

## State Investment Commission

September 24, 2015

2:00 p.m. ~ Room 182 ~ Capitol Annex  
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on September 24, 2015 at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were W. Fred Brashear, II, President & CEO, Hyden Citizens Bank, Hyden, Kentucky; William Fallon, President & CEO, The Bankers’ Bank of Kentucky, Frankfort, Kentucky; Lori Flanery, Secretary of the Finance and Administration Cabinet (“FAC”); and Will Adams, proxy for Governor Beshear.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director of OFM and Secretary to the Commission; Steve Jones, Deputy Executive Director; Sandy Williams, Deputy Executive Director; Brian Caldwell, Hannah Hogston, Kim Bechtel, Jonathan Eakin, and Tammy McCall.

Other Guests: Ed Ross, Controller, Office of the Controller, FAC; and Katherine Halloran, Legislative Research Commission.

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 the June 25, 2015, meeting. A motion was made by Mr. Bill Fallon and seconded by Mr. Fred Brashear to approve the minutes as written. Motion **CARRIED**.

**Update on Compliance Reporting** – Mr. Jonathan Eakin gave a report on quarterly details. He reported that since the last SIC meeting, there were four compliance alerts triggered and three compliance rule changes. On June 29, 2015, three compliance rules were added to Bloomberg by Ms. Kim Bechtel. The rule ID’s were MAX25, MMKTSEC and ABS. The name of the MMKTSEC rule was changed to better reflect the asset types. These rules had previously been deleted from Bloomberg on February 26, 2015. The next day, on June 30, a compliance alert was triggered for the purchase of JP Morgan Money Market due to the MMKTSEC rule being re-entered. Due to limitations to Bloomberg, the compliance rule could not include overnight repo in its calculations, causing an incorrect test value higher than the allowable percentage of holdings in the portfolio. This was not a violation and it has not occurred since. On July 22 and September 21, three compliance alerts were triggered for Rule IDs: JABS, JCORP and JMBS. A purchase of \$25MM for security 90262DVX0 caused the alerts. This was a normal Commercial Paper trade and should not have triggered an alert. These rules were incorrectly entered in Bloomberg. The compliance rules had not been corrected as of the date of the meeting. Since the last meeting the Investment group posted the Compliance Rule Change Log to a shared drive for audit and research purposes. All entries on the Log matched the Compliance Rule Audit Trail Summary.

Mr. Steve Jones informed the Commission on personnel changes. Since the last SIC meeting, Ian Blaiklock and JD Lester left OFM employment. OFM was going through the hiring process and expected to have both positions filled by the end of October. Mr. Jones stated that the Investment staff was short-handed through the summer months but hopefully would be fully staffed in the near future.

Mr. Jones reported further on the rules and regulations regarding compliance reporting. He explained that the exposure limits were based on regulations that state that no more than 10% of total pool assets may be invested in mutual funds; no more than 25% of the total portfolio may be invested in mortgages; and asset-backed securities may be no more than 20% of the total portfolio. Since the overnight repo is not in the Bloomberg system, it cannot be included when the percentages are calculated. OFM Staff is working on an approach to be built into the overnight processing system that would use CAMRA (the Investment accounting system) to do the calculations and would then generate a report to be reviewed. Once that was completed and working properly, the inaccurate rule in the compliance module would be eliminated.

Mr. Jones informed the Commission of two new rules that needed to be built into the system. The first rule states that an entity may hold no more than \$25 million of any particular name of a Muni. The second rule states that no security inside the Limited Term Pool may have a maturity of more than twelve months at the time of purchase.

**Update on Cash Management Alternatives** – Mr. Jones updated the Commission on actions taken by Staff regarding cash management alternatives. OFM has been running the bilateral repo with Invesco for month long transactions since January 2015. There have been some difficulties with the settlement of those trades and OFM has had to develop some work arounds to get them settled. A method using faxes is being used for those transactions. A more automated system is being developed with full checks and balances before expanding into overnight transactions. Mr. Jones added that as of the date of this meeting there was a contract in place with a second entity that is ready to do overnight business and a contract is under review with a third entity.

