses accrue more experience and tend to maintain state-of-the-art operations, which is important as the custody business has become an increasingly technology-driven business. Also, organizations that derive a significant portion of their revenues from the custody business are likely to be more stable and make the necessary investments to remain competitive. BNY Mellon derives approximately 60% of its total bank revenue from its securities services business, which includes the custody business. This amount is significant and indicates a greater level of stability due to the bank's overall reliance on this business for its total revenues. We describe BNY Mellon's capabilities in some of the key areas of service that a custodian provides.

Client Service

A custodian should have sufficient experience and expertise with particular client types (e.g. public funds, corporate funds, endowments, etc.) to be able to meet their specialized needs. BNY Mellon has $1.3 trillion total public fund assets, which represents 15% of total U.S. custody assets. BNY Mellon has 182 U.S. based public fund clients.
The single most important factor in determining the level of client satisfaction is the quality of the people assigned to the custody relationship. At BNY Mellon each Relationship Manager has an average of seven clients. The average Relationship Manager has between 18 and 22 years of custody experience, which is high relative to some of BNY Mellon's competitors. The BNY Mellon Relationship Manager for SBA has 24 years of custody experience, complimented by an on-site (Tallahassee) Client Service Officer with 14 years experience. Based on our experience and our client's BNY Mellon consistently delivers high quality client service, which is a key differentiator for them among their peers.

Securities Processing

Securities processing services involve a wide range of transaction, information, reconciliation, and funds movement processing. With increased automation and technological advancement, these services have become fairly generic in nature among the industry's leading custodians. BNY Mellon is a member of the Depository Trust and Clearing Corporation (DTCC) and the Federal Reserve Bank Book Entry System (FBE), as well as a participant in leading depositories abroad. In addition, BNY Mellon has sufficient processes in place to ensure timely receipt of information relating to corporate actions, such as tender offers, exchange offers, etc.

Systems/Data Processing

Institutional custody is primarily a technology-based business. A combination of shrinking profit margins and rapid advances in technology are challenging custodians to increase the volume of their business and to spend substantial amounts on technology maintenance and development each year. BNY Mellon's internally-developed Custody Management System (CMS) is dedicated solely to the bank's custody business. To ensure proper maintenance and reduce downtime of CMS, BNY Mellon has a committed staff of 2,000 employees for the system. Roughly 20% of the custodian's expenses are dedicated to technology.

Accounting/Reporting

The accounting and reporting function is one of the most important services provided by a custodian. It is essential that custodians determine and maintain accurate asset and transaction data and possess the ability to efficiently deliver this information to clients. BNY Mellon offers a sophisticated online reporting system to their clients that provides information on all aspects of an investment program or individual portfolio. The reporting system is logical and user-friendly and provides relevant, real-time data to clients.

Performance Reporting Capabilities

In general, BNY Mellon reports performance measurement data on at least a monthly basis and, in addition, provides clients with the ability to view unaudited data on a daily basis. This is generally consistent with the performance data that they provide to the LGIP. Performance measurement data is accessible to clients via an online system and is available three to five days after the accounting deadline. BNY Mellon has approximately 1,800 clients that utilize their performance measurement services, which is high relative to their competitors and suggests great depth of experience.

We do note, however, that should the SBA decide to change the method of calculating performance from a monthly calculation to a calculation that is more consistent with the current SEC regulation for 2a-7 registered money market funds, the LGIP would most likely need to be moved to another accounting system in order to accommodate this calculation (more information on the recommendation to change the yield calculation is included in the *Accounting* section of the report). While the legacy Mellon system does not currently have this functionality, fortunately, the legacy Bank of New York's (BoNY's) system does have the capability to produce a 2a-7 yield calculation, which legacy BoNY has historically provided to a large number of mutual fund companies and bank collective funds with custody and performance reporting services. Therefore, we continue to be comfortable with the BNY Mellon organization as the best choice to provide performance reporting for the LGIP.

Summary

BNY Mellon is one of the largest custodians in the industry today, with significant industry experience. They have a large number of U.S.-based clients and assets, including a considerable client base of public funds. BNY Mellon provides standard services for the LGIP and has the capability of ensuring accurate accounting, reporting, pricing, reconciliation, and performance measurement.

