

***VIRGINIA
LOCAL
GOVERNMENTS***

***CASH, INVESTMENTS
and DEBT***

– A STATUTORY GUIDE –

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Virginia local governments accept the responsibility for strict accountability over public funds. The governing body of a local government is charged by law with managing its budget, cash assets, investments, debt and borrowing. The historical importance of preserving principal is not merely an assumed obligation by localities, but a time-honored duty. Localities balance this duty against the need to encourage economic development, which in turn has the potential to create more revenue for the locality as well as jobs and opportunity for its citizens. This article reviews Virginia statutes and policy issues related to local government's role in managing a locality's cash, investments and debt.

CASH

Cities in Virginia operate under special charters granted by the Virginia General Assembly. Under such auspices, Virginia's cities may be granted greater flexibility for establishing procedures to oversee and manage their cash assets. For example, an independent city auditor may be empowered to examine and report on all financial aspects of the City. In other cases, the City Council will retain direct oversight of cash matters in association with the City Treasurer. In this publication we will examine, the body of Virginia laws relating to cash management by County Governments as codified in the *Code of Virginia*.

COUNTY FINANCE BOARD- CASH MANAGEMENT *A Shared Responsibility*

Traditionally, Virginia Counties operated a County Finance Board. The purpose of the County Finance Board was to "oversee the financial aspects" of county government in cooperation with the County Treasurer. The Board of Supervisors, according to Virginia law, could also exercise its discretion and abolish the County Finance Board. In that event the Board of Supervisors would assume the duties of the County Finance Board.

Today the role of the County Finance Board or the Board of Supervisors in directly overseeing the financial aspects of county government is remarkably different. It is now, for all practical purposes, a role delegated to the County Treasurer and/or the County Finance Officer. A County's governing body, the Board of Supervisors, understandably prefers to have the risk/management decisions made by persons having more technical expertise in analyzing risk. The nature of financial markets along with globalization of the banking system has all but eliminated the ability of a legislative body to directly supervise cash and investments. The Virginia statutes creating a "County Finance Board" are indicative of a by-gone era where technology, as we know it today, did not exist. That being said, these outdated statutes still exist.

Va. Code Section 58.1-3151 County Finance Board.

~ Each county of the Commonwealth may establish a county finance board which shall consist of the chairman of the governing body of the county, the treasurer of the county and a citizen of the county of proven integrity and business ability. The citizen member shall be appointed by the circuit court of the county. However, in any county adjoining any county having a population of more than 500 per square mile, the County Finance Board shall consist of the chairman of the governing body, the treasurer, the attorney for the Commonwealth and a citizen of the county of proven integrity and business ability. The citizen member thereof shall be appointed by the circuit court of the county or by the judge thereof in vacation. The term of the citizen member shall be four years, but the circuit court of the county may remove for cause any such member and appoint some other qualified citizen of the county in his stead for the unexpired portion of his term.

The governing body of any county which has a county finance board established under the provision of this section may, by ordinance duly adopted, abolish the finance board whereupon all authority, powers, and duties of the finance board shall vest in the governing body.

The legislature decided to add the “attorney for the Commonwealth” for more densely populated localities. Clearly, this position was included in recognition of the importance of having a legal perspective on the finance board, but did not necessarily extend to the level of legal representation.

Va. Code Section 58.1-3152 Organization and procedure of board.

~ The chairman of the governing body of the county shall be the chairman of the county finance board and the clerk of the governing body shall be ex officio clerk thereof. The board shall meet at such times and at such places as the chairman or a majority of the members of the board may decide. The clerk shall record the activities and proceedings of such board in a suitable record book which shall be provided for such purpose by the governing body.

Va. Code Section 58.1-3154 Selection and approval of depositories.

~ The depository or depositories for the money received by a county treasurer shall be selected pursuant to the provisions of the *Virginia Security for Public Deposits Act* (Sections 2.2-4400 *et seq.*).

The County Treasurer can only select a depository qualified pursuant to the provision of the *Virginia Security for Public Deposits Act*¹. If an unapproved depository is selected in error, the treasurer would bear the liability for this action.

Va. Code Section 58.1-3156 County finance boards may direct treasurer to invest under certain circumstances.

~ Notwithstanding other provisions of this article, whenever the county finance board determines that county or district funds would otherwise draw a lesser rate of interest, the finance board may direct the county treasurer to invest such funds in accordance with guidelines issued by the State Treasurer.

¹Va. Code Sections 2.2-4400 *et seq.*

The investment guidelines² issued by the State Treasurer are not specific to a County Treasurer. Short of the County Finance Board simply directing the County Treasurer to find an investment in compliance with the *Investment of Public Funds Act*³, this law has no practical application. Investments are now so diversified that the concept of drawing a lesser rate of interest is expressed in terms of total returns. Moreover, in 2013, interest rates are nearly at a rate of zero.

Va. Code Section 58.1-3158 Duties of the treasurers.

~ No treasurer shall permit any public deposit to be deposited with any depository unless it is a “qualified public depository” as defined in Section 2.2-4401. All such deposits shall be secured pursuant to the *Virginia Security for Public Deposits Act* (Sections 2.2-4400 *et seq.*).

The Treasurer will be exempted from any personal liability, provided the Treasurer selects a depository that is a qualified depository under the *Virginia Security for Public Deposits Act*⁴.

Va. Code Section 58.1-3160 Monthly report of treasurer to board.

~ At the end of each month each county treasurer shall report to the county finance board the amount of money on deposit with each depository.

Monthly reports to the governing body are a statutory responsibility for all constitutional officers. Presumably, the county finance board would also receive a report of all investments and market values where monies are invested in other than certificate of deposits with financial institutions. Some county treasurers give detailed reports to the governing body, including cash and investment schedules, while others provide only oral or verbal updates.

²*General Account Investment Guidelines*, adopted by Virginia Department of Treasury in 2009.

³Va. Code Sections 2.2-4500 *et seq.*

⁴Va. Code Sections 2.2-4400 *et seq.*

Va. Code Section 58.1-3161 Interest on deposits.

~ Each depository of each county shall, in the discretion of the county finance board, pay interest on money deposited under the provisions of this article. The rate of such interest shall be agreed upon by the treasurer and the depository subject to the county finance board if it so desires.

