State Investment Commission  
June 27, 2012  
10 a.m. ~ Room 182 ~ Capitol Annex  
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on Wednesday June 27, 2012, at 10:00 a.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; David Allen, proxy for Governor Beshear; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Dwight Price, Brett Antle, Deputy Executive Director, Kim Bechtel, and Marcia Adams.

Other Guests: Mr. Ed Ross, Controller, Kristi Culpepper, Joshua Nacey, and Kelly Dudley from Legislative Research Commission (LRC); Jeff Mosley, General Counsel, Finance and Administration Cabinet, and Barbara Fava, Senior Managing Director, PFM Asset Management, LLC.

Treasurer Hollenbach verified that a quorum was present and that the press had been notified of the meeting.

Treasurer Hollenbach called for a motion to approve the minutes from March 22, 2012. Mr. Steve Jones informed the Commission of one misspelled word on page 7. A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens to approve the minutes with the changes noted. Motion CARRIED.

Mr. Steve Jones thanked the Commission members and staff for their time and attention, who have reviewed and drafted the changes to these documents about to be discussed. The agenda lists multiple items to review and after discussion, the Commission agreed to review the entire list, noting pending changes, before entertaining a single motion for acceptance or not of the inclusive list.

State Investment Commission Powers KRS 42.500 - Mr. Jones stated that statute, KRS 42.500, is for the State Investment Commission’s (“SIC”) activities and responsibilities. One substantial change is number 9 i, where the restriction is being lifted of 10% of total assets in mutual funds. Barbara Fava of PFM Asset Management, made this recommendation as the Commonwealth uses money market mutual funds as a place to park money for flexibility. At times, there is a need beyond 10% of the total portfolio. All other changes in the statute are bringing the proper terminology up to date with the Securities and Exchange Commission (“SEC”), and the nationally recognized rating organization. Mr. Lawson asked if the original 10% was satisfactory before the lower interest rates. Mr. Tom Howard stated that adding mutual funds to the portfolio goes back to the 1980’s and was a novelty so the 10% limit was established to evaluate how it went and determining if changes in the market would make it appropriate. Mr. Jones added that while increasing the amount in mutual funds, we have restrictions on what funds we are allowed to utilize.

Qualified Investments 200 KAR 14:011 -- Mr. Price stated this is also a cleanup of wording, using SEC terminology; changing the previous limit of $25,000,000 per issuer to $50,000,000 and limiting $25,000,000 per pool (Intermediate & Limited-Term Pools) to increase the Commonwealth’s corporate exposure with high-end choices. The second major change is the using the 2a-7 Rule for the Limited-Term Pool, which will be discussed further down the agenda. Mr. Jones added staff is
working to build our in-house credit analysis capabilities. The Commonwealth has always relied on the rating agencies, and during the next 6 months, OFM anticipates adding staff and developing a more formalized approach to the Commonwealth’s credit review process. The Commonwealth is raising the limits but improving the ability to manage those limits.

Treasurer Hollenbach asked where does the Commonwealth find credit analysis people. Mr. Price answered that Steve Jones has a CFA certification (Chartered Financial Analyst), will be the lead on this and recently had 3 days of training. OFM will add an entry-level staff person and send them to training as well. Mr. Howard added that this analysis would support both investments and debt. On the debt side, staff has a derivatives contract that needs to be monitored. Mr. Spragens asked about funding for this additional staff. Mr. Howard replied that pending OFM retirements and expected reorganization will allow for this additional credit area personnel.

Repurchase Agreement 200 KAR 14:081 – Mr. Jones discussed the Repurchase agreement 200 KAR 14:081, and the most notable change being the capital to asset ratio up to 8%, and the return on asset ratio to ½ of a percent as well as changing wording to current terminology. Treasurer Hollenbach asked if the increases were enough. Mr. Jones stated that staff makes sure that the banks the Commonwealth lends to have a positive return on assets and are actually making money. With raising the capital slightly, it creates more cushion between the regulatory required capital and what the Commonwealth is comfortable with. Mr. Lawson questioned what the capital requirements will be for banking institutions and wondered if adding verbiage will assist in not having to make adjustment changes sooner. Commission members agreed to add “or regulatory requirements” to Section 8 line (c).

