

Hewitt ennisknupp

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Florida PRIME Best Practices Review

Florida State Board of Administration (SBA)

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Executive Summary

Based on Hewitt EnnisKnupp's (HEK) Best Practices Review of the Local Government Surplus Funds Trust Fund (Florida PRIME), we continue to believe that the pool is being managed according to best practices. In this report we review the most recent Rule 2a-7 changes and how they are affecting Florida PRIME, enhancements made to the website over the past year, consideration of a second credit rating, and adding a second or third pool with different risk characteristics. In addition, we provide a summary of the 2011 participant survey results and review the recommendations made in the 2010 Best Practices Review and the actions taken by the SBA in response to those recommendations.

Recommendations:

- Maintain the current rating from S&P and do not pursue an additional rating from another rating agency. The rating achieved from S&P is sufficient for Florida PRIME to communicate the quality, liquidity, and stability of the fund.
- Wait to begin the process of adding a second or third investment option within Florida PRIME until the market environment and participant interest improves.

2011 Participant Survey Results

Each year, the SBA conducts a survey of Florida PRIME participants to gain a better understanding of overall investor satisfaction, gauge interest in various enhancements contemplated for Florida PRIME, and obtain information on investors' usage of the website and online transaction and reporting system. As of the time of this report, the SBA had obtained responses from 149 participants (18% response rate) for the 2011 survey. While the survey was not officially closed at the time of the production of this report, there was only one day remaining and therefore, we feel that this preliminary information will be largely representative of the final survey results.

Responses were diversified among type of governmental unit including colleges and universities, constitutional officers, counties, municipalities, school boards, and school districts. Approximately two-thirds of respondents indicated that they employ less than 1,000 employees. Half of the respondents indicated that they utilize the Florida PRIME website and the financial transaction module at least once a month. Overall, participants feel that the website is very easy to use and the Florida PRIME representatives, when answering questions over the phone, are helpful, knowledgeable, and responsive. Participants also find the new monthly notices very or somewhat informative and useful. We discuss participants' views on the new ACH functionality, access to education and training, and additional pool options throughout this report.

2010 Recommendations

SBA Staff has continued to make improvements to Florida PRIME that directly benefit the pool's participants. Below we provide a summary of our recommendations from the 2010 Best Practices Review and the corresponding actions that have been taken over the past year in response.

- Revise the investment policy statement to reflect the expected changes in the management of the pool resulting from the recent SEC Rule 2a-7 reforms, specifically related to liquidity and illiquid securities

Action: The investment policy statement approved by the Board of Trustees on July 1, 2010 reflects the most recent SEC Rule 2a-7 reforms.

- Consider having Federated present a summary of the stress tests performed on the pool at least annually

Action: Federated, in conjunction with the SBA, implemented periodic stress tests that examine the fund's ability to maintain a stable NAV per share in the event of market shocks. This report is provided by Federated to the Investment Oversight Group at the SBA on at least a quarterly basis.

- Work with Federated to adopt a process similar to that recommended by the SEC that will create a list of four approved Nationally Recognized Statistical Rating Organizations (NRSROs) for the pool

Action: Given direction from the Dodd Frank Act to the SEC to review money market funds' reliance on rating agencies, the SBA and Federated have not adopted procedures to approve four NRSROs. The SEC review may change this proposed guideline and, therefore, the SEC has postponed adoption of this particular guideline until its review is completed.

- Post the 7-day yield to the Florida PRIME website in addition to the 30-day and daily yields

Action: Since July 2010, the SEC 7-day yield has been posted to Florida PRIME's website.

- Retain Federated as the investment manager for the Florida PRIME, and continue to service the participants internally at the SBA; however, the SBA should consider the additional enhancements that Federated's full service model can offer and assess whether these services will increase the value of the pool to participants

Action: Federated continues to manage Florida PRIME while SBA services participants internally. We discuss additional enhancements that directly benefit participants in Section 3 of this report.

- Consider additional enhancements to the Florida PRIME website that will result in more readily available information on the home page and fewer Adobe Portable Document Format (PDF) documents

Action: There have been many significant improvements to the Florida PRIME website over the past few years. This recommendation would create a more streamlined website, but it is not critical to its success and we understand that the SBA is currently working to determine how best to adopt this recommendation.