The original purpose of this statute was internal control. When banks were locally owned, deposits by local governments were a significant source of capital for the bank. Often county treasurers were shareholders of local banks. So, where one local bank was favored over another, additional review was merited. Today, as noted, with interest rates at near zero levels and very few local banks able to meet the complex service needs of a local government, this code section is inconsequential.

Va. Code Section 58.1-3162 Disbursement of money deposited.

~ A. Money deposited under the provisions of this article shall be disbursed only upon checks signed by the county treasurer and drawn in payment of lawfully issued and properly drawn orders or warrants and lawfully issued and properly drawn and matured bonds, notes or other obligations of the county, for the payment of which funds are available.

B. This section shall not be construed as preventing any county treasurer or his duly authorized deputy from (i) transferring, by check or wire transfer, money from one approved depository to another, (ii) from settling with the Commonwealth, without an order from the governing body of his county, for state revenues, or other items collected and remittable by him to the State Treasurer, or (iii) from paying to the State Treasurer without an order from the board of supervisors or other governing body of his county, any amount or amounts pursuant to provisions of law.

This statute merely restates existing law applicable to the County Treasurer and Board of Supervisors. One can infer

that the Commonwealth did not want the County Finance Board to exceed their authority. The County Treasurer alone has the legal duty to disburse, transfer, and deposit public funds. Further, the Commonwealth wanted to eliminate any possibility that the locality could prevent the remittance of State funds, specifically state income tax estimated payments. Subsection A of this code section restates the “appropriation and availability of funds” test outlined in Va. Code Section 15.2-2506, where the Board of Supervisors is charged with management of the payment of claims.

Va. Code Section 15.2-1547 Creation of local finance boards to manage the assets of post-employment benefits trust or equivalent arrangement; compensation of such boards; alternatives to such boards; liability; and removal from office.

~ Except as otherwise provided herein, the governing body of any county, city or town that establishes a trust, trusts or equivalent arrangements for post-employment benefits, other than pensions, pursuant to this article shall also create a finance board to serve as trustee of such a trust, trusts, or equivalent arrangements and to manage and invest the assets of that trust, trusts or equivalent arrangements. Such a finance board shall be composed of at least three members who shall include the chief financial officer of the locality, the treasurer of the locality and at least one other additional person who shall be a citizen of the Commonwealth with proven integrity, business ability and demonstrated experience in cash management and in investments. If the locality does not have a chief financial officer or treasurer, then that position may be filled by the chief administrative officer of the locality or by a citizen who meets the qualifications set forth above. The citizen member shall be appointed initially by the governing body of the locality for a term of two years and if more than one citizen is appointed to serve on any such board the locality body may appoint those citizens for staggered terms of one and two years. Subsequent appointments shall be for two-year terms or to fill the balance of any unexpired term. The finance board shall annually elect

one of its members as chairman and another as vice-chairman. The finance board shall meet at least four times a year and a majority of the members shall constitute a quorum.

Any school board of a local school division or the governing body of any other political subdivision that establishes its own post-employment benefits trust, trusts, or equivalent arrangements pursuant to this article shall create a finance board to serve as trustee of such a trust, trusts, or equivalent arrangements and to manage and invest the assets of that trust, trusts, or equivalent arrangements. Such a finance board shall be composed of at least three members consisting of the chief administrative officer of the entity, the chief financial officer of the entity and at least one additional person who shall be a citizen of the Commonwealth and who meets the qualifications above. The citizen member shall be appointed initially by the governing body of the locality for a term of two years and if more than one citizen is appointed to serve on any such board, then the local governing body may appoint those citizens for staggered terms of one and two years. Subsequent appointments shall be for two-year terms or to fill the balance of any unexpired term. The finance board shall annually elect one of its members as chairman and another as vice-chairman. The finance board shall meet at least four times a year, and a majority of the members shall constitute a quorum

Local governments have recently begun establishing trusts for the purpose of setting aside monies for post-employment benefits. Post-employment benefits are liabilities other than pensions or deferred compensation benefits, for continuing expenses for employees after their retirement, e.g., health insurance benefits. In 2007, Code Section 15.2-1547 was added to the *Code of Virginia* by the General Assembly to require the creation of a special county finance board to oversee and manage those funds.

In lieu of establishing a separate local finance board to manage the assets of the post-employment benefits trust, the governing body that has already established a retirement board or deferred compensation board⁵ to

⁵See Local Retirement Systems (Va. Code Sections 51.1-800 *et seq.*) and Government Employees Deferred Compensation Plan Act (Va. Code Sections 51.1-600 *et seq.*)

manage pension benefits for its employees may designate that board to serve as trustee and to manage the assets of the trust or equivalent arrangement related to these additional post-employment benefits. Such board will have all the duties and powers of the finance board, *mutatis mutandis*⁶.

Except in the case of gross negligence or intentional misconduct, any member of a finance board established pursuant to this section, any director of finance or another appointed official with a similarly named position, or any member of a retirement board, who is acting in accordance with the provisions of this article, shall not incur any liability of investment losses suffered by a trust. Nevertheless, members may be subject to removal.

This finance board created to manage post-employment benefits is different in many respects from the County Finance Board. It does not appear possible that this special finance board could also serve as the Locality's Finance Board because its membership and requirements are too dissimilar. Changing the law to authorize the County Finance Board to serve all these functions would seem to be effective, efficient and logical.

Va. Code Section 51.1-803 Investments of Retirement Systems.

~ ...shall be invested with the care, skill prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with the same aims. Such investments shall be diversified so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

The Commonwealth of Virginia offers complete retirement services for most local governments (VRS). However, a County, City or Town may establish its own retirement system. A few local governments have elected not to

⁶ *Mutatis mutandis* is a Latin phrase that means "with the necessary changes in points of detail, meaning that matters or things are generally the same, but to be altered when necessary." *Black's Law Dictionary*.

participate in VRS. In these cases, the Code section above applies and provides general guidance for a locality's investment policy in the instance it establishes its own retirement system. In developing written investment policies, given the fact that retirement funds may become large in dollar value and represent the future financial well-being of retirees, the locality should include a specific policy that addresses minimizing investment risks in this context.

