

MINUTES OF MEETING
STATE BOARD OF FINANCE

AUGUST 4, 2016

A meeting of the State Board of Finance of the State of Arkansas was held in the Conference Room, Office of the Treasurer of State, Suite 275, Victory Building, Little Rock, Arkansas, at 11:00 a.m., Thursday, August 4, 2016, pursuant to notice duly given to each member of the Board by the Chairman.

The following members were present:

Larry Walther, Director, Department of Finance and Administration
Dennis Milligan, Treasurer of State
Marjorie Greenberg, Representing Governor Asa Hutchinson
John Ahlen, Representing Andrea Lea, Auditor of State
Ann McDougal, Representing Edmond Waters, Arkansas Securities Commissioner
Luther Guinn, Representing Candace Franks, Arkansas Bank Commissioner
Cale Turner, Appointed Member
Gabe Holmstrom, Appointed Member
Keith Konecny, Appointed Member

Others present were Jason Brady, Grant Wallace, Autumn Sanson, Ed Garner, Larry Tate, Melissa Corrigan, and Celeste Gladden of the Treasurer's staff; Paul Louthian of the Department of Finance and Administration; David Bell of the Governor's office; Jim Fowler and Jacob White of the Rose Law Firm; and Mike Wickline of the Arkansas Democrat Gazette.

Larry Walther served as acting Chairman in the absence of Governor Hutchinson and called the meeting to order with recognition of a quorum.

Minutes of the meeting held on June 21, 2016 were approved as distributed.

Chairman Walther recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report. This Report is included in the Minutes as Attachment 1. Treasurer Milligan addressed the Board and said that today he is presenting the final totals for fiscal year 2016. He told the Board that the short term portfolio receipted a total of \$1.71 million for the month of June

and a total of \$11.7 million for fiscal year 2016; and the long term portfolio received a total of \$5.07 million for the month of June and a total of \$37.2 million for fiscal year 2016. Treasurer Milligan told the Board that the Treasurer's office has received a total of \$48.98 million in returns from the investment of state funds for fiscal year 2016. He stated that the results are tremendous, and to put it in perspective, it is over double the \$22.31 million received last year. He continued, explaining that in historical perspective, it is even better than what the office did in 2005 of \$44 million, and 2009 of \$47.5 million, when interest rates ranged between 3% and 2% respectively. Treasurer Milligan said that the results were generated through active management and with the federal fund rate at only 0.25%. He told the Board that without increases in the interest rates by the Federal Reserve, it is unlikely that the Treasury will again experience the dramatic increases like it has since he took office. He reminded the Board that in 2006, 2007, and 2008, when the office received approximately \$87, \$112, and \$95 million respectively, interest rates ranged between 3% and 5% in 2006-2007, and then 5% and 2% in 2007-2008. He said that we are a far distance from those rates today. Treasurer Milligan stated that his job as Treasurer of State is to provide liquidity to pay the warrants of the state, to invest the state's funds to the best of his ability, and to maximize returns while minimizing risk. He also said that, other than the upcoming discussion of repos, he does not plan to ask for any new authority to invest in other financial products or instruments in the near future. He continued by saying the Treasury will be vigilant and work as hard as they can; but wants the Board to understand that the Treasury might be at or near the ceiling in returns until different market conditions arise. The Treasurer then thanked the Chairman and members of the Board, and asked if there were any questions.

Keith Konecny asked if the securities held are valued to market price. Ed Garner responded that the securities are priced nightly, so the valuation is known, and premiums and discounts and accrued and amortized, but performance is not gauged in a total return format and profits or losses are not based on the market value of the portfolio.

Cale Turner asked if there a goal of how much of the earnings go into the reserve fund. Chairman Walther responded that the ultimate goal is to fully fund the \$125 million. He explained that there are lot of benefits to it just from the perspective of the investment community, organizations like Standards and Poors, to show the State's desire to have a reserve. He continued by saying that the Treasury portfolio is risk intolerant, the length of terms that are being invested in are fairly short, so that type of strategy overall will minimize, not prevent, but minimize exposure to large market fluctuations, where they can be dealt with quickly. Mr. Konecny added that he agreed that with the portfolio being short, the Treasury is going to be in a better position to take advantage of market changes rather than being exposed to them.

There being no further discussion, Chairman Walther asked for a motion from the Board to accept the Investment Performance Report into the record. The motion was made by Keith Konecny and seconded by John Ahlen. All members were in favor.

Next, Chairman Walther made a motion to establish that no funds are available for deposit into the State Board of Finance certificate of deposit investment program. The motion was seconded by Luther Guinn. All members were in favor.

The Chairman then made a motion that the Board direct the Treasurer of State to purchase warrants for the succeeding quarter, October 1, 2016 – December 31, 2016, pursuant to Act 1088 of 2013, and to keep reasonable amounts in demand deposit accounts and money markets during the next quarter for the transactions of the day to day activities of the State. The motion was seconded by Marjorie Greenberg. All members were in favor.

