

Florida PRIME™ Best Practices Review

Florida State Board of Administration (SBA)

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Hewitt EnnisKnupp, An Aon Company

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Executive Summary

Hewitt EnnisKnupp (HEK) conducts a Best Practices Review of Florida PRIME™ on an annual basis. Based on our most recent review, we continue to believe that the pool is being managed in a manner consistent with best practices. In this report, we review the responses to the annual participant survey, provide an update on recent participant enhancements, review the onsite due diligence meeting at Federated Investors and provide an update on the most recent developments surrounding the SEC 2a-7 reforms. We will begin the report with a review of the recommendations that resulted from the 2012 annual review, followed by a summary of our current recommendations.

2012 Recommendations

- Review the independent compliance verification process completed by SBA Staff and consider reducing the frequency from monthly to quarterly.

Action: The frequency of the independent verification process SBA Staff conducts was discussed at length and the decision was made to maintain verification on a monthly basis.

- Continue to stay apprised of the 2a-7 reform discussions and keep participant needs and best interests at the forefront of any contemplated policy or guideline changes.

Action: SBA Staff, Federated and HEK continue to stay apprised of the ongoing 2a-7 reform discussions and consider the potential impact on the Florida PRIME™ pool.

2013 Recommendations

- Consider additional efforts to remind participants of the Education Center that is conveniently available to them on the Florida PRIME™ website and that offers beneficial education courses at discounted prices.
- Continue to stay apprised of the 2a-7 reform discussions and keep participant needs and best interests at the forefront of any contemplated policy or guideline changes

2013 Participant Survey Results

The SBA conducts a survey of Florida PRIME™ participants every year to gain a better understanding of overall investor satisfaction, gauge interest in various enhancements, and obtain information on investors' usage of the website and other resources. The 2013 survey attracted 87 respondents, a modestly lower number than in previous years. This was the first year the SBA issued two separate surveys, one for the Florida PRIME™ and one for Fund B. The lower participation rate for the Florida PRIME™ survey could be due to participants choosing to complete one or the other, and not both. Despite the lower turnout, the survey continues to provide insight into participant satisfaction and areas for improvement.

A diversified group of governmental units responded to the survey, ranging from colleges and universities, constitutional officers, counties, municipalities, school boards, and school districts. Roughly 77% of respondents indicated that they employ less than 1,000 employees. When asked how often respondents utilize the Florida PRIME™ website, 88% indicated that they visit the website at least once a month, with 71% indicating that they find the website very useful and 64% indicating that they find its functionality very easy to use. The survey indicated that participants continue to utilize the website primarily to access account balances and statements and to make transactions. The SBA launched the Education Center in April 2012. Of the 16 respondents that answered the question, 75% indicated that they found the overall quality of the service to be very useful and the remaining 25% indicated that they found it somewhat useful. When asked about the usefulness of multiple communication pieces, 97% of respondents noted that they find the monthly account statements very useful, and 96% indicated that they find the monthly summary reports and the periodic eNotices very or somewhat useful. Respondents indicated that they call or e-mail their Florida PRIME™ service representatives fairly infrequently; however, when utilized, the large majority of respondents found them to be very helpful, knowledgeable, and responsive.

The survey also posed questions related to competing and complementary vehicles participants are utilizing. The survey indicated that just over half of respondents utilized an SEC-registered money market fund in the past twelve months in addition to Florida PRIME™. When asked what is liked most about competing services currently available from other companies, over 60% of respondents indicated the yield level. Additionally, the survey indicated mixed results from respondents regarding their interest level in a potential additional investment vehicle offered by the SBA. When asked what level of interest a respondent would have if the SBA were to develop one (or more) additional investment pools, with either lower or higher levels of risk and return, between 33% and 35% indicated they would be somewhat likely interested and between 33% and 37% indicated they would be not very likely interested.

Participant Enhancement Update

SBA Staff is committed to enhancing the Florida PRIME™ participant experience by consistently evaluating potential website enhancements, educational opportunities and reporting improvements, among other things. The SBA utilizes an online tracking tool and the annual participant survey to monitor and identify participant behaviors and areas where enhancements may be implemented.

In the last annual review, we noted two specific enhancements that have been recently made for Florida PRIME™ participants. The first was the customized Florida PRIME™ Education Center that was launched in April 2012. The Education Center is conveniently accessible through Florida PRIME™'s website and provides training programs through two well-established online training development organizations, Intuition and BiskCPEasy, each with over 300 financial courses. The courses cover a wide variety of relevant investment and financial topics and many of which can fulfill continuing education units and continuing professional education requirements. As of December 2012, approximately two dozen pool participants have utilized the Education Center since it was launched in April 2012.