VIRGINIA SECURITY FOR PUBLIC DEPOSITS ACT

Prior to the enactment of the *Virginia Security for Public Deposits Act in 1973*, (VSPDA) governing bodies were directly or indirectly involved in safeguarding public funds. During that period elected officials inspected the collateral for public deposits held for safekeeping in local banks by comparing deposits against value of the collateral. The County Finance Board would approve escrow agreements with banks, compare deposits against the actual collateral, and record in its minutes any official acts. Auditors would also, in certain cases, examine the physical securities pledged and be on hand to assist in this process. The responsibility for monitoring and guaranteeing the adequacy of the collateral for local deposits was a local one.

Today, many of these duties and responsibilities are shared with the Commonwealth of Virginia and much changed by the Nation's system of banking through electronic commerce. Now all security verifications are controlled by the Virginia State Treasurer, and local governments cannot require any additional security for public deposits. The result of the *Virginia Security for Public Deposits Act*⁷ has been to place the total oversight for the safety of public funds held by local governments with the Treasury Board of the Commonwealth. Their oversight of banks and related institutions is so critical that any serious mistakes of policy or enforcement would be a breach of immeasurable consequence. Fortunately, the mega banks, hurt financially by bad loans and risky investments, have been universally supported and subsidized by the Federal Reserve Bank.

⁷See Va. Code Sections 2.2-4400 *et seq.*

The intent of *Virginia Security for Public Deposits Act* was to create a single body of law applicable to the collateral requirement for public funds on deposit in financial institutions. Legal and regulatory procedures are now in place for securing deposits uniformly throughout the Commonwealth. Under the *Act*, Local Treasurers can confirm that a financial institution is a “qualified public depository”⁸ with the Treasury Board of the Commonwealth.

The Act has consolidated the responsibility for collateralizing public deposits with the Treasury Board. They now must determine the requirements for collateral coverage for a public depository and also monitor the adequacy of the collateral. For example, a bank that has accounts for all 95 counties must have security for each locality which speaks to the amounts of collateral. The exposure for loss changes, literally, every second.

With the consolidation of most local and regional banks into “World Wide Financial Companies,” presumably the monitoring of collateral has become easier. Despite this circumstances and the protections offered by the *Virginia Security for Public Deposits Act*, the recent financial panic has created a sense that localities cannot rely exclusively on the Treasury Board of the Commonwealth to determine safe public depositories. Instead, many localities seek out financial institutions that are not only “qualified public depositories,” but that are also back stopped by FDIC insurance. However, even FDIC coverage, while adequate for certificates of deposit, cannot adequately cover the losses of demand deposits for accounts such as payroll or construction.

Va. Code Section 2.2-4402 Collateral for public deposits.

~ Qualified public depositories shall elect to secure deposits by either the pooled method or the dedicated method. Every qualified public depository shall deposit with a qualified escrow agent eligible collateral equal to, or in excess of, the required collateral. Eligible collateral shall be valued as determined by the Treasury Board.

⁸See Va. Code Section 2.2-4401.

Substitutions and withdrawals of eligible collateral may be made as determined by the Treasury Board.

Notwithstanding any other provisions of law, no qualified public depository shall be required to give bond or pledge securities or instruments in the manner herein provided for the purpose of securing deposits received or held in the trust department of the depository and that are secured as required by Section 6.2-1005 of the *Code of Virginia* or that are secured pursuant to Title 12, Section 92a of the United States Code by securities of the classes prescribed by Section 6.2-1005 of the *Code of Virginia*.

No qualified public depository shall accept or retain any public deposit that is required to be secured unless it has deposited eligible collateral equal to its required collateral with a qualified escrow agent pursuant to this chapter.

Prior law required the banks to deposit eligible collateral with the State Treasurer, Federal Reserve of Richmond, or any other bank or trust company. The new definition of a qualified escrow agent means the State Treasurer or any bank or trust company, approved by the Treasury Board, may hold collateral pledged to secure public deposits. The question of required collateral has always remained a mystery to the public and what actions, if any, are taken when collateral is determined to be insufficient.

The *Code of Virginia* offers two types of security programs for a qualified public depository. They are the pooled method and the dedicated method.

Va. Code Section 2.2-4403 Procedure for payment of losses by pooled method.

~ When the Treasury Board determines that a qualified public depository securing public deposits in accordance with this section is a defaulting depository, it shall, as promptly as practicable, take steps to reimburse public depositors for uninsured public deposits using the following procedures;

1. The Treasury Board shall ascertain the amount of uninsured public deposits held by the defaulting

depository either with the cooperation of the Commissioner of Financial Institutions, the receiver appointed for such depository, or by any other means available.

2. The amount of such uninsured public deposits ascertained, as provided in subdivision 1, plus any costs associated with liquidation, shall be assessed by the Treasury Board first against the defaulting depository to the extent of the full realizable market value of the collateral pledged to secure its public deposits.
3. In the event the realized value of the pledged collateral, as provided in subdivision 2 above is insufficient to satisfy the liability for the defaulting depository to its public depositors and the Treasury Board, the Treasury Board shall assess the remaining liability against all other qualified public depositories securing public deposits according to the following ratio: total average public deposit balance for each qualified public depository held during the immediately preceding twelve months, divided by the total average public deposit balance for the same period held by all qualified public depositories under this section other than the defaulting depository.
4. Assessments made by the Treasury Board, in accordance with subdivision 3 shall be payable by the close of business on the second day following demand. Upon the failure of any qualified public depository to pay such assessment when due, the State Treasurer shall promptly take possession of the eligible collateral deposited with the non-paying depository's escrow agent and liquidate the same to the extent necessary to pay the original assessment plus any additional costs necessary to liquidate the collateral.

Va. Code Section 2.2-4404 Procedure for losses by dedicated method.

~ When the Treasury Board determines that a qualified public depository securing public deposits in accordance with this section is a defaulting depository, it shall as promptly as practicable take steps to reimburse public

depositors of all uninsured public deposits using the following procedures:

1. The Treasury Board shall ascertain the amount of uninsured public deposits held by the defaulting depository with the cooperation of the Commissioner of Financial Institutions, the receiver appointed for such depository, or by any other means available.
2. The amount of such uninsured public deposits ascertained as provided in subdivision 1, plus any costs associated with liquidation of the eligible collateral of the defaulting depository, shall be assessed by the Treasury Board against the defaulting depository. The State Treasurer shall promptly take possession of the eligible collateral deposited by such depository with the depository's escrow agent, as is necessary to satisfy the assessment of the Treasury Board and shall liquidate the same and turn over the net proceeds to the Treasury Board.
3. Upon receipt from the State Treasurer of the eligible collateral liquidated, the Treasury Board shall reimburse the public depositors from the proceeds of the collateral up to the extent of the depositor's deposit liability to them, net of any applicable deposit insurance.