Guidelines for Money Market Instruments 200 KAR 14:091 – Mr. Price noted the changes in Section 5, the limit of money market instruments, will increase from 20% to 35%, which is in line with the credit increase and will allow better management. Staff is looking to better manage this portfolio with additional staff. Mr. Jones stated that with the added personnel, Kim Bechtel will be assigned the primary portfolio manager on this pool.

This concluded changes to existing documents and the following documents to be discussed are new.

SEC 2a-7 Procedures Manual – Ms. Barbara Fava, consultant to the SIC, led the discussion for Rule 2a-7 Procedures Manual, aka Valuation of Pool Securities and Stabilization of Net Asset Value for the Limited Term Pool. To meet the requirements of Rule 2a-7, there are specific procedures the Commission has to do. One is to determine the price at which shares will be sold. When the market value of securities in the portfolio are downgraded and fall below what the shares were purchased for, the Commission must decide what will happen if those securities were to be redeemed. Rule 2a-7 effectively states the Commonwealth will only allow the Pool (Limited Term Pool) market value to stay near the purchase price to continue to sell and buy shares. If it gets beyond this minor threshold, staff will need to bring it back inline and adjust by selling a security to realize the gain or loss to bring it back within the threshold. The SEC prescribes the portfolio be managed to keep the average maturity very short. By accepting the 2a-7 document created by the SEC, the Commonwealth will abide by these statements and maintain the portfolio within this margin. Treasurer Hollenbach asked if a security were to go way off in the portfolio. Ms. Fava replied that again, staff can sell or buy a security to offset the realized gain/loss flows through to the income distribution to bring the portfolio back in line. If it is a serious problem, you can temporarily
suspend redemptions until you get a handle on the issue. Another option is to shut down the Pool completely, give all the investors a piece of each security through an in-kind redemption, but that is highly unlikely to get to that extreme. 2a-7 lays out all the options the Commission has and also specifies when staff would have to alert the Commission to a problem. Steve Jones noted that Brett Antle and the accounting staff have been working diligently and has brought OFM accounting up to the 2a-7 Rule requirements, including the month end reports to the agency investors. An analysis of the daily NAV (Net Asset Value) calculations for the last 18 months of this Pool has shown the largest deviation to be .02 cents, well within the .05 cents Ms. Fava noted earlier. Mr. Lawson asked if the securities are in total or individual securities. Ms. Fava answered that the calculation is on the entire Pool and staff has the discretion as to how to bring the Pool back within limits if there is a deviation. Mr. Jones stated that this Pool consists of only state agency funds and staff maintains as much liquidity as possible for the ever-changing needs of each agency. Staff would work diligently to prevent suspension of redemptions if there ever was a deviation close to or over the limits set by Rule 2a-7.

Ms. Fava discussed how the SEC implemented changes after the market problem in 2008. The SEC required that the Board (SIC) determine how much daily liquidity was required in the portfolio (Pool) and how much weekly liquidity was required in the portfolio. PFM has done this analysis for OFM going back 5 years of historical data. PFM reviewed the accounts that are in the Pool today on a fund-by-fund basis. PFM reviewed the single largest daily total draw in a week, total funds drawn in a week, and showed those percentages of the pool. The greatest one-day redemption was around 14.85%. The SEC states that the Board has to decide what the minimum one-day liquidity is for the Pool and PFM recommends using 15% as that minimum liquidity level. PFM also looked at weekly liquidity and found a 22% redemption in 2009 and recommends using a weekly minimum of 30% weekly liquidity. Mr. Jones added that the Pool has much more daily liquidity, in excess of 60%. Ms. Fava stated that as the Board, the Commission needs to set liquidity minimums based on historic cash flow. Treasurer Hollenbach asked if the 30% or 15% is reached, what is required. Mr. Jones answered that staff will need to sell longer-term securities to generate liquidity.

