

# Orange County Investments: The Need for Stronger Oversight

## Summary

In the past 18 months financial markets all around the world have collapsed more completely and more comprehensively than at any other time in recent memory. This extraordinary environment underscores the need for Orange County to seek out safe and secure investments, and continuously monitor them to insure they maintain this standard.

This report traces Orange County's investments in Structured Investment Vehicles (SIVs), a type of investment used by international banks to re-package and sell mortgages, student loans, credit swap arrangements, and other complex financial instruments to investors who relied too heavily on credit ratings. Having already experienced the largest municipal bankruptcy ever, the citizens of Orange County expect their leaders to stick with simple, conservative investments for the County's surplus funds. Enhanced oversight, expected to provide an additional level of security to protect principal, has not been as effective as it was intended. As was the case fifteen years ago, the lure of higher yields from riskier investments is compelling. The lessons of the past have been forgotten.

The Grand Jury believes that the County's involvement in SIVs, which began about ten years ago and continues into 2009, was an imprudent pursuit of yield compromising the safety of principal. At one time representing over \$800 million, the SIV investments occurred under the assigned watch of an oversight committee established

after the bankruptcy to prevent imprudent investments from happening.

This report highlights the breakdown in the oversight process of the County's investment pools. In particular, it highlights what the Grand Jury believes is the ineffectiveness of the Treasury Oversight Committee (TOC) in fulfilling its role as outlined in the Government Code to oversee the Treasurer's primary goal of safeguarding principal. This report also offers a number of recommendations that, if implemented, will strengthen the oversight process and establish a more involved and disciplined approach for the TOC.

## Reasons for Investigation

Orange County's investment pools represent the County's savings accounts which earn interest to help fund critical County operations. For that reason, the Treasurer, who is charged with managing those investments, must insure they are safe and available when needed. In fact, this is so important that California law requires it. Government Code Section 53600.5 states that, "*When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of a trustee shall be to safeguard the principal of the funds under its control. The secondary objective shall be to meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under its control.*"

Given the headlines surrounding the housing crash and the turmoil

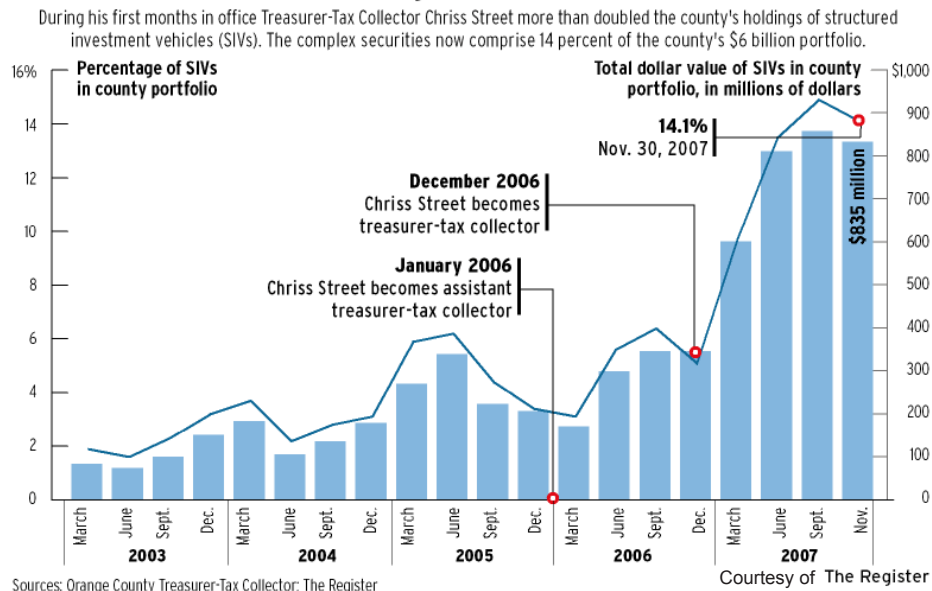
created by sub-prime mortgages, the Grand Jury became concerned with news of certain Orange County investments. Various sources in the media indicated that the Orange County Treasurer-Tax Collector had invested in controversial and potentially risky assets and had allowed them to grow to a significant proportion of the portfolio in the past few years. The controversial investment that Orange County had purchased were Structured Investment Vehicles (SIVs). This is a type of fund that borrows money by issuing short-term (commercial paper) or medium-term securities at low interest rates and then lends that money by buying long-term securities at higher interest, making a profit for its managers and owners. As reported in the Register and shown in Figure 1 on the following page, these investments grew to over \$800 million representing 14% of the County's \$6-billion portfolio by late 2007.