Va. Code Section 2.2-4405. Powers of Treasury Board relating to administration of this chapter.

~ The Treasury Board shall have power to:

1. Make and enforce regulations and guidelines necessary and proper to the full and complete performance of its functions under this chapter;
2. Prescribe and enforce regulations and guidelines fixing terms and conditions consistent with this chapter under which public deposits must be secured;
3. Require additional collateral, in excess of the required collateral of any or all qualified public depositories as the Board may determine prudent under the circumstances;

4. Determine what securities or instruments shall be acceptable as eligible collateral, and fix the percentage of face value or market value of such securities or instruments that can be used to secure public deposits;
5. Establish guidelines to permit banks to withdraw from the procedures for the payment of losses under Section 2.2-4403 and instead be governed by the procedures for the payment of losses under Section 2.2-4404, consistent with the primary purpose of protecting public deposits;
6. Require any qualified public depository to provide information concerning its public deposits as requested by the Treasury Board; and
7. Determine when a default or insolvency has occurred and take such action as it may deem advisable for the protection, collection, compromise or settlement of any claim arising in the case of default or insolvency.

Va. Code Section 2.2-4408 Authority to make public deposits.

~ A. All public depositories are hereby authorized to make public deposits under their control in qualified public depositories, securing such public deposits pursuant to this chapter.

Va. Code Section 2.2-4410 Liability of public depositors.

~ When deposits are made in accordance with this chapter no official of a public depositor shall be personally liable for any loss resulting from the default or insolvency of any qualified public depository in the absence of negligence, malfeasance, misfeasance, or nonfeasance on his part or on the part of his agents.

Va. Code Section 2.2-4411 Reports of qualified public depositories.

~ By the tenth day after the end of each calendar reporting month or when requested by the Treasury Board each qualified public depository shall submit to the Treasury Board an electronic report of such data required by the

Treasury Board to demonstrate that the current market value of its pledged collateral was equal to or greater than the amount of required collateral for the previous month, certified as to its accuracy by an authorized official of the qualified public depository.

INVESTMENTS

The *Investment of Public Funds Act*⁹ of the *Code of Virginia* provides statutory requirements for localities investing public funds. The Virginia Department of the Treasury in 2009 adopted *General Account Investment Guidelines* to apply to the State Treasurer's investment activities. These same Guidelines should be followed by localities investing public funds. The *Guidelines* state that "the primary objective of investment activities shall be, in priority order, safety of principal, liquidity and return on investments." Any financial investment bears risk. Local government's goal of instituting investment policies and strategies that successfully balances these risks and objectives can be promoted by its following the requirements of the *Investment of Public Funds Act* statutes and the safeguards of the *General Account Investment Guidelines*.

INVESTMENT OF PUBLIC FUNDS ACT

The *Investment of Public Funds Act* is a financially technical series of statutes that specify the types of investment vehicles localities are allowed to use for the purposes of investing public funds. It is critically important that each locality develop carefully-drafted investment policies, including policy mechanisms for internal control. Each locality should also seriously consider retaining an independent financial professional to assist it with investment decisions and financial forecasting. Review of the Virginia *Investment of Public Funds Act* makes it clear that investing public funds must be approached by each locality methodically, following the statutes of the *Act*, the *General Account Investment Guidelines* and its own carefully-developed investment policies.

⁹Va. Code Sections 2.2-4500 *et seq.*

Certain basic principles stated earlier in this article bear repeating:

- The County Treasurer is the custodian of, and responsible for, all County Funds, which includes all cash, bonds, US Treasury obligations, and other financial instruments.
- While the County Finance Board has oversight responsibility, there is no doubt that for all practical purposes the County Treasurer controls investments in all regards.
- The County Treasurer is required to deposit all cash received pursuant to the *Virginia Security for Public Deposits Act*, which requires only simple verification that the bank has been approved by the State Treasury Board as a qualified public depository.

The following types of financial instruments are state-approved investments for local governments:

- The Commonwealth of Virginia created the Local Government Investment Pool (LGIP)¹⁰ - where County Treasurers can invest funds without, presumably, any risk of loss. The LGIP fund initially provided excellent returns to local governments, but now has not matched the returns provided by certificates of deposit. It has become a less attractive investment alternative for local officials.
- Certificates of Deposit have customarily been the principal method to invest idle cash balances of local governments. CD's are not technically investments, because there is no risk to the principal. The increase of the FDIC insurance limits has reduced the risk of loss to amounts in excess of \$250,000. The prior FDIC limit of \$100,000 exposed local governments to more institutional risk.
- US Treasury Bills, Notes, and other direct obligations of the United States Government;
- Obligations of Agencies of the Federal Government include, but are not limited to the following: Federal

¹⁰See Va. Code Sections 2.2-4600 *et seq.*

Farm Credit Bank, Federal Home Loan Bank, Federal National Mortgage Association, Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Student Loan Marketing Association; and

- Obligations of the Commonwealth of Virginia and of its local government and public bodies, including obligations related to the LGIP, provided such obligations have a debt rating of at least “AA” or equivalent by Moody’s and/or Standard & Poor’s.

Evaluating the best investment choices for local governments can be confusing and difficult. From the most elementary perspective, investments involve aggressive, moderate or conservative levels of risk. Local Governments can only invest in conservative investments prescribed specifically by statute. The challenge for Local Government is to balance and diversify investments in order to reduce the risk of loss. Often, the County Treasurer and Finance Board must rely on professional advisors to help select the best and most appropriate investments. Many offerings are only available via private offering sheets or telephone or intranet postings. These types of offerings include:

1. Banker’s Acceptances;
2. Repurchase Agreements;
3. Asset Backed Securities-Duration of no more than 5 years-AAA Rating; and
4. Obligations of Sovereign Governments.