**Proposed Regulatory Changes** – Mr. Jones stated that the regulatory changes approved by the Commission took effect on September 4, 2015. He summarized the changes as follows: 1) removed any reference to the SEC Rule 2A-7 from the Limited Term Pool; 2) included explicit language that allow bilateral repurchases with non-brokers and requires a full credit review for all entities; 3) implemented a \$25 million per name limit on municipals; and 4) allowed brokerage business with electronic exchanges. Mr. Jones added that in order to get all of the SIC policies and procedures compliant with the regulations, the OFM Investment Manual will need to be revised and brought to the Commission for review and approval. He hoped to have that ready by the next meeting.

**Trading Limits** – Ian Blaiklock and JD Lester were removed from the Trading Limit authorization. Mr. Jones stated that the replacement for Mr. Lester would be involved in the trading and execution of transactions for the Commonwealth's portfolio. Because of the wide range of experience and capabilities of the applicants, Mr. Jones was not comfortable with asking the Commission to approve a trading limit for that position at this meeting. He also stated that if the position was filled at the end of October and the next meeting for the Commission to approve trading limits was scheduled for the end of December, then the new person in that position would have to sit idly for two months. Mr. Jones proposed to the Commission three alternatives: 1) have a full SIC meeting earlier in the 4<sup>th</sup> Quarter, such as November; 2) call a short meeting after the position was filled for the sole purpose to delegate trading limit authority; or 3) the Commission could delegate authority to an OFM staff member to authorize the trading limit to the new employee. Mr. Ryan Barrow recommended that the Commission delegate authority to either himself, as the Executive Director, or to Mr. Ed Ross, Controller. Because the position to be filled is a grade 16 and oversight will be given by Kim Bechtel, Mr. Barrow felt comfortable with starting the individual at the same level that Mr. Lester had when he left. He stated there was already an internal process in place for

authorization if a person needed to exceed their limits that reached all the way to Mr. Ross. If a person needed a higher trading limit, then authorization could be approved at the next SIC meeting. Treasurer Hollenbach asked if the Commission could delegate authority and were trading limit authorizations given to the position's title or to the named individual. Secretary Flanery added that she wasn't sure about delegating authority but felt comfortable with giving the trading limit authorization to the position since it would be a part of the duties of whoever was selected, subject to any issues raised by the General Counsel for FAC. Mr. Jones confirmed that he would be comfortable with starting whoever filled Mr. Lester's position the same trading limit authority Mr. Lester had.

After a brief discussion, Mr. Barrow recommended to the Commission that the Fin Inv & Forecasting Program Specialist position start at the Money Market Trader level. Mr. Jones added staff's recommendation to remove Mr. Blaiklock and Mr. Lester from the trading limits. Treasurer Hollenbach made a motion based on Mr. Barrow and Mr. Jones' recommendations subject to any issues raised by the General Counsel for FAC. The motion was seconded by Mr. Fred Brashear. Motion CARRIED.

**Bridges Pool** – Mr. Jones reminded the Commission that the Bridges Pool is managed separately and independently from the other pools. A cash projection of the outflows was given at the time the original investments were made and then investments were made to generate the cash required to meet those outflows, which creates a portfolio with basically no market risk. He reported that the money market fund as of September 15, 2015 had a balance of \$92,319,402. The Current Holdings listed four securities that will mature this year and next year. The Book Income earnings were \$1,027,933.23, with an unrealized gain of \$49,681.03. The Projected Net Cash Flow chart showed the excess cash balance that is projected. The cash position was reported much higher than originally projected due to seasonality. More work was performed on the project in the winter than expected and less work performed in the summer. The cash balance is expected to drop after the winter months.

Mr. Jones informed the Commission that staff had expected the federal government to raise interest rates the week before this meeting and in preparation of that had accumulated cash to hopefully invest at a higher rate. That did not happen since the rates were not increased. He also remarked on the possibility of a federal government shut down and reassured the Commission that, if that happened, the impact to the Commonwealth would be fairly minimal. Because of the possibility of an overdraft issue, staff will continue to hold excess levels of cash in the portfolio. Mr. Jones has also reached out to the insured cash sweep, Invesco REIT, the securities lending agent, and the depository bank to make them aware of possible liquidity problems. Treasurer Hollenbach asked if the build-up of cash reserves would have an impact on the portfolio's performance. Mr. Jones answered it would have some negative impact on performance but not a material impact.