In addition, an internal auditor's opinion letter was issued in June, 2008, pursuant to Government Code Section 26920(b) for the report entitled "*Statement of Assets Held by the County Treasury as of December 31, 2007.*" That report included a qualified opinion with respect to the valuations assigned to the SIVs by the Treasurer that raised a "red flag", stating the auditor was "...unable to obtain sufficient appropriate audit evidence to support Treasury Management's valuation of the fair market value of two Whistlejacket Capital LLC Structured Investment Vehicle medium term notes with a

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Figure 1

## Raising the stakes



stated fair value of \$69,117,440 and two Sigma Finance Inc. Structured Investment Vehicle medium term notes with a stated fair value of \$70,987,050 described in Note 2 of the financial statements.”

For the reasons stated above, the Grand Jury became sufficiently concerned and commenced a study of the County’s \$6-billion investment portfolio, the Treasurer’s adherence to the primary objective of safeguarding principal as required by law, and the effectiveness of the management oversight committee.

### Method of Investigation

The Grand Jury gathered background information on the Orange County investment pools including historical published reports issued by the Treasury Department over the past several years. This information included specific investments in each of the pools and their historical performance. The original private placement offering memorandums for two SIVs, Sigma Finance, Inc. and Whistle-

jacket Capital, LLC issued by their investment dealers that highlighted, among other things, liquidity and investment risk, were reviewed.

The investment policies approved by the Board of Supervisors (BOS) detailed in the IPS were examined and compared to the various sections of Government Code pertinent to the management of the investment pools. These included Sections 27130 through 27137 pertaining to the requirement and makeup of the County’s Treasury Oversight Committee (TOC); and Sections 53600 through 53692 describing the prudent investor standard and allowable types of investments. Minutes of TOC and BOS meetings, County financial statements, internal audit reports, external audit reports, and outside consultant reports were reviewed and examined to determine whether the policies in the IPS and the Sections of the Government Code were adhered to and practiced.

The Grand Jury researched and analyzed specific complex financial

concepts and financial instruments utilized in the current environment including the use of derivatives in risk management, the basics of investing in SIV’s, and mark-to-market accounting. The Grand Jury conducted numerous meetings and interviews, and sought assistance from well respected experts and sources both inside and outside the County government, including members and/or representatives from the following sources:

#### Inside Orange County

- Office of the Treasurer-Tax Collector
  - Board of Supervisors
  - Treasury Oversight Committee (TOC)
  - Treasury Advisory Committee (TAC)
  - Audit Oversight Committee (AOC)
  - Internal Audit Department
  - Office of the County Executive Officer (CEO)
  - Office of the County Financial Officer (CFO)
  - Office of the Auditor-Controller
- #### Outside Orange County
- Los Angeles and San Diego County Treasurers’ Offices
  - PFM Asset Management (a consulting firm utilized by County to perform a risk analysis of the County’s investment portfolios)
  - Moreland & Associates (CPA firm utilized by County to perform compliance audit with certain, but not all, relevant sections of the Government Code)
  - Macias Gini & O’Connell (CPA firm utilized by the County to perform compliance audit with certain, but not all, provisions of the IPS)
  - Vavrinek, Trine, Day & Co., LLP (CPA firm utilized by the County to perform the annual financial

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audit of the County Annual Financial Report (CAFR)

- Various outside experts, media sources and publications

The Grand Jury attended meetings of the Board of Supervisors, TOC, and AOC to observe how these sessions are conducted and to hear the discussions addressing issues pertaining to the County's investment pools. The Grand Jury met with current and prior members of the Treasury Advisory Committee to gain an understanding of the role the TAC plays in the investment evaluation process.