Here are typical examples of investments allowed pursuant to the *Investment of Public Funds Act* of the *Code of Virginia*:

1. Virginia General Obligation-public Higher Education use
Coupon 2.1% Yield to Worst 1.591%
2. Commercial Paper-Fixed Income Offering-American Express Credit
Coupon .02 Yield to Worst .02
3. Israel St US GovT
Coupon .000 Yield to Worst .059
4. T Bond-2/15/2041
Coupon 4.75% Yield to Worst 2.766%

5. Corporate Notes AA or better Westpac Banking Corporation
Coupon 2.5% Yield to Worst 2.5%
6. Virginia Municipal Leesburg, VA
Coupon 5.0 Yield to Worst 2.530
7. CD-Capital One Bank
Price 106.830 Yield to Worst .0618
8. JP Morgan Government Bond A-Standard return
2.96% for 2011 12 month period returns
9. Government/Mortgage Funds PIMCO Strategic
Global Fund
10. Treasury T-Strip
Coupon 0.00% Yield to Worst .698

DISCLAIMER: These various issues/investments were traded at the above prices, on or about December 15, 2011, and are shown for illustrative purposes. They do not reflect current market conditions or portend to be suggestions for specific investment opportunities. It is a certainty that the above issues are subject to call provisions so they will not be held to maturity unless rates rise significantly. Further, all of the above options would be subject to “market fluctuations” placing principal at risk should capital markets change.

The policy and investment examples above show that it is imperative that localities employ independent (non-commission/non-management fee) professional financial advisors to advise them on making competent and effective investment decisions. These independent professionals should be able to forecast financial information, negotiate financial agreements, oversee insurance analysis, and undertake many other complex financial procedures.

INVESTMENT POLICIES

A government, financial institution or business seeks return on its intangible assets. The County Treasurer or Director of Finance for all practical purposes control investment decisions for a locality. In order to make sure that investment decisions are made in accordance with

the law and the intention of the Local Governing Body, each locality must have agreed upon investment policies, reduced to writing, which comport with the laws of the Commonwealth of Virginia.

The most important investment choices are made in consideration of the cash flow needs of the locality. An example of an investment policy that takes into consideration the various cash flow needs of a locality is as follows:

1. If Cash is needed to meet current expenditures, then invest in LGIP or Short Term Certificates of Deposit.
2. If there are intermediate short term cash requirements, then invest in LGIP, Certificates of Deposit, or Treasury Instruments.
3. If there are long-term cash reserves, then invest in Bonds, Eligible Stock Investments, and Long-term Certificates of Deposit.
4. If the funds available for investment are for long-term liabilities, then invest in Stocks and Long-term Bonds.

The locality's basic long term investment strategy must also be articulated into a succinct written policy. The local government's policies must balance factors such as legality, risk, liquidity and return on investment. An example of an investment policy which balances these factors is as follows:

- ❖ Investment of Public Funds must only be made in accordance with the *Code of Virginia* pursuant to the *Virginia Security for Public Deposits Act*. The Virginia State Treasurer approves all Banks that hold public funds.
- ❖ Public Funds may be invested in the following instruments:
 - U. S Treasury Bills, Notes and other direct obligations of the United States Government;
 - Obligations of Agencies of the Federal Government including, but are not limited to the following: Federal Farm Credit Bank, Federal National

Mortgage Association, Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Student Loan Marketing Association;

- Obligations of the Commonwealth of Virginia and of its local government and public bodies, including the Local Government Investment Pool, provided such obligations have a debt rating of at least “AA” or equivalent by Moody’s and/or Standard & Poor’s;
- Repurchase Agreements executed through Federal Reserve Member Banks or Primary Dealers in U.S Government securities, and collateralized by Treasury or Agency obligations of the market value of which is at least 102% of the purchase price of the repo;
- U.S. dollar denominated Banker’s Acceptances issued by a domestic bank or a foreign bank with an agency domiciled in the U. S. and rated by Thomson Bankwatch at least B/C (issued bank) and I (country of origin). Not more than 40% of the total funds available for investment may be invested in Banker’s Acceptances;
- U.S. dollar denominated Commercial Paper issued by an entity incorporated in the U. S. and rated by at least two of the following: Moody’s Investors Service, Inc., within its NCO/Moody’s rating of prime 1, by Standard & Poor’s, Inc., within its rating of A-1, by Finch Investor Services, Inc. within its rating of F-1, by Duff and Phelps, Inc. within its rating of D-1, or by their corporate successors. Not more than 35% of the total funds available for investment may be invested in commercial paper, and not more than 5% in the obligations of any one issuer;
- U. S. dollar denominated, high quality corporate notes and bonds with a duration of no more than 5 years and a rating of at least A by two ratings agencies, one of which must be either Moody’s Investor Services, Inc., or Standard & Poor’s, Inc.;
- Money Market Mutual Fund traded on a constant net asset value and which invests solely in securities otherwise eligible for investment under these guidelines; and

- Asset-backed securities with a duration of no more than 5 years and a rating of no less than AAA by two rating agencies, one of which must be either Moody's Investor Services, Inc., or Standard & Poor's, Inc.

A locality must also have policies and a system of internal control to protect against losses related to human error, fraud and/or mismanagement. The potential for such losses is greater for localities that have inadequate resources and personnel dedicated to these tasks and that have no mechanism for review or oversight by the Board or its Treasurer.

Due to the ease of making investment transactions via electronic means, access controls and monthly external reviews are employed to reduce the potential for exposure to risky investments. A relatively recent example of trading losses by a Virginia locality occurred when the Director of Finance did not understand the concept of "derivatives." In an attempt to make up what was lost he then engaged in transactions that resulted in even greater losses. This example illustrates why internal controls over investment activities are abundantly important.

DEBT

The necessity, real or perceived, to borrow money by governments is universal. The Virginia Constitution has granted to Counties, Cities, Towns, as well as their instrumentalities, the authority to issue debt in limited circumstances.

Broader authority is granted for debt issues, payable exclusively from the receipts of a particular undertaking. The intent of the law is to permit debt for both short term and long term government needs. Moreover, since the time of John Law, the financial adviser to the regent of France in the early 18th century, credit has been used to stimulate markets and development.

Virginia Constitution, Article VII, Section 10.