- Revisit procedures regarding initiation and approval of cash wires associated with Federated's investment management activities and consider allowing Federated to handle cash wire activity

Action: No further issues with cash movement have arisen since the last review and, therefore, no major changes have been made to the process.

SEC Rule 2a-7 Reform Update

As noted in the 2010 Best Practices Review, the SBA has made a number of changes over the past two years to continue managing Florida PRIME in-line with the rules and best practices set forth by the SEC for registered 2a-7 money market funds. We acknowledge that Florida PRIME is not a registered 2a-7 fund and does not report to the SEC; however, these changes are in the spirit of the pool remaining a “2a-7 like” fund. In the 2010 Best Practices Review, we detailed the new reforms put in place by the U.S. Securities and Exchange Commission (SEC) as a result of the events of the 2008 credit crisis, with the goals of increasing transparency and lowering the overall risk of money market funds by increasing liquidity and limiting lower quality investments. Of the ten major reforms approved by the SEC in January 2010, two had not yet been adopted by Florida PRIME including, 1) Designation of 4 NRSROs considered reliable by the fund’s board and 2) Implementation of periodic stress tests that will examine the fund’s ability to maintain a stable net asset value (NAV) per share in the event of market shocks. We discuss the status of Florida PRIME’s adoption of these two reforms below.

Board Approval of NRSROs

As a reminder, this reform requires a designation of four Nationally Recognized Statistical Rating Organizations (NRSROs) that are considered reliable by a fund’s board. The 2010 Best Practices Review recommended the SBA work with Federated to adopt a process similar to that recommended by the SEC that will create a list of four approved NRSROs for Florida PRIME.

Since this recommendation, the Dodd Frank Act was voted into law in July 2010. The component of this act relevant to this new SEC reform for money market funds is the direction to the SEC to review regulation related to creditworthiness and remove any reference to or reliance on ratings. The purpose of this portion of the Dodd Frank Act is to address a concern related to investors’ and regulators’ over-reliance on rating agencies. This directly affects the SEC 2a-7 Rule (Rule) that defines an “eligible security” as one that has a “remaining maturity of 397 calendar days or less that has received a rating from the requisite NRSROs in one of the two highest short term rating categories”. The use of a credit rating in determining eligibility also applies to securities that have a demand feature or guarantee as well as in the definition of “first tier” and “rated security” within the Rule.

Because of this direction from the Dodd Frank Act, the SEC determined that asking fund boards to approve four NRSROs by December 31, 2010 would not be useful and the SEC allowed funds to defer adoption of this reform. Then, in March 2011, the SEC voted unanimously to propose elimination of the reliance on rating agencies within the Rule; however, there has not been formal adoption of this proposal. The SBA, HEK, and Federated continue to monitor this proposal and will seek to comply with the Rule depending on the ultimate outcome. For these reasons, the Florida PRIME has not adopted procedures to approve four NRSROs and will wait until a decision is made by the SEC before proceeding.

Stress Tests

As indicated in the 2010 Best Practices Review, the new Rule required adoption of periodic stress tests that would test the ability of the fund's NAV to withstand extreme market events. The Florida PRIME Investment Policy, revised in July 2010, states that the "Investment Manager will periodically stress test Florida PRIME and at least quarterly report the results of the stress tests to the Investment Oversight Group." When the 2010 Best Practices Review was presented to the Investment Advisory Council and the Participant Local Government Advisory Council in June 2010, Federated was in the process of drafting and re-writing the current procedures for stress testing and reporting these results to the SBA.

These processes and procedures have since been completed and agreed upon by both parties. Federated will stress test Florida PRIME on a monthly basis unless the NAV of the fund falls below \$0.9975, which will prompt Federated to complete the stress testing weekly. Stress tests can also be completed as requested by Federated's Chief Investment Officer (CIO). The stress tests include stressing the NAV of the portfolio in the case of large cash flows, changes in short-term interest rates, downgrades and defaults, and interest rate spreads on variable rate securities. The report created by Federated includes the stress test results for the current and previous three quarters and will be provided to the Investment Oversight Group at the SBA at its next regularly scheduled meeting or more frequently as determined by Federated's CIO. We feel this process is robust and fulfills the requirements as specified in the 2a-7 Rule and the Investment Policy Statement of the Florida PRIME.