Organizational

Federated is well-known in the asset management industry for its focus on managing money market mutual funds. Founded in 1955, Federated began managing money market mutual funds in 1973, and the strategies now comprise 87% of its firm-wide assets under management. Federated manages over $407 billion in assets with approximately $356 billion of those assets in money market funds. Of the 45 domestic money market funds managed by Federated, 10 are Prime, 13 Government, and 22 Tax-Free.

Federated Investors, Inc. is a Registered Investment Advisor based in Pittsburgh, PA whose sole line of business is investment management. The Class A shares, which are voting shares, are privately held by co-founder, Director and Chairman John Donahue and his family. The Class B shares are publicly-traded (NYSE: FII) and are non-voting shares. There have been no material changes to the firm's ownership structure since its Class B shares went public in 1998.

Federated was instrumental in helping the SEC write the 2a-7 guidelines for registered money market funds. In addition, Federated placed two representatives on the Investment Company Institute Money Market Working Group and has had influence in the suggested changes to the management and regulation of money market funds that are being presented to the SEC.

Investment Team

Deborah Cunningham is the CIO for Federated's money market investment team. Ms. Cunningham's team consists of 38 investment professionals dedicated to cash: 11 portfolio managers, 13 analysts, and 14 traders. Of those 38 professionals, 18 are dedicated to taxable money market funds and stable value products: 4 portfolio managers, 6 analysts, and 8 traders. Federated feels strongly that the credit analysts, portfolio managers, and traders should have separate roles in the portfolio management process to ensure that each individual remains focused on one clear objective. The team is both experienced and long-tenured at Federated. Typically, an investment employee will begin his or her career as a credit analyst and eventually move into the role of a portfolio manager.

Investment Strategy

Federated's investment strategy emphasizes, in the following order of importance, preservation of capital, liquidity, and yield. Federated employs a conservative, bottom-up approach to managing its money market mutual funds. The manager de-emphasizes making investment decisions it considers "speculative," such as duration, yield curve, and sector rotation. The manager instead attempts to add value through security selection that is grounded in credit research. Federated tends to avoid purchasing complex instruments such as structured investment vehicles (SIVs). Federated manages their money market funds using a barbell approach wherein the manager holds securities at the short-end and longer-end of the yield curve. The front-end (0-7 days) makes up 30-40% of the portfolio and is comprised of repurchase agreements, time deposits, and variable rate instruments. Federated invests in commercial paper, bank instruments, asset-backed securities, and corporate notes on the longer-end (~90-397 days) of the portfolio. The portfolio managers generally avoid one- to three-month commercial paper (middle end of the yield curve) as they believe this to be the most expensive part of the curve given the large number of investors buying in this space. Instead, they focus on investing in longer-dated variable demand notes, which have a put feature that allows them to sell the asset back to the issuer at specific reset dates, and other assets that they deem to have both value and, importantly, minimal credit risk.

Investment Process

Federated's portfolio managers, traders, and credit analysts all play a key role in the investment process. The portfolio managers are primarily responsible for developing portfolio structure and constraints. The traders make the individual security selection and seek to find relative value opportunities while staying within the limits set by the portfolio managers and the credit analysts.

The credit team is made up of six credit analysts that are solely dedicated to the taxable money market strategies. The analysts are organized by industry type and conduct extensive analysis on issuers by reviewing financial statements, talking to Treasurers and CFOs, gaining insight from other industry analysts, and information from rating agencies. Each credit is rated based on Federated's scale of 1-5 and is brought for approval to the Bank Credit or Corporate Credit Committee. Once approved, the credit analyst sets limits for the portfolio managers such as the allowable maturity, overall exposure to a name, and overall exposure to each issue. This allows the credit analyst to further assert their view on each particular credit. In addition, this process is central to Federated's risk management process that revolves around minimizing default risk through credit research.