Ms. Fava continued stating that quarterly reporting will be required to show that staff is following these guidelines and Commission members will receive new reports showing compliance. The rest of this memo states the monitoring required, record keeping, and posting the portfolio online monthly. Mr. Jones added that the full package of reports will be presented at the next meeting. Ms. Fava added that Rule 2a-7 requires that there be procedures related to the Repurchase Agreement. This Annex statement is consistent with the regulation stating as the requirements and defining policies pertaining to who, what, when, and how when setting up repurchase agreements. Mr. Jones noted a change since the members’ last review of the document. The short-term rating of the Commonwealth’s repo counter parties will be raised even though all securities are 102% collateralized with a third-party custodian. The Commonwealth is restricted to primary dealers, and staff will be reviewing all repo counter parties ratings. Treasurer Hollenbach asked if this Annex statement was a product from staff or collaboration with Ms. Fava and PFM. Ms. Fava answered that in her initial report to OFM and the Commission PFM recommended the limit and the corporate notes not to go below AA rating, a consistency PFM noted from public entities across the country. Today the ratings criteria have changed and entities are lowering their credit standards to meet the new criteria from the rating agencies.

**Limited Term Pool Information Statement** – Ms. Fava stated that if the Commonwealth operated a registered fund with the SEC, OFM would need to provide an offering statement called a
prospectus provided to shareholders and updated annually. It would document the fund’s investments, the investment objectives, the costs, historic return information, operating procedures, limits on investments, and so forth. This new Limited Term Pool Information Statement is similar to a Prospectus document previously provided but has been updated for consistency with the 2a-7 Rules and required disclosures. It discloses that the Commonwealth is using amortized costs, the risks of the fund, and the 5 basis point limits. Mr. Lawson asked if this statement would be used instead of audits for our Commonwealth agency investors. Ms. Fava answered affirmatively and Mr. Jones added that it would be available to the public on our website. Mr. Howard added that the Budget Shop is the advisor to state agencies on which of the accounts their funds should be invested. The Budget Shop advises agencies on market value changes and volatility relating to the Intermediate Pool and Limited Term Pool. There is regular communication with the agencies pertaining to income and distributions to their accounts. Ms. Fava stated that if the Commonwealth was a public company, then the Pool shares could be considered municipal securities. If the Commonwealth was to sell to an investor, the Commonwealth would have to provide a disclosure document and this is what the Limited Term Pool Information Statement is.

Securities Lending Policy – Mr. Price stated that the Commonwealth never had a Securities Lending Policy therefore staff drafted a policy for the Commission members to review and approve. It states exactly what staff can do with securities, collateralization, reinvestment, maximum lending amounts, maturity, and primary brokers available.

Mr. Spragens moved to adopt all discussed changes, updates, and additions to the aforementioned documents. Mr. Lawson seconded the motion. Motion CARRIED.

SEC Rule 144a Analysis – Jeff Mosley, General Counsel of the Finance and Administration Cabinet, discussed the Commonwealth’s acquisition of certain securities that PFM’s report identified that were not allowed pursuant to SEC Rule 144a. That rule promulgated by the Securities Act of 1933 lists certain eligible entities can acquire certain securities, of which governmental agencies are not listed in this area. This Act was established to prevent unsophisticated purchasers of these types of securities. It is apparent during this meeting that the Commission member and staff of OFM are very knowledgeable and this Act may not apply to the Commonwealth, however the rule does exist.