Participant Enhancements

The SBA Staff continues to look for ways to enhance the Florida PRIME product offering for participants. During 2010 and early 2011, Staff implemented website enhancements that include a website tracking tool for Staff, pop-up definitions on the website home page, Automated Clearing House (ACH) withdrawals, and future-dated transactions. In addition, Florida PRIME participants may be able to take advantage of the education and training portal that has recently been developed by the SBA. We provide a summary of these enhancements below.

Website Enhancements

In order to track how participants are utilizing the website, the SBA is now utilizing a Google tracking tool that is reviewed on a quarterly basis. The tracking tool records website activity and compiles data that shows the number of visits, number of pages viewed per visit, average time on the website, and areas of the website that receive the most hits. In addition, the tool tracks website usage by city. This report also shows changes in these metrics from quarter to quarter so the SBA can track changes in the levels of usage, time spent on the website, and utilization by various locations.

SBA also added pop-up definitions to the website home page – a recommendation made in the 2010 Best Practices Review – for terms such as market value, amortized cost, and the various yield calculations. These definitions are readily available and will help current and prospective participants understand the information presented on the website.

The SBA also enhanced the functionality of the online transaction system utilized by participants by adding the ability to input ACH withdrawals and future dated transactions. These were two items that participants expressed keen interest in through the 2010 annual Florida PRIME participant survey. Allowing ACH withdrawals on the Florida PRIME system will result in cost savings for participants as transfer charges are significantly lower for ACH transactions compared to bank wires. Approximately 58% of participants that responded to the 2011 participant survey indicated that they considered this a convenient improvement to the website. In addition, the future dated transactions will allow participants to schedule transactions in advance, which increases the flexibility and convenience of the online system.

Education and Training Portal

In order to provide further resources to Florida PRIME participants, the SBA has evaluated extending participants access to a version of the new comprehensive education and training portal that is currently being utilized by internal staff. The SBA is able to create a specialized training portal that will be customized to the needs of the Florida PRIME participants. The training programs will cover a variety of topics and will have a wide selection of courses that participants can take that will fulfill continuing education unit (CEU) and continuing professional education (CPE) requirements for Certified Public Accountants. These training programs will be offered to current participants and the cost will be borne solely by those participating in order to maintain the low cost of the pool for other participants. The portal currently offers over 250 financial courses through *Intuition*, a well-established online training

development organization. The available courses cover a wide variety of relevant investment and financial topics including but not limited to accounting, alternative assets, corporate governance, custody, derivatives, economics, fixed income, interest rates, risk, and trade processing. Florida PRIME participants that responded to the 2010 annual Florida PRIME survey expressed mild interest in access to training programs. The current SBA Learn Center also offers courses through various other providers and based on pricing and interest, these can also be fully extended to Florida PRIME participants in addition to the *Intuition* courses. Approximately two-thirds of participants that responded to the 2011 Florida PRIME participant survey indicated that they would be somewhat or very likely to utilize a service that provided education courses with CPE credits. There was slightly less interest for courses that did not earn CPE credits. In addition, approximately two-thirds felt that they would be somewhat or very likely to utilize education modules that covered investment, treasury/cash management, and government finance topics.

Conclusion

We fully support these changes and feel that through these additional enhancements the SBA continues to position Florida PRIME as a premier fund in the state of Florida by bringing additional cost savings, efficiencies, and enhanced services to Florida PRIME participants. In addition, we continue to recommend that the SBA consider additional enhancements to the Florida PRIME website that will result in more readily available information on the home page and fewer Adobe Portable Document Format (PDF) documents.