While the usage of the Education Center has been lower than expected, it is important to note that the Education Center can continue to be made available to participants at no additional cost to the SBA. Further, the Education Center has only been available for approximately one year. While only a small percentage of participants have taken advantage of the service thus far, of those that have, over 90% rated the course selection and cost effectiveness of both Intuition and BiskCPEasy as very useful or somewhat useful (as indicated in the 2013 participant survey). So, while participation may be low, we find it notable that of those who have used the service, satisfaction has been high. We recommend the SBA gently remind participants that the Education Center is available to them and to make note of the beneficial courses they have access to at discounted prices.

The second enhancement the SBA made available for participants was the implementation of the "Go Green" initiative in late 2011. This initiative provides participants access to monthly account statements online and allows participants to opt out of receiving hard copies through the mail. The "Go Green" program has experienced a significant participation rate and has saved on hard copy mailing costs. Since the program was launched, 344 participant accounts have opted out of receiving monthly statements in the mail, representing 20% of Florida PRIME™'s total accounts.

Florida PRIME™'s investment manager, Federated Investors, also is consistently adding to the Florida PRIME™ participant experience. Federated continues to keep itself in front of participants with appropriate updates and remains very responsive to participant needs. Federated holds multiple conferences throughout the year and will attend a total of 12 different conferences around Florida in order to communicate the investment opportunity and services Florida PRIME™ provides to local governments.

Conclusion

The SBA continues to be dedicated to exploring potential enhancements for Florida PRIME™'s participants and to improving the participant experience. The SBA continues to make diligent efforts to enhance the services, the delivery of information and the level of transparency provided to Florida PRIME™ participants. Further, the SBA continues to make use of the participant survey to ensure that services provided are those that are most important to participants and will create efficiencies for participants on a daily basis. We view the Education Center as a valuable enhancement and believe that many participants can benefit from taking advantage of the discounted education courses. We recommend the SBA consider additional means to reminding participants that the Education Center is available to them and of the ways in which participants can benefit from this opportunity.

Federated Investors Onsite Due Diligence Meeting

SBA Staff and HEK conduct onsite due diligence meetings at the Federated offices on a regular basis. In April 2013, the SBA and HEK visited the Federated offices in Pittsburgh, PA. The goal of the visit was to conduct a comprehensive overview of Federated's business and processes, and specifically those that impact the Florida PRIME™ investment pool and its participants. Below we provide a brief summary of the topics covered and the surrounding discussion.

Corporate Overview and Legal: Federated Investors is very well-known in the money market industry with a sole focus on asset management. As of December 31, 2012, Federated managed a total of \$380 billion, of which roughly 75% was invested in money market funds and approximately 32% was in prime money market funds. As of December 2012, twenty-six states were using Federated's services in a direct form. Additionally, of the 50 money market portfolios Federated manages, 15 are prime, 15 are government and 20 are tax-free. The firm works with six internal lawyers and two outside counsels. Currently there are no lawsuits pending.

Compliance: The Federated Compliance Department is comprised of over thirty employees who are responsible for the development and enhancement of compliance programs and who are dedicated to overseeing the investment activities of Federated's business units. The team monitors the investment activities and operations for compliance with applicable regulations, client guidelines and corporate standards.

Federated utilizes three trade order management systems that the Compliance Department is responsible for overseeing. The applicable trading system utilized for stable NAV funds, and specifically for the management of Florida PRIME™, are proprietary systems FedPorts and FedCMS. The Compliance Department works in tandem with the Business Information Services Division (BISD) and Investment Management Operations (IMO) to develop and implement automated tests within the trading systems that are conducted to assure trading compliance with applicable regulations and guidelines. Due to the proprietary nature of Federated's trading system, the Compliance Department, in conjunction with the BISD and IMO, has created a set of rules specifically for the Florida PRIME™ portfolio that are constantly reviewed and updated.

The Compliance Department reviews the applicable regulations and guidelines governing the Florida PRIME™ portfolio and helps to interpret them into automated tests that can be implemented within the trading system. Every trade that is generated runs through compliance. Should any trade placed not comply with the set of rules, a notice of either 'Warn,' 'Fail' or 'Stop' will be received and will need to be rectified before the trade can be processed. Each notice has a different level of importance and corresponding parameter on who can validate the trade. Should a disagreement arise on whether a trade is permissible or not, Federated has a proven escalation process to solve the issue. Federated also conducts manual tests for certain guidelines that are not able to be automated in the trading systems.

Federated also has a nightly process that runs pre-trade and batch checks for the Florida PRIME™ portfolio. Additionally, Federated reviews the Florida PRIME™ Compliance Checklist on a daily basis, which is also provided in the Monthly Summary Reports that are posted to the Florida PRIME™ website. Further, the Compliance Department provides Florida with a Code of Ethics Certification on an annual basis.