To gain a historical perspective of Orange County's 1994 bankruptcy, the Grand Jury reviewed the March, 1995, report from the California State Auditor concerning the reasons for the bankruptcy and the corrective actions recommended to the Board of Supervisors.

### Background and Facts

#### County Investment Pools

The County maintains two investment pools: the Orange County Investment Pool and the Orange County Educational Investment Pool. Each pool consists of a Money Market Fund and an Extended Fund. The Money Market Funds invest in short-term cash-equivalent securities that are designed to meet liquidity needs. The Extended Funds invest in longer-term high-grade securities to earn higher yields. Both investment pools are collectively managed by the County Treasurer-Tax Collector utilizing a staff of managers, financial analysts, and administrative staff who are involved in the activities of investment management, cash management, and financial reporting. The market value of the Money Market Funds and the Extended

Funds as of December 31, 2008, was \$4.5 billion and \$2.6 billion, respectively.

Recently, Standard & Poor's (S&P) issued its AAAM rating for the County's two Money Market Funds, the first such County-managed portfolios in the nation to earn S&P's highest safety rating, according to a County press release issued in January. Each fund holds about \$1.8 billion of Treasury securities, high-grade corporate paper and other short-term investments. The Treasurer and his staff should be commended for this rating, however, it is not as unusual as it might seem. A report issued by S&P at the end of 2007 shows numerous government investment pools with AAAM ratings. In addition, the S&P rating for the County does not apply to the Extended Fund portfolios. The Grand Jury learned that the other major rating agency, Moody's Investor Services, issued its comparable AAA rating in June, 2008 for the County's investment pools including the Extended Funds. However, in order to get this rating the defaulted securities of Whistlejacket Capital LLC (described later in this report) had been removed and placed into a separate pool which was not rated by Moody's. The Grand Jury has concluded based on Moody's press release that if not for this separation, it would not have rated the pools as highly. Further, the County did not seek a rating from S&P on the Extended Funds due to the status of the defaulted SIV's. The Grand Jury believes the goal of achieving the highest safety rating should apply equally to all pools and no investments should be excluded. Orange County should have the highest safety rating for all of its funds with no exceptions.

#### Investment Policy Statement

The County Treasurer maintains and files for annual approval by the Board of Supervisors an Investment Policy Statement (IPS). The key components of the IPS are based on the requirements of Government Code Sections 53600 through 53692 and includes the overarching policy of the County's investments, the primary objectives, as well as all of the allowed and prohibited investments, the diversification standards, and other administrative responsibilities. It serves as the guide for the Treasurer's office to manage the County's investment pools. It can be more, but not less, restrictive than the Government Code. The three primary objectives are the following:

1. Safety of Principal
2. Liquidity
3. Yield

These objectives, with safety and security of principal being the most important objective, underscore the conservative nature expected of the investments in the County pools. They mean that the Treasurer, acting as trustee of the County's funds, and parties involved in oversight of those funds, must adhere to the prudent investor standard. This standard is well defined in section 53600.3 of the Government Code:

*"When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character*

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*and with like aims, to safeguard the principal and maintain the liquidity needs of the agency.”*

The Grand Jury learned that the IPS approved in February, 2007, was re-affirmed without modification in December, 2007. In December, 2008, after numerous revisions, a modified policy was finally approved by the Board of Supervisors.

Also of interest were the types of investments prohibited under the guidelines of the 2007 IPS. Among those prohibitions are these two:

1. Investments in commercial paper are allowed only if they are issued by entities organized and operating in the U.S., otherwise they are prohibited. Medium-term notes, which are held in the Extended Fund portfolios, must be issued by corporations organized and operating within the United States or by depository institutions licensed and operating within the U.S.
2. Investments in derivatives such as options, futures, swaps, caps, floors and collars for any of the funds are strictly prohibited.