Credit Rating Review

Currently, Florida PRIME is rated AAAm by Standard & Poor's (S&P), which is the highest rating available for a money market fund and indicates "an extremely strong capacity to maintain principal stability and to limit exposure to principal losses due to credit, market, and/or liquidity risks". As noted in the 2009 Best Practices Review, we believe that having a credit rating from a credible rating agency such as S&P is considered a best practice as it allows participants and prospective investors to compare the rating with those of other money market funds and also creates a documented process that reassures investors that Florida PRIME is always in compliance with fund guidelines and objectives. In addition, the Government Finance Officers Association (GFOA) recommends that governments investing in local government investment pools (LGIPs) review the fund rating assigned to an LGIP as one measure of due diligence.

S&P monitors Florida PRIME on a weekly basis by reviewing statistical information on the Fund such as weighted average maturity (WAM), exposure to A-1+ and A-1 securities, maximum final maturity of floating rate notes, and the daily mark-to-market NAV. S&P also analyzes the portfolio holdings. Both Moody's and Fitch, also accredited and well-known rating agencies, provide money market fund ratings like S&P. We do not recommend that the SBA adopt a second or third rating for Florida PRIME and explain the reasons for this recommendation below.

Peer Practices

According to the iMoneyNet 2009 Special Report on Government Investment Pools, 80 of 114 of the local government investment pools in the study have public ratings, which indicates that receiving a public rating is common practice. However, of these only one of the largest local government investment pools (defined as greater than \$3 billion in assets under management) is rated by two agencies and two are rated by three agencies. The table below shows the top twenty-five local government investment pools by assets under management and indicates the public ratings received. For those local government investment pools that have a credit rating, peer practice clearly supports receiving one public rating as opposed to multiple.

Name of Pool¹	State	Rating Source
Local Agency Investment Fund	CA	Not Rated
TexPool	TX	S&P
State of New Jersey Cash Management Fund	NJ	Not Rated
Georgia Fund 1	GA	S&P
Utah Public Treasurers Investment Fund	UT	Not Rated
Local Government Investment Pool	TN	Not Rated
Mass Municipal Depository Trust-Cash Portfolio	MA	Not Rated
Local Government Investment Pool	WA	Not Rated
Local Government Surplus Funds Trust Fund	FL	S&P
State Treasury Asset Reserve of Ohio	OH	S&P
North Carolina Capital Management Trust: Cash Portfolio	NC	S&P
TexSTAR Cash Reserve Fund	TX	S&P
(Riverside) Treasurer's Pooled Investment Fund	CA	Moody's, Fitch
The Illinois Funds – Money Market Fund	IL	S&P
San Diego County Treasurer's Pooled Money Fund	CA	S&P
State Treasurer's Short-Term Investment Fund	CT	S&P
Local Gov't Investment Pool	OR	Not Rated
San Bernardino County Investment Pool	CA	S&P, Moody's, Fitch
King County Investment Pool	WA	S&P
Colotrust PLUS+	CO	S&P, Moody's, Fitch
Commonwealth of Virginia LGIP	VA	S&P
Local Gov't Investment Pool	WI	Not Rated
PFM Funds: Prime Series/SNAP Fund	VA	S&P
Arizona Pool 5 LGIP	AZ	S&P
Sacramento County Pooled Investment Fund	CA	Not Rated

Rating Methodologies

All three rating agencies conduct both quantitative and qualitative analyses on the investment characteristics of money market funds including local government investment pools and quality of fund management. While there are minor differences in the methodology and process of the three rating agencies, there is very little difference in the quantitative and qualitative factors being analyzed. All three rating agencies focus on credit quality, liquidity, exposure to interest rate changes, and the market stress on the mark-to-market NAV of the fund. In addition, all three also take into account qualitative attributes of each fund that they glean from face-to-face meetings

¹ Data provided by iMoneyNet Special Report: Government Investment Pools: Investment Strategies, Facts, Figures, and Trends; February 2009

with portfolio managers and key decision makers associated with each fund, including risk management, portfolio management process, and sponsor support. Therefore, we feel that the rating achieved from S&P is sufficient for Florida PRIME to communicate the quality, liquidity, and stability of the fund and do not believe that an additional rating would be materially different or change the overall characterization of Florida PRIME's stability, high credit quality, and sufficient liquidity.