Next, the Chairman recognized Grant Wallace for the next agenda item, consideration of Treasurer of State employees minimum qualifications and standards for FY17. Mr. Wallace addressed the Board and stated that in compliance with Arkansas code §19-3-704(a)(6) or Act 1088 of 2013, presented is the minimum qualifications for the office of Treasurer of State for fiscal year 2017,

along with the version that was approved by the Board last year for fiscal year 2016. Mr. Wallace told the Board that the highlighted items on the 2017 chart are the items that have changed for this year. He said that those changes only reflect title changes that were made to the Treasurer's 2017 appropriations bill which was passed during the previous fiscal session, and that no changes were made to the standards, but only matched the new titles to the existing standards. Mr. Wallace stated that there were no positions added and the office remains at 33 staff members. He then listed the specific changes: the Deputy Chief of Staff and Assistant Chief of Staff positions were changed to Chief Deputy Treasurers; one of the Treasury Division Director positions was changed to Senior Investment Manager; the Deputy Chief Information Officer was changed to the Chief Operating Officer; some of the Treasury Manager positions were renamed to Manager IV's; and the Treasury Assistant V positions were done away with. Mr. Wallace concluded his presentation by asking for approval from the Board.

The Chairman asked for motion from the Board to approve the changes as presented. The motion was made by Keith Konecny and seconded by Marjorie Greenberg. All members were in favor.

Chairman Walther then recognized Jim Fowler of the Rose Law Firm to present the next item on the agenda, proposed legislation for repurchase agreements. Mr. Fowler addressed the Board and stated that he, along with Jacob White from his firm, are here to update the Board on a couple of items that were brought up in the last meeting. He stated that first he thought it would be helpful to describe the scope of the Rose Law Firm's engagement with the Treasurer's office. He told the Board that the Attorney General's office advised the Treasurer that they were not comfortable opining on some of the matters of legality of investments and that the Treasurer's office should seek outside counsel. After going through the process that the Attorney General has for the selection of that counsel, the Rose Law Firm was selected. He explained the scope of the engagement is to advise the Treasurer on the legality of investments and other matters relating to public finance. Mr. Fowler said the first item

of question was repurchase agreements. He further explained that repurchase agreements are a very safe and secure investment vehicle, with a 2.5 trillion dollar market, widely used by state treasurers across the nation for handling their cash. He said that the Rose Law Firm was asked about the legality of the Treasury entering that market, and unfortunately the most common collateralization for a repurchase agreement is not permitted under the Arkansas statutes. Mr. Fowler then pointed the Board to a slide presentation that explains further. This presentation is included in the Minutes as Attachment 2. Mr. Fowler explained: Subchapter 5 under the State Treasury Management law outlines the permitted investments by the State Treasurer, there are 14 categories of permitted investments, number 12 of that is repurchase agreements. Under Subchapter 5, repurchase agreements currently must be collateralized with direct obligations of the U.S. Government or general obligations of state and local governments. Direct obligations are legally defined as treasury bills, bonds, and notes. The typical collateral used for repurchase agreements, government agencies, is not permitted under the Arkansas statute. He continued by stating that the Rose Law Firm questions why state and local government general obligations were ever put in to begin with because the credit quality could vary widely. Mr. Fowler stated that with these limitations, only treasury bills, bonds, and notes could be used as collateral. He explained that what the Rose Law Firm is proposing is to delete the authorization to collateralize repurchase agreements with municipal bonds, and add the government agencies and securities that are backed by a direct guarantee of the United States government as collateral for repurchase agreements. He said that these are modes of collateral that are commonly used across the country now. He also noted that that these changes will not change any of the permitted investments in the current investment policy, it just allows a substitution of what the repurchase agreement category can be collateralized with. Mr. Fowler asked the Board if there were any questions.

Chairman Walther asked if his understanding is correct, that the Treasury is not currently using municipal bonds as collateralization for repos. Mr. Fowler answered affirmatively, and added that

currently the Treasury is not investing in repos and has not done so in the past to a great degree, although the Treasury would like to begin using repos as they are a very useful tool in the management of state funds. He added that some treasuries are investing in repos in a total of 40% of their portfolio. Chairman Walther asked if the Treasury would begin using repos like other treasuries, and how long would the terms be. Ed Garner responded that the terms vary quite a bit, and he does not see the allocation being anything similar to the other states. He added that the Treasury has a maturity niche to fill that would bridge the gap between very short commercial paper holdings and the mortgage backed securities, so the target would be under a year in maturity, as that is the hole in cash flow management that the repos would be needed for.

There was some discussion about the different collateral types that would be used. Mr. Garner told the Board that the Treasury would be looking at agencies like Freddie Mac or SBA, agencies which are fully guaranteed by the government. Marjorie Greenberg asked Mr. Garner if he foresees revisiting with the Board what types of items would be available for repurchase agreements, and would he be coming back to the Board with the list? Mr. Garner answered affirmatively.