After this situation was identified, the question was how the Commonwealth should deal with this position now and in the future. It is Mr. Mosley’s recommendation to the Committee to not purchase these types of securities in the future. The remedy with the currently held securities is to continue to allow OFM to address and manage these securities as needed going forward, not to immediately sell, as the Commonwealth is benefiting from the payments currently being received. It is the General Counsel’s recommendation to continue to manage these securities in the best interest of the Commonwealth going forward, to selling or keeping as appropriate, and manage as needed. Mr. Howard added information about a rule which FINRA (Financial Industry Regulatory Authority) redefined. FINRA rules are approved and adopted by the SEC and Rule 21-11 defines the institutional sophisticated investors with the ability to review and analyze securities on their own and make an independent judgment outside of the broker selling it to you. The Commonwealth does fit in with the institutional sophisticated investor portion and applies to municipal securities. It is the Broker Dealer’s responsibility to confirm the buyer falls within the definitions of these rules of accredited investors. Mr. Howard also added that staff would be working with Mr. Mosley on drafting regulations for the filing with LRC to begin the changes to the regulations and documents through the required legislative process.
Linked Deposit Program – Ms. Bechtel noted that South Central Bank is now in compliance and no longer on this list, but informed the Commission of an addition, Clinton Bank, that does not comply with the Linked Deposit Program. Two banks had no change since the last report but the Bank of Carlisle is not improving and is further out of compliance. Staff will look at the call report and determine if action is needed. Mr. Jones reminded the Commission that this loan is fully collateralized and the funds are under the Commonwealth's control and not on the Bank of Carlisle's books. Treasurer Hollenbach asked if staff was looking at public reports and if staff has reached out to the principals at the bank. Ms. Bechtel answered that the reports are on the FDIC website but the bank has not been contacted yet. Mr. Jones added that previously when banks did not meet the qualifications and showed up on the list, staff reached out. Some banks withdrew from the program while others expressed a great interest to stay with the program. Ms. Bechtel added that staff looks at the lending to deposits and whether the bank needs this liquidity. Currently this bank's deposits are going up and the loans are going down, therefore it would be more worrisome if they were non-performing loans.

Securities Update - Mr. Price explained that the same two securities are on the downgraded list. There is a large unrealized loss showing on this report, which the last quarterly report showed a large gain. Staff believes it was mismarked previously and the result was close to even between the two reports. This past quarter, over $882,000 in principal was returned and staff anticipates these securities to be paid back in the next year. It has benefited the Commonwealth to hold these securities and a report will be presented at the next meeting of the savings the Commonwealth has experienced by holding these since they appeared on this list.

Mr. Jones continued with the securities in the direct portfolio showing receipts about $4 million in Par; all are making their interest payments except three experiencing some principal losses. The market value loss is $14 million from $17 million previously, showing improvement. In reviewing these securities structures, pricing them, staff is developing a strategy going forward. The gain/loss on this list maxed out at just over $60 million and none of these securities are in the Limited Term Pool.

Mr. Spragens moved to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Mr. Lawson. Motion CARRIED

Broker/Dealer List - Mr. Price presented the list of firms that qualify to do business with the Commonwealth per the SIC regulations. There are two new additions, primary dealer, Bank of Montreal and non-primary dealer, CRT Capital Group from Chicago. Several banks asked to be on the list but did not qualify with the regulation of $100 million of net excess capital. If the bank is not a primary dealer, they have to have in excess of $100 million of net excess capital, except the Kentucky brokers do not have to have that excess if their trades are guaranteed through a primary dealer. There are a few adjustments of names due to merges and name changes but the list is the same as last year's with the new additions.

A motion was made by Mr. Lawson and seconded by Mr. Spragens to approve the Broker/Dealer list as presented. Motion CARRIED.
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**Other Business** – Mr. Jones noted at the next meeting staff will have an information statement for the Intermediate Pool and the first 2a-7 Board/Commission report and will be sent prior to the next meeting for the members review.

Mr. Spragens motioned for adjournment. Mr. David Allen seconded. The meeting stands adjourned.

Respectfully submitted,

[Signature]

F. Thomas Howard
Secretary