Trading and Technology: The Federated trading team is well tenured, consisting of twelve traders with an average of eighteen years of experience. The team is organized by sector and meets on a weekly basis. The trading process begins with the development of the investment strategy, which is followed by a credit analysis and review before trading takes place. The team utilizes a best execution policy when selecting brokers and has a committee that oversees the broker selection practices that meets on a quarterly basis. During the onsite, the trading team illustrated a live demo of the trading process, allowing us to view the functionality of the automated tests, mentioned above, which ensure each trade is in compliance with the applicable guidelines and regulations. The trading team works together with Federated's other business units to execute Florida PRIME™'s investment strategy on a seamless basis.

We also heard from the Business Information Services Division (BISD) and specifically from the Money Market Fixed Income Cash unit of the Investment Management Business Services unit. In addition to working with the Compliance Department, the BISD manages the communications network and information technology infrastructure. Federated utilizes a dual data center architecture located on separate power grids which allows the business to run smoothly in the event of an emergency. All data entered into the trading systems is replicated to a second system in real time. The system has a recovery time of two hours or less, and a goal of zero data loss. Additionally, we heard from the Corporate Business Continuity unit that is responsible for aligning the workplace and technology recovery plans together. All systems are tested on a regular basis to ensure trading and day-to-day business can be run as usual should an unexpected event occur.

Risk Management: The Florida PRIME™ portfolio is managed to a fairly conservative mandate with the goal of providing, in priority order, safety, liquidity and competitive returns with minimization of risks. During the onsite, we met with Senior Portfolio Manager, Paige Wilhelm, and Senior Investment Analyst and Portfolio Manager, Mark Weiss. Ms. Wilhelm provided a brief update on Florida PRIME™ and an overview of what she is seeing in the marketplace. As of March 2013, the Florida PRIME™ portfolio has performed favorably over both short and long periods relative to its performance benchmark, and has provided the safety and liquidity characteristics needed by its participants.

Mr. Weiss then provided us with an overview of the credit review process. All credits must go through Federated's Credit Committee, which meets on a weekly basis. A credit will not be put onto the approved list until it goes through the Credit Committee. Once a credit is approved, an

analyst can immediately downgrade or put it on hold if they deem necessary. However, in order for a credit to be upgraded, it must go through the Credit Committee.

Federated also provided us with an update and their view on the money market fund reform debate. As we discuss later, to date of this report there has not been any concrete proposals put forth. However, Federated did provide a brief description of what they see as likely outcomes. At the time of the onsite, Federated anticipated a proposal centered around a floating net asset value, gating restrictions and/or further adjustments to portfolio limits similar to the reforms in 2010 (i.e., restrictions on weighted average life, weighted average maturity, etc.). Federated continues to make significant contributions to the 2a-7 reform debate and continues to make meaningful efforts to help achieve a reasonable outcome for the industry.

Participant Servicing & Education: Federated offers a comprehensive participant service model that is centered on the participant experience. The model offers a wide-range of services, including customizable technology and reporting services, education opportunities and multiple communication portals, among other things. Currently, SBA Staff provides Florida PRIME™ participants with a comprehensive service model. Though the Federated model is compelling, the SBA has been very successful in servicing the pools' participants in an efficient and effective manner.

Conclusion

The onsite meeting provided a very comprehensive overview of the Federated business and detailed processes related to Florida PRIME™. The meeting reinforced our confidence in Federated's capabilities with regard to the people, the process and the technology to continue to successfully manage the Florida PRIME™ portfolio. We continue to find Federated among the top managers in the money market asset management business and believe they will continue to successfully manage the Florida PRIME™ portfolio and keep the SBA and Florida PRIME™ participants well informed and ahead of the curve as the industry progresses.

Compliance Exception

A single compliance exception was identified by the Auditor General's Office and brought to Federated's attention on September 11, 2012. The breach was due to a 144A issuance that was available for sale only to Qualified Institutional Buyers. Such a security is not eligible for the Florida PRIME™ portfolio and therefore constituted a breach of compliance. At the time of purchase, the security's non-applicability for Florida PRIME™ was unknown to Federated Investors. Immediately after becoming aware, Federated notified SBA's Fixed Income Investment Oversight Group (IOG), per Policy. The following day, the IOG held an ad hoc meeting where it was recommended the security be sold. On September 13, the SBA Executive Director & CIO approved the recommendation and the next day the security was sold with a small realized gain.

We note that the compliance exception was not material and did not cause any notable impact on the Florida PRIME™ portfolio or its participants. The compliance procedures in place at Federated and at the SBA were executed as designed and the issue was resolved quickly and seamlessly. Further, Federated promptly implemented an additional automated test that will prevent any future purchase of a 144A security until it is confirmed that it is eligible for the Florida PRIME™ portfolio.