Mr. Fowler addressed the Board again and said that before them was draft legislation for their consideration. This draft legislation is included in the Minutes as Attachment 3. He reiterated that the legislation deletes the municipal bonds, deletes the narrative reference to direct obligation, and then incorporates those items that are already in the statute that have the government backing behind them.

Chairman Walther asked if there were any questions. There were none. He said he would like to have a motion of support by the Board for this proposed legislation, with the understanding that it is a draft, and it could possibly change, but he felt like it is the right direction to go for the Treasurer and the investment team. The motion was made by Treasurer Milligan and seconded by Keith Konecny, all members were in favor.

Next, Chairman Walther recognized Autumn Sanson to discuss the next item on the agenda, proposed legislation for the ROI distribution date change. The proposed legislation is included in the

Minutes as Attachment 4. Ms. Sanson addressed the Board and stated that a change to the ROI distribution date to agencies is necessary because there is no way to make an accurate distribution on the first day of the month, like is currently done, because the data used for calculating returns does not come out until the 25th of the month. She told the Board that there is currently a temporary procedure in place in which two distributions are done per month. Ms. Sanson said that agencies, cities, and counties are being notified that the distribution date will be changed from the 1st to the 26th, and no pushback is expected since distributed earnings have increased significantly. She then asked if there were any questions.

Chairman Walther stated that this change falls in line with the change in the timing of the quarterly meetings and puts everything into a more logical sequence where the timing allows the investment team to get the work done to make the report and then plan for the next quarter.

Cale Turner asked if the first month after the change is made, if the distribution will be done on the 1st of the month and then again on the 26th of the month. Ms. Sanson replied there will be some lag time in the first distribution. To which, Mr. Turner replied and asked if the agencies are being told to manage their cash flow based on this lag. Following this exchange, there was some additional discussion amongst several present whether it would be a full month or more of potential lag time. At that point Mr. Paul Lothian, Chief Accountant of the Department of Finance and Administration, clarified to the Board that it was determined that the lag will be a full month. He stated that in July, there will not be a distribution. The first distribution will be the 26th of August for the month of July. He continued by saying that the distribution timing as it is, is currently not in compliance with Arkansas law. At this time, a process is in place where a distribution amount is being estimated, and then being trued up the next month, which was a deal made with Legislative Audit premised on the fact that the law would be changed by next fiscal year. Mr. Lothian told the Board that the distribution will be done like the sales tax distributions, local sales tax is collected in the current month and distributed on the 25th of the following month. The ROI distribution will be following that

same pattern. There being no further discussion, Chairman Walther asked for a motion from the Board. The motion was made by Keith Konecny and seconded by Treasurer Milligan. All members were in favor.

Ms. Sanson addressed the Board again to continue with the next agenda item, an update on the progress of securing a new safekeeping agent. She explained, after receiving notice in June of the Treasury's current safekeeping bank no longer covering the account, legal counsel advised how to go through a "best practice" procedure to secure a new custodian. She stated that that this procedure would include sending formal RFQ to interested custodial firms. Ms. Sanson told the Board that several firms are being looked at and many can offer customized services to fit the needs of the Treasury, and the RFQ is based those needs. She stated that after receiving multiple proposals, staff will then carefully analyze and choose the firm that can best meet requirements. She added that with changing safekeeping agents, she is also anticipating a much improved work flow and audit trail. Ms. Sanson then handed the presentation over to Jacob White of the Rose Law Firm to provide additional details.

Mr. White introduced himself to the Board and stated that he was going to give a very brief update on the status of finding a new safekeeping custodian. His presentation is included in the Minutes as Attachment 5. He told the Board that the Treasurer's investment policy states that, "The services of a master custodian and money manager will be obtained through a competitive evaluation of proposals submitted to the Treasurer of State's Office." Mr. White stated that the Rose Law Firm is going to follow with the guidance that's in the investment policy that has been approved by the State Board of Finance. He continued, and said that he has reviewed several RFQ's, looked at how other state treasuries have dealt with this issue, and has developed a rough draft of an RFQ for the Treasurer to use. He said that the qualifications being looked for include the scope of services, the experience in offering custodial services, the size of the portfolios that they have previously done before, and a real-time online platform. Mr. White explained that an ideal platform will allow the

Treasury to see exactly the value of their collateral daily. He concluded his presentation by saying that the RFQ is going to include a questionnaire covering these items, along with questions regarding collateral safekeeping, compliance monitoring, performance and risk assessments, and reports.

Chairman Walther stated that this issue does not require a vote at this time, but is simply informational. He then asked if there was any more business to come before the Board. There was not. The Chairman reminded the Board that next meeting will be November the 10th and declared the meeting adjourned.

ATTEST:

Secretary of the State Board
of Finance of the State of Arkansas

Acting Chairman of the State Board
of Finance of the State of Arkansas

Secretary's Note: All documents pertaining to the issues considered are filed in the permanent records of the State Board of Finance.