Compliance

Federated's compliance process is largely automated and utilizes a proprietary system called FedPorts. The various portfolio constraints that are set by Rule 2a-7, portfolio investment guidelines, and Federated's credit analysts are entered into the system. FedPorts then constrains the traders on a pre-trade basis from executing any trades that would cause a violation of these various rules. Specific procedures are in place that the traders follow based on whether they receive a "warning", "fail", or "stop exception". The compliance team at Federated also reviews these exceptions on a daily basis and investigates further when warranted. In addition, the compliance team prepares a monthly report for the SBA that shows, on a post-trade basis, whether any violations occurred during the month and, if there was a fail, why it occurred.

Conclusion

We have a favorable opinion of Federated's capabilities in managing money market strategies. Federated's investment process is comprehensive and also straightforward in nature. We view this favorably as they select securities for which they can completely understand the structure and risks. They do not seek to add yield by investing in complex structures where they do not receive complete transparency into the bond's structure or underlying collateral. In addition, their credit research process is robust and their credit selection conservative, which served them well in late 2008 as they avoided exposure to the various impaired securities (i.e. Lehman) and other troubled assets that hurt money market funds during the fourth quarter of 2008. Paige Wilhelm, lead portfolio manager for the LGIP, whom we interviewed at our onsite in Pittsburgh, appeared extremely knowledgeable about the various aspects of the money market space and was also able to clearly articulate Federated's investment process. In addition, the risk management focus and compliance procedures are robust and comprehensive. We believe Federated's approach to managing money market products is absolutely focused on principal protection rather than looking to aggressively seek higher yield. Federated is focused on relative value within the primary constraints of principal protection and liquidity management.

Lastly, we note Federated's keen focus on delivering high touch client service to participants. Not only does Federated have a team dedicated to communicating with participants directly, the LGIP has been assigned its own Participant Consultant whose sole responsibility is to communicate directly with the LGIP's current and prospective participants. For these various reasons, we support the use of Federated to manage the LGIP.

(This page left blank intentionally)

Compliance

Currently the investment policy statement for the LGIP states that the “Executive Director will organize an Investment Oversight Group to regularly review, document, and formally escalate compliance exceptions and events that may have a material impact on the LGIP.” In compliance with this policy, the Investment Oversight Group meets on a monthly basis and is composed of the following individuals:

Name	Title
Kevin SigRist	Deputy Executive Director
Robert Smith	Senior Investment Officer for Fixed Income
Sheilah Smith	Fixed Income Compliance Officer
Long Yang	Manager of Enterprise Risk Management & Compliance

Responsibilities

The group is responsible for reviewing the monthly compliance reports that are compiled by Federated and making recommendations to the Executive Director if exceptions arise. At each meeting the compliance report is presented and any compliance violations are reviewed. In addition, the group discusses other updates or any process improvements they think could be undertaken related to the compliance monitoring aspect of the LGIP.

If compliance exceptions exist, the Investment Oversight Group receives a recommendation from the investment manager, Federated, and then makes a recommendation to the Executive Director. The Executive Director makes the final decision on what action should be taken with regards to the compliance exception. The group also meets on an ad-hoc basis if a violation occurs that needs to be addressed outside of the monthly meetings.

Reporting

The compliance reports delivered to the Investment Oversight Group are comprehensive in nature and qualitatively state the investment guideline, the guideline’s numerical limit, the actual limit at month-end, and whether the portfolio passed or failed the test. For any that fail the test, a full explanation is provided within the report explaining the violation. In addition, supplemental details are provided even on those that are shown to have passed the violation at time of purchase, but may have been over the numerical limit at the time of the report.

At each meeting, the entire process including the discussions had by the Investment Oversight Group and the Executive Director, are recorded in the meeting minutes, which are subsequently posted to the LGIP’s website and included in the monthly management summary that is sent to the Board of Trustees.

Conclusion

We view the establishment of the Investment Oversight Group favorably, as it is separate and distinct from the investment manager that is responsible for reviewing and monitoring compliance of the LGIP with its investment guidelines. In addition, the escalation process is well structured and well defined. We also note that Federated's reports are comprehensive and provide sufficient information for the Investment Oversight Group to adequately assess the portfolio's compliance with its guidelines. We support the current process that is in place and believe it to be in line with best practices for similar investment portfolios.