As part of the 2011 Best Practices Review, we assessed the procedures Florida PRIME™ has in place to ensure compliance with its Investment Policy Statement (IPS). We concluded that Federated has established thorough and effective compliance procedures and we have full confidence in their ability to manage the portfolio successfully and in compliance with the applicable guidelines. Given the recent compliance exception, our opinion of Florida PRIME™'s compliance procedures and Federated's ability to safeguard Florida PRIME™'s assets has not changed. We note that prior to this exception there has not been a breach of guidelines for over three years. Further, the execution by Federated and the SBA to escalate and resolve the issue, as well as implement additional precautions, confirms the effectiveness of the procedures in place.

SEC Rule 2a-7 Reform Update

Florida PRIME™ is not a registered money market fund and therefore is not mandated by law to follow the guidelines set forth by the U.S. Securities and Exchange Commission (SEC) for registered 2a-7 money market funds. However, Florida PRIME™ has dedicated itself to being managed as “2a-7 like,” as defined by the Governmental Accounting Standards Board (GASB). The Florida PRIME™ Investment Policy Statement states that the portfolio will be managed in a manner consistent with the diversification, credit quality and maturity conditions of Rule 2a-7. Accordingly, Federated and Staff have stayed current in managing the portfolio in accordance with the most up-to-date guidelines and best practices as set forth by the SEC for 2a-7 funds.

As a reminder, new regulations for 2a-7 funds were approved by the SEC in 2010. Since approval, Florida PRIME™ has adopted the new guidelines and Federated has managed the portfolio under the most up-to-date 2a-7 regulations. Though the 2010 regulations were received positively and viewed as effective, there has been a push for additional regulations to further protect the industry and the broader economy from another run on money market funds as experienced in 2008.

At the time of the last annual review, significant attention was being paid by industry participants to whether additional reforms were needed or not. Since the last review, Mary Schapiro, former Chairman of the SEC and a strong advocate for money market fund reforms, attempted to push through a proposal that would require capital buffers and redemption restrictions, or alternatively, a move from the current stable net asset value (NAV) structure to a floating NAV structure. The proposal was not well received and three of the five SEC commissioners were not convinced that additional reforms were even necessary. Since that time, a significant research effort and focus has been maintained by industry participants and it has now become widely accepted that additional regulations will ultimately be implemented. Accordingly, the focus of discussion has progressed to identifying the most appropriate and effective measure. Additionally, the SEC has a new Chairman, Mary Jo White, who was sworn into office in April 2013. While Ms. White's tenure as Chairman has been short, she has confirmed her commitment to finding a balanced and effective solution to the money market reform debate.

The most recent and significant update was announced during the first week of June 2013. The SEC met on June 5th and voted unanimously to propose a new set of rules. The proposal is reported to include two main reform alternatives that were written to be adopted either alone or in combination. One alternative would require prime institutional money market funds to transition to a floating net asset value. The second alternative would allow the use of liquidity fees and redemption gates in periods of market stress. The proposal is also said to include additional diversification and disclosure regulations that would apply whether either alternative is passed. As a result of the unanimous agreement by the SEC commissioners, the proposal will be open for public comment for a period of 90 days. While we view this development as a positive move in

the right direction, it is important to note that though the commissioners agreed to solicit feedback, uncertainty remains whether they will agree on final reform measures.

Conclusion

We find it important to emphasize that while Florida PRIME™ has historically fully complied with the 2a-7 guidelines, the portfolio is not a registered money market fund and therefore is not obligated by law to comply with any potential additional regulations the SEC may enforce. We believe this flexibility provides great advantage for Florida PRIME™ and is common among other local government investment pools around the nation.

As was the case when the previous annual review was written, there continues to be more unknowns than knowns surrounding the potential money market reforms at this time. However, we believe significant progress has been made over that past year towards finding a common middle ground between the industry participants wanting additional reform and those that deem it unnecessary. We believe the proposal most recently released for public comment is much closer to being appropriate for and acceptable to the majority of industry participants. We note that uncertainty still remains surrounding which reforms may ultimately be passed and surrounding the specifics of how the proposed measures will impact various industry participants. Additionally, given the process for reform, it may be years before new regulations will come into effect.

We have confidence that the reforms ultimately approved by the SEC will be in the best interest of money market participants and that the SBA and Federated have the capabilities to adjust the management and oversight of Florida PRIME™, should the decision be made to continue to manage the portfolio as “2a-7 like.”

We note that both the SBA and Federated have continued to stay well informed of the developments surrounding the money market reforms and well aware of potential impacts on Florida PRIME™. We recommend that the SBA continue to focus on the needs of, and potential impact on, Florida PRIME™’s participants when determining whether any new SEC rules should be adopted by Florida PRIME™.