Complexity and Cost

In addition, adding a second credit rating would increase the complexity and cost of managing Florida PRIME. While this would not result in significantly more work for the SBA Staff, we do acknowledge that obtaining a second credit rating would require Federated to submit additional surveillance reports to other rating agencies on a weekly or other periodic basis. In addition, depending on the rating agency, a fee to receive a second rating in the range of \$20,000 - \$30,000 would be incurred and passed along to Florida PRIME participants.

Conclusion

Based on the information provided above, we do not recommend the SBA pursue an additional credit rating from a different rating agency. The current credit rating is received from Standard & Poor's, which is one of the most credible rating agencies in the industry and has significant name recognition among investors. In addition, as explained above, when comparing the rating methodologies across the three most prominent rating agencies – S&P, Moody's, and Fitch – while there may be slight differences in their process, they all evaluate the same characteristics and criteria when rating money market funds. In addition, peer practice among local government investment pools like Florida PRIME is to receive one credit rating as opposed to multiple. For these reasons, we do not see significant value to adding a second credit rating.

Additional Fund Offerings

In the 2009 Best Practices Review, we recommended that the SBA "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." The SBA has considered this option over the past two years; however, given a lack of demand for additional funds from participants and the desire to first stabilize the management and grow participation within Florida PRIME, the SBA has not pursued adding an additional fund.

Given the significant number of improvements to Florida PRIME over the past few years and the stabilization of the assets under management, we feel it is prudent to explore this recommendation once again. The two options that could be added include a government-only fund and an enhanced cash fund. A government-only fund will only invest in government obligations of the United States including Treasuries and agencies. The second option, an enhanced cash fund, typically targets a portfolio duration of six months to one year, whereas a money market fund's weighted average maturity target is 60 days. An enhanced cash portfolio is also managed on a total return basis instead of a constant \$1 net asset value (\$NAV) and will allow a maximum maturity of 2-3 years on individual securities as opposed to the 13 month limit for money market funds. Below we briefly review the advantages and the challenges of providing additional fund options.

We also note that out of the states that offer the largest local government investment pools (listed on page 8 of this report), ten of the twenty-five offer more than one investment option.

Advantages

Providing additional fund options, with varying levels of risk, allows local governments to determine the level of risk that is most appropriate for their circumstances and invest accordingly. In addition, offering fund options with different risk profiles allows participants to diversify their risk, if desired, within their cash investments. We also believe that both of these advantages, if desired by participants and marketed appropriately, would serve to increase the appeal of the Florida PRIME compared to other investment options for local governments within the state of Florida.

Challenges

However, we do acknowledge that offering additional fund options will create additional operational and administrative complexities as the tasks that are completed today for Florida PRIME would also need to be completed for any additional fund(s). This applies to not only the initial set-up work required for the new fund(s), but also, on an ongoing basis, applies to such

tasks as recordkeeping, custody, administration, valuation, return calculations, cash flow management, etc.

Secondly, it is important to take into account the current market environment when considering the launch of a government-only or enhanced cash fund and how this may influence the success of attracting investors to these new funds. For example, given the low interest rate environment, a government-only fund would not necessarily be attractive to participants when compared to the current Florida PRIME fund. In addition, launching an enhanced cash fund that has the ability to invest farther out on the yield curve (as compared to the current fund that is managed within 2a-7 guidelines) brings additional complexities given that the accounting for the fund would need to be on a total return basis as opposed to constant \$NAV. This would require additional education for participants to ensure, before investing, that they fully understand the risks as well as the similarities and differences compared to investing in a constant \$NAV fund. In addition, there is the risk that should investors choose the riskier cash fund option and rates rise, performance will lag the less risky, constant \$NAV investment options, creating frustration among investors.

Lastly, the 2011 participant survey indicated a lack of participant interest in an additional fund option. More than 50% of respondents are not very likely or not at all likely to invest in a lower risk/lower return or higher risk/higher return investment fund.

Conclusion

While we acknowledge the merits of providing fund options with different levels of risk, given the challenges the SBA faces to successfully implement and market an additional fund offering, we do not recommend that the SBA begin the process of adding an additional fund at this time. However, we do feel that further discussions with Federated, given their experience launching new products, will be beneficial in determining the optimal time to launch a new fund.