~ (a) No city or town shall issue any bonds or other interest-bearing obligations which, including existing indebtedness, shall at any time exceed eighteen per

centum of the assessed valuation of the real estate in the city or town subject to taxation, as shown by the last preceding assessment for taxes. In determining the limitation for a city or town, there shall not be included the following classes of indebtedness:

- (1) Certificates of indebtedness, revenue bonds, or other obligations issued in anticipation of the collection of the revenues of such city or town for the then current year; provided that such certificates, bonds, or other obligations mature within one year from the date of their issue, be not past due, and do not exceed the revenue for such year.
- (2) Bonds pledging the full faith and credit of such city or town authorized by an ordinance enacted in accordance with Section 7, and approved by the affirmative vote of the qualified voters of the city or town voting upon the question of their issuance, for a supply of water or other specific undertaking from which the city or town may derive a revenue; but from and after a period to be determined by the governing body not exceeding five years from the date of such election, whenever and for so long as such undertaking fails to produce sufficient revenue to pay for cost of operation and administration (including interest on bonds issued therefor), the cost of insurance against loss by injury to person or property, and an annual amount to be placed into a sinking fund sufficient to pay the bonds at or before maturity, all outstanding bonds issued on account of such undertaking shall be included in determining such limitation.
- (3) Bonds of a city or town the principal and interest on which are payable exclusively from the revenues and receipts of a water system or other specific undertaking or undertakings from which the city or town may derive a revenue or secured, solely or together with such revenues, by contributions of other units of government.
- (4) Contract obligations of a city or town to provide payment over a period of more than one year to any publicly owned or controlled regional project, if the

project has been authorized by an interstate compact or if the General Assembly by general law or special act has authorized an exclusion for such project purposes.

~ (b) No debt shall be contracted by or on behalf of any county or district thereof or by or on behalf of any regional government or district thereof except by authority conferred by the General Assembly by general law. The General Assembly shall not authorize any such debt, except the classes described in paragraphs (1) and (3) of subsection (a), refunding bonds and bonds issued, with the consent of the school board and governing body of the county, by or on behalf of a county or district thereof for capital projects for school purposes and sold to the Literary Fund, the Virginia Supplemental Retirement System, or other State agency prescribed by law, unless in the general law authorizing the same, provision be made of submission to the qualified voters of the county or district thereof or the region or district thereof, as the case may be, for approval or rejection by a majority vote of the qualified voters voting in an election on the question of contracting such debt. Such approval shall be a prerequisite to contracting such debt.

Any county may, upon approval by the affirmative vote of the qualified voters of the county voting in an election on the question, elect to be treated as a city for the purposes of issuing its bonds under this section. If a county so elects, it shall thereafter be subject to all of the benefits and limitations of this section applicable to cities, but in determining the limitation for a county there shall be included, unless otherwise excluded under this section, indebtedness of any town or district in that county empowered to levy taxes on real estate.

THE NATURE OF DEBT INSTRUMENTS

There are many legal instruments that may have both the characteristics of debt and equity. The Virginia *Public Finance Act*¹¹ authorizes two specific types of debt

¹¹Va. Code Sections 15.2-2600 *et seq.*

for all Virginia localities, including cities. These types of debt instruments are:

Va. Code Section 15.2-2602 Definitions.

~ “General Obligation bonds” means the bonds of a locality for the payment of which the locality is required to levy *ad valorem* taxes¹², including any obligations which may be additionally secured by a pledge of revenues, special assessments or funds derived from any other source; and,

“Revenue bonds” mean bonds of a locality for which only the specified revenues of the locality are pledged and to which no *ad valorem* or other taxes of the locality are pledged, including, without limitation, bonds of a locality for which only the revenues of a revenue producing undertaking or undertakings, or such revenues together with a mortgage or deed of trust lien on the undertakings, are pledged for their payment.

Most local governments are now active in matters of their economic development. While once the prevailing rule was to allow “market forces” dictate the extent, nature and character of industrial and economic development within their localities, now local governments intervene to compete for and foster industrial and economic development. Most Virginia localities now offer some form of financial inducement to encourage industry and development with expectations that said development will result in real property improvements, new employment opportunities, increased revenue and an incentive for additional investments in development and industry. In many cases, debt is issued by a locality to engage in “projects” to improve its competitiveness in this context. The *Public Finance Act* sets forth the permitted reasons for a project in its definition section earlier cited:

~ “Project”¹³ means any public improvement, property or undertaking for which the locality is authorized by law to appropriate money, except for expenses, and specific undertakings from which the locality may derive

¹²*Ad valorem* is a Latin phrase that means “according to value.”
Black’s Law Dictionary.

¹³Va. Code Section 15.2-2602.

revenues (sometimes called “revenue-producing undertakings”) including, without limitation, water, sewage disposal, and garbage and refuse collection and disposal systems and facilities as defined in Section 15.2-5101, recycling facilities, facilities for the production of energy from waste, gasworks, electric light and other lighting systems, airports, off-street parking facilities, and facilities for public transit or transportation systems.

The Act also gives significant powers to the locality regarding securing public financing for these “projects.”

Va. Code Section 15.2-2604 Powers generally.

~ Subject to the provisions of Articles 3 (Sections 15.2-2632 *et seq.*) and 4 (Sections 15.2-2638 *et seq.*), any locality may:

1. Acquire, construct, reconstruct, improve, extend, enlarge, equip, maintain, repair and operate any project which is located within or outside the locality;
2. Contract debts for any project, borrow money for any project, and issue its bonds to pay all or any part of the cost of acquiring, constructing, reconstructing, improving, extending, enlarging and equipping any project;
3. Refund any bonds previously issued by the locality or for which the locality is responsible or may assume responsibility for payment;
4. Provide for the rights of owners of bonds issued by the locality;
5. Secure bonds issued by the locality as permitted by law;
6. Issue bonds to create any self-insurance reserve fund;
7. Issue bonds to pay all or any part of the cost of satisfying a final judgment imposed against the locality (including its local school board) by a court of competent jurisdiction;
8. Acquire in the name of the locality, by purchase, gift, or the exercise of eminent domain, land and rights and interests in land, including land under water and

- riparian rights, and acquire personal property as the governing body of the locality may deem necessary in connection with any project;
9. Enter on any land, water or premises located within or outside the locality for the purposes of making surveys and such entry shall not be deemed a trespass. . . . , but the locality shall make reimbursement for any actual damages resulting from the entry;
 10. Receive and accept from any federal or state agency grants for or in aid of construction of any project, and receive and accept aid or contributions from any source of money, property, labor or other things of value, to be held, used and applied for the purposes for which the aid or contributions may be made
 11. Employ consulting engineers, attorneys, accountants, construction and financial experts, superintendents, managers, and other employees and agents as may be necessary;
 12. Acquire, hold, and dispose of real and personal property in the exercise of its powers and the performance of its duties under this chapter;
 13. Enter into all contracts and agreements necessary or incidental to the performance of its duties and the execution of its powers under this chapter;
 14. Do all things necessary or convenient to carry out the powers expressly given in this chapter and to carry out any project;
 15. Assess, levy and collect unlimited *ad valorem* taxes on all property subject to taxation to pay the principal of and premium, if any, and interest on any bonds . . . ; and
 16. Fix and collect rates, rents, fees and other charges for the services and facilities furnished by, or for the use of, or in connection with any revenue producing undertakings . . .