**Intermediate Pool Performance** – Brian Caldwell directed the Commission members to the Intermediate Term Pool report as of August 31, 2015. The Pool market value stood just over \$2 billion. The Yield to Worst was 0.67% which was slightly under the benchmark. Quality remained high at Aaa. Duration stood at slightly over 1 year but continued to be short of the benchmark as a defensive position for anticipated higher rates at some point in the future. The Portfolio Sector Allocations page gave a snapshot of how the Portfolio is diversified across the different sectors of the market as of August 31, 2015. There were no changes since the last SIC meeting. Mr. Caldwell continued with the Portfolio Performance page, which showed the Pool performance versus the Benchmark as of August 31, 2015. The month of August was slightly down as rates rose across the

curve, but the Portfolio produced positive returns and close to the Benchmark for all other time periods since July 1995.

**Limited Term Pool Performance** – Ms. Kim Bechtel presented the monthly performance of the Limited Term Pool compared to the Local Government Investment Pool benchmark as of August 31, 2015. The first page was the monthly performance graph showing the Limited Term Pool outperforming the Local Government Investment Pool. She mentioned that while the cash on hand wasn't reinvested there were still some securities that were extended that outperformed even after the federal government made no move on the rates. The second page showed a breakdown by credit rating and sector distributions. The next page listed all the securities held in the Pool as of August 31, 2015. The next page provided detail on the weighted average maturity and life plus liquidity positions. Ms. Bechtel noted the Pool was very liquid because of the time of the year, the federal government's decision on interest rates and the potential federal government shut-down. The Net Asset Value graph was steady as it should be. The most recent largest daily withdrawal was by the University of Kentucky Hospital on 1/20/15. The largest weekly withdrawals were the same as the daily withdrawals. The largest individual account in the portfolio was the Employee Self-Insurance Fund. The daily liquidity requirement as set forth by the Commission is 15% and the weekly liquidity requirement is 30%. Staff recommended maintaining the current liquidity requirements of the Pool requiring no action from the Commission. The Commission took no action. Mr. Jones added that the reports for this Pool were driven by the 2A-7 rules of Money Market Mutual Funds and were required quarterly as referenced in the Kentucky Administrative Regulations. Since the SEC rule was removed from the Regulations on September 4, 2015, the reports were no longer required. Mr. Jones stated that the information was important and would continue to be reported to the Commission, if there was no objection. Treasurer Hollenbach agreed.

**Linked Deposit Program (Country Bank Program)** – Ms. Kim Bechtel stated there was no change in the Country Bank Program since the last meeting. She stated that the Bank of Columbia's non-performing loans to capital ratio increased from 26% to 27% since 3/31/15, but that Staff was not concerned since it was so close to where it should be at 25%. Bank of Jamestown's loans to deposits ration was low at 63%. Farmers Deposit Bank had a low loans to deposit ratio of 46% and a low return on assets ratio of .46%. Staff recommended no action from the Commission. Mr. Jones noted that collateral is being held against the banks so, if there were any problems, the Commonwealth has physical electronic possession of the collateral. Treasurer Hollenbach asked if either one of the bankers on the Commission had any concerns or questions. Mr. Fallon and Mr. Brashear stated they had no concerns. The Commission took no action.

**Credit Considerations** – Ms. Hannah Hogston stated that since the last meeting no names had been added or removed from the Corporate Credit List. There were 28 non-financial companies and 27 financial companies for a total of 55 companies to be approved by the Commission. Mr. Bill Fallon made a motion which was seconded by Mr. Fred Brashear. Motion **CARRIED**.

**Other Business** – Mr. Jones reported to the Commission that the SEC and the MSRB have issued new municipal advisor rules which stated that an entity cannot be a principal in a transaction with a municipal advisor client. Mr. Jones restated the rule as meaning if the Commonwealth does business with a broker which is a municipal advisor then they cannot be a broker. Four brokerage firms stated they no longer wanted to do business with the Commonwealth and were dropped. Traditionally the Commonwealth does not hire financial advisors and Mr. Jones did not expect for the Commonwealth to fall under the new rules.

Mr. Jones asked the Commission if they would prefer to have a November meeting instead of December because of the administration changes that will be occurring after the November election. Treasurer Hollenbach stated he thought a November meeting would be good to take care of whatever business that was needed and would give the new administration time to settle in before the 1<sup>st</sup> quarter meeting.

With no further business, Treasurer Hollenbach called for a motion to adjourn. Mr. Fred Brashear made a motion which was seconded by Mr. Bill Fallon. The meeting stands adjourned.

Respectfully submitted,



Ryan Barrow  
Secretary