Accounting

Yield Calculation

According to policy, the internal staff at SBA calculates three yields on the LGIP: the participant yield, a daily yield, and the 30-day average yield. The participant yield is calculated each month based on the participants' earned income and the participants' average daily balance for the month net of administrative charges. The daily yield is based on daily accrued earnings and that day's investment balance at cost. In addition, SBA posts the 30-day average yield, which is calculated daily on a two-day lag, on the LGIP's website. This yield is calculated based on the cumulative daily accrued earnings and the average daily investment balance at cost of the 30 previous days.

While these calculations are not inaccurate, best practice for money market funds is to calculate the yield based upon the methodology described in SEC 2a-7 FORM N-1A. In addition, registered 2a-7 funds calculate a 7-day yield, which ensures that direct performance comparisons can be made across multiple funds. The SEC's yield calculation is more accurate than the SBA's current calculation, which, as explained, is currently based on an average monthly balance and is calculated based on 30 days instead of 7.

In keeping with best practices, we recommend that the SBA calculate yields based upon the methodology described in FORM N-1A and post a 7-day yield on the LGIP website to allow current and prospective participants to compare the LGIP's performance to other money market fund products. In addition, we recommend BNY Mellon, the custodian and book of record for the LGIP, calculate yields based upon this same methodology. In discussions with BNY Mellon thus far, they have indicated that this should not come at much, if any, additional cost to the SBA and will more fully automate the process.

Treatment of Realized Gains and Losses

Treatment by the SBA

The Realized Gain/Loss Allocation Policy for the LGIP specifies the various practices that should be followed with respect to the treatment of realized gains and losses from selling securities prior to maturity or from defaults. Within the recordkeeping system, the SBA maintains a Gain/Loss Participant account wherein all realized gains and losses are held. The proposed policy specifies that at the end of each month, if there is a net gain, the portfolio manager may choose to hold the gain until the end of the fiscal year, when it will be distributed to participants. If there is a net realized loss the portfolio manager may decide to retain the net loss for up to eight years and offset this by gains. On an annual basis the portfolio manager will assess the net gain or loss in the Gain/Loss Participant account and either distribute net gains to participants, offset a net loss with the Reserve Account, or distribute a net loss to participants if the Reserve Account balance is insufficient to cover the net loss.

The Reserve Account has been in existence for many years and has been funded using a variety of methods. However, there has not been a clear policy as to how to maintain, fund, or manage the Reserve Account. We note that the SBA staff is currently working to formalize an investment policy statement for the Reserve Account that will be brought forward in the near future.

SEC Guidelines

Registered 2a-7 funds follow the guidelines set forth by the SEC, and applicable tax regulations, in determining how to account for realized gains and losses in taxable money market funds. Generally, registered funds net realized losses against realized gains. If there is not enough realized gain to offset the loss, then the investment manager has eight years to offset that realized loss with realized gains. If, after eight years, there have not been sufficient gains to offset the loss, then either the participants bear that loss or the fund manager has to make the portfolio whole. This same process applies to gains, which can also be carried forward over eight years. This process helps to smooth out any large gains or losses that may occur.

Based on discussions with money market fund managers, it appears that these net gains and losses are tracked during the year and then after 12 months, the investment manager, based on the size of the net gain or loss, decides whether to adjust the yield or take eight years to offset. This decision is at the discretion of the manager as the SEC does not specify specific limits at which point the manager is forced to affect the yield or hold for eight years. We note that according to Florida statute, the SBA cannot offset any losses with income and therefore, would not be able to reduce the yield to offset an investment loss.

Conclusion

While we recognize that the LGIP's gain/loss policy is not entirely consistent with how most registered 2a-7 funds account for gains and losses, it is similar to how 2a-7 funds account for realized gains and losses and is in line with how other states account for gains and losses in their "2a-7 like" pools. As long as the policies are written clearly and are transparent to all parties involved, including the new Reserve Account policy, we recommend the SBA proceed with the proposed policy.