PROCEDURAL REQUIREMENTS FOR ISSUING BONDS

In order to issue bonds, a locality must follow the specific requirements of the Virginia *Public Finance Act*. Failure to do so can, in extreme cases, invalidate the bond issue and create a hardship on the locality. Since in this subject matter area the cost for failure to comply with rules and regulations is quite steep, a locality should seek legal and financial advice to ensure compliance.

The first step in the process to issue bonds is to have a public hearing related to the proposal¹⁴. Notice must be published twice in a newspaper having general circulation in the locality. The notice must include the purpose of the bond issue, the maximum amount to be borrowed and, the time and place of the hearing on the bond issue. The hearing shall not be held less than six days after and no more than twenty-one days after the date the second notice appears in the newspaper. However, no notice or public hearing is required for bonds which have been approved by a majority of the voters of the issuing locality voting on the issuance of the bond or bonds, or on temporary loans, refunding bond or bonds issued in anticipation of federal revenues.¹⁵

A locality is authorized to provide, by ordinance or resolution, for the issuance of bonds that may include certain provisions.¹⁶ Specifically, they may contain the following:

1. The payment of principal of and premium and interest on bonds from *ad valorem* taxes on all property subject to taxes and the pledging of the full faith and credit of the locality;
2. The pledge of specified revenues of the locality;
3. The granting of a mortgage or deed of trust on any revenue producing undertaking;
4. The securing of payment of the bonds by ordinance resolution, trust agreement indenture or other

¹⁴Va. Code Section 15.2-2606.

¹⁵*Id.*

¹⁶Va. Code Section 15.2-2607.

- instruments, which may appoint any trust company or bank within the Commonwealth as trustee; restrict the individual rights or actions of bondholders and other provisions that are reasonable for a bondholder;
5. The payment of principal, premium, and interest from one or more source of funds and pledging these sources for this purpose;
 6. Designate the rates, fees, charges, taxes and other revenues or receipts of any revenue producing undertaking and the use of the funds;
 7. Setting aside reserves or sinking funds and the regulation and disposition of them;
 8. Limitations of the right of the locality to regulate the use of any project;
 9. Limitations on the purpose to which the proceeds of any bond may be applied;
 10. Limitations on issuance of additional revenue bonds;
 11. The procedure, if any, the terms of any contract with the bondholders may be amended;
 12. Conferring upon the bondholders or the trustee under any ordinance, resolution, trust agreement, indenture or other instrument remedies of enforcing the rights of the bondholders and requiring the governing body to carry out any agreement with the bondholders;
 13. Any other matter required by any state or federal agency as a condition precedent to the obtaining of a direct grant or grants of money for or in aid of any project or to defray or partially to defray the cost of the labor and materials employed upon any project or to obtain a loan or loans of money for in aid of any project from any state or federal agency; and
 14. Any provisions necessary to qualify the interest on the bonds for exclusion from gross income for federal income tax purposes.¹⁷

¹⁷*Id.*

The ordinance or resolution authorizing the issuance of the bonds may be finally adopted at the meeting at which it is introduced, which may be a regular or special meeting, by a majority of the members of the governing body. A certified copy of the ordinance or resolution shall be filed in the circuit court of the locality. The ordinance or resolution need not be published, posted or advertised.¹⁸

To restate, any locality may, following Article VII, Section 10 of the Constitution of Virginia, issue bonds for any revenue-producing undertaking. Further, the authority to issue bonds does imply the authority to expend the proceeds of the bonds with an appropriation. In some instances the Constitution of Virginia requires voter approval of bond issues. The process related to requesting and holding a referendum vote on a bond issue is outlined in Virginia Code Sections 15.2-2610 and 15.2-2611. Other statutory provisions related to technical aspects of the bond issuance process, e.g., dating and interest rates of bonds, form and signatures required, etc. can be found in Virginia Code Sections 15.2-2612 through 15.2-2613.

Of historical significance is Virginia Code Section 15.2-2614 which recognizes that bonds may be issued in bearer form or registered book entry form. During the 1960s and before, there were many bearer bonds and stock certificates, but there are almost none today. A bearer bond was circulated like currency as a negotiable instrument.

Bonds in any form may be sold by the governing body at public or private sale, at such price as the governing body may determine.¹⁹ That being said, it is doubtful that bonds will ever be sold on the Courthouse steps to the public.

Of special importance is the accounting for bond proceeds as shown below:

Va. Code Section 15.2-2618 Disposition of proceeds; separate fund.

~ Unless otherwise specifically provided by the governing body of a locality or a locality or in the ordinance, resolution, trust agreement, indenture or other

¹⁸*Id.*

¹⁹Va. Code Section 15.2-2617.

instrument authorizing the issuance of bonds, all proceeds received from the sale of the bonds of any locality issued under the provisions of this chapter shall be paid to, or at the direction of, the treasurer or chief financial officer of the locality who shall promptly deposit the funds in a bank or other depository to the credit of the locality as prescribed by general law or the provisions of the charter applicable to the locality. The treasurer or chief financial officer shall account for the money through a fund, separate from all other funds, in the system of accounting of the locality.

It is implausible that a treasurer in the Commonwealth would neglect to deposit bond funds in a bank or other approved depository. Previously, a treasurer may have taken the funds in actual currency. Today, with the limited circulation of cash, a more likely mistake would be made by a treasurer authorizing an electronic transfer of bond proceeds to a Hong Kong bank that is not authorized to do business in the Commonwealth.

Va. Code Section 15.2-2619 Investment of proceeds pending application to authorized purpose.

Should a locality realize investment income or profit from the investment of the proceeds of the bonds prior to expenditure, those earnings are considered part of the proceeds.²⁰ This is a logical determination because the interest expense starts to accrue upon issue of the bond and is reducing the total bond's proceeds. The locality may, by resolution of the governing body, apply the interest accruing on the investment and any profit realized from it to pay costs already incurred for the project supported by the bond.²¹ Typically, a locality will incur many startup costs on a bond project and Virginia Code Section 15.2-2619 grants the locality authority to repay these costs to itself with bond interest and profit. That being said, given the lack of returns in current markets, it is unlikely this statutory authority will result in a locality being able to significantly repay itself for the startup costs.

²⁰Va. Code Section 15.2-2619.

²¹Id.

Va. Code Section 15.2-2620 Bonds made legal investments.

As previously discussed bonds issued under the *Public Finance Act* are legal investments for all localities, banks and fiduciaries. Localities cannot deal in their own securities, but they may purchase the investments of other Virginia local governments. This has been an overlooked opportunity.

Va. Code Section 15.2-2640 Resolution for bond issues; request for bonds for school purposes. - and - Va. Code Section 15.2-2642 School district bond.

Virginia case law has long established the fact that a County Treasurer and Board of Supervisors cannot control the disposition of School District Bonds, except to the extent of acting as custodian of the proceeds and investment of same. Where a county, city or town issues a general obligation bond for a school project, then the control is shifted, in part, back to the Board of Supervisors.²²

Va. Code Section 15.2-2624 Tax to pay principal and interest.

~ Notwithstanding any other provision of law or any charter provision, the governing body is authorized and required to levy and collect annually, at the same time and in the same manner as other taxes of the locality are assessed, levied and collected, a tax upon all taxable property within the locality, over and above all other taxes, authorized or limited by law and without limitation as to rate or amount, sufficient to pay when due the principal of and premium, if any and interest on any general obligation bonds of the locality issued under the provisions of this chapter to the extent other funds of the locality are not lawfully available and appropriated for such purpose.

Of long standing in Virginia is the statute that bondholders look to for mandatory repayment of principal and interest. It is a certainty that the General Assembly did not want

²²Va. Code Sections 15.2-2640 and 15.2-2642.

the localities to default on the payments of their bonds due to the lack of will to set a tax rate sufficient to make the payments, or the failure to appropriate monies. This statute provides a powerful back stop in the event a locality considers the option of default.

Va. Code Section 15.2-2625 Deposit of funds; security; investment of funds.

Proceeds from bond funds must be deposited with some solvent bank, pursuant to the provisions previously referenced from the *Virginia Security for Public Deposits Act*.

OTHER SOURCES OF FINANCING

Bonds and debt issues, during the early twentieth century in Virginia, governmental bonds and debt issues were originally purchased by banks and individuals. Law firms would help prepare the bond documents for the localities. Today, there are many avenues open to Virginia localities to obtain financing. There are quasi-governmental entities, commercial brokers, investment advisors and underwriters who can assist local governments. Regardless of the path chosen to obtain financing, there is a significant cost to the locality for this service.

The Commonwealth of Virginia created the Virginia Resources Authority in 1984 as a political subdivision of the Commonwealth of Virginia. Its original purpose was to provide a source of financing for local governments for local infrastructure projects related to water and sewer. Today, it has expanded to include up to 18 different project areas. The Authority continues to maintain its purpose of assisting communities with low-cost financing through a pooled financing program with the enhanced credit rating of the Commonwealth, capitalized grant funds and the Virginia Transportation Infrastructure Bank. This source of funding remains a consistent provider of funding for localities with over \$1.3 billion in net assets. It remains highly visible in water, wastewater and airport financing.

School divisions have a large need for debt financing. The Virginia Public School Authority, created by Chapter 11,

Title 22.1, of the *Code of Virginia*, as amended,²³ provides financing to local school divisions. Typically, school boards have been unable to accumulate sufficient reserves to fund new or improved school facilities without issuing debt. From the standpoint of equity, matching the usage of a long term asset to the users is logical. Consequently, a debt service paid over a twenty year period is seen as good policy. The Authority has provided Virginia school division bonds through its pooled bond program. Of special significance is the Authority's 1997 resolution. It authorizes as security for the bonds by the locality, interception of its state appropriations, or distributions from the Commonwealth's general fund, to make payments in lieu of default.

Virginia Local Governments have created not-for-profit entities that serve as an advocate for their interests. For example, in 2003, the Virginia Municipal League and the Virginia Association of Counties formed a joint venture operating as the VML/VACO Finance. This program offers loans of varying sizes for fixed terms, interim and variable rate financing, and leasing. Equipment Leasing is now a popular program for localities to finance large equipment or transportation vehicles. Financing instruments now avoid the possible conflict with the Virginia Constitution, where one board of the governmental entity cannot bind beyond its term a successor board, such as by adding a moral obligation resolution or non-appropriation clause.

The list of commercial financiers, who supply bond financing, is deep and long, including Wells Fargo, Davenport and Company and Bank of America. These organizations may act as underwriters for the project which provides that the bonds will not be sold at an open market price, but purchased by the underwriter/entity to be resold to their clients. Usually, this involves some risk to the underwriter, but not as much in today's low interest rate environment. In fact, for 2012, rates fell well below 2% for a 15-year issue and demand by investors for these securities is strong. Tax laws create incentives for investors to take advantage of these investments which generate tax exempt income. For a resident of the Commonwealth of Virginia,

²³Va. Code Sections 22.1-162 *et seq.*

the earnings are free from federal and state income taxes. Moreover, recent federal tax law increases have NOT impacted this tax treatment, serving only to increase the desirability of Virginia local government debt instruments.

CONCLUSION

In Virginia the governing body of a local government is charged by state law with managing its budget, cash assets, investments, debt and borrowing. The governing body follows the strictures of the law and the guidelines of its policies to balance its sometimes competing goals of the preservation of assets and the promotion of economic development and opportunity for its citizens.



Disclaimer Statement:

All comments contained herein are the opinions of the authors. We urge all localities to solicit expert legal advice when appropriate.

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