The Grand Jury researched the nature of a derivative and found that it is basically a type of security the price of which is dependent or derived from some other type of asset. It is a contract between two parties linked to the valuation of an asset such as stocks, bonds, commodities or currencies. A derivative can be used to hedge risk and also to speculate. Derivatives can include futures contracts, forward contracts, swaps, and options, and can quickly grow even more complex involving credit default swaps and collateralized debt obligations. The price of derivatives can be extremely volatile. Warren Buffet once described them as “financial

weapons of mass destruction.” It is the opinion of the Grand Jury that the County should avoid taking unnecessary risk by investing in such complex financial instruments as derivatives, especially when they involve international assets. The County’s investments in SIVs did both.

### **The Revised IPS Approved in December, 2008**

The IPS approved late last year contained numerous changes, many that came from recommendations made by the PFM Consultants in its risk analysis of the County’s investment portfolios described later in this report. The Grand Jury supports these revisions including those associated with prohibited transactions. For example, it is now clearly stated that SIVs are prohibited. However, there are other examples where the Grand Jury recommends that further clarification would be even more beneficial. One instance is in Section III of the revised IPS that reads: “...*the standard of prudence to be used by County investment officers shall be the prudent investor standard and shall be applied in the context of managing an overall portfolio.*” This statement appears less restrictive than the actual language used in Government Code Section 27000.3 upon which it is based. The language used in the Code pertaining to prudent investing reads: “*Within the limitations of this section and considering individual investments as part of an overall investment strategy, investments may be acquired as authorized by law.*” The IPS suggests that the standard for measuring prudence is the performance of the entire portfolio, rather than risks associated with individual investments. This language should be clarified to read that all **individual**

**investments** will meet the prudent investor standard.

Another concern, also in Section III, is the language used to describe how the Treasurer should act to invest with care and prudence under the prevailing circumstances: “...*specifically including, but not limited to, the general economic conditions and the anticipated needs of the County and other depositories....*” Even though this language comes directly from Section 53600.3 of the Government Code, this phrase suggests that the County’s budgetary requirements could be dependent on yield to an extent that might influence the degree of care and prudence required. The Grand Jury believes this statement should be further clarified to ensure that, in the future, the County’s budget needs will not impact the County’s requirement to safeguard principal.

Finally, the language used to describe the investments in the Extended Fund in Section II of the revised IPS should be clarified. It reads: “*It will be invested primarily in high grade securities commensurate with achieving a higher yield, while also considering preservation of capital.*” The Grand Jury believes this places an emphasis on yield before safety of principal. Also, the use of the word “primarily” permits investments in less than “high-grade securities.” The language in the IPS should be clarified to show that yield is not a priority over safety, and that investments will be made only in high-grade securities.

### **What Is A Structured Investment Vehicle (SIV)?**

SIVs are investment funds that borrow money by issuing short-term (commercial paper) or medium-term securities at low interest

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rates and then lend that money by buying long-term securities at higher interest, making a profit on the difference. SIVs typically invest in a range of asset-backed securities that are a type of debt security collateralized by the cash flows of a specified pool of underlying assets. The underlying assets are pooled to make them more attractive and to achieve diversification. Some of the more common assets within the pools are credit card receivables, auto loans, student loans, and home mortgages. A typical structure for an SIV is found in Figure 2. It shows the debt issued by the SIV on the right side of the chart and the securities comprised in the pool on the left. The debt issued by the SIV is either commercial paper (CP) or medium-term notes (MTN).

An SIV operates much like a bank in that it borrows money by issuing notes and commercial paper (the depositors) and then loans that money out by purchasing various debt instruments (borrowers). In effect, it is providing the funds for

mortgages, credit cards, student loans or other types of debt. However, an SIV is not a bank, and therefore is not regulated like one. It does not have the capital requirements nor the reporting requirements as banks operating within banking regulations are required to have. The amount of debt it can raise is unlimited which raises the credit risk to an investor. It is not surprising that some of the largest banks in the world were the sponsors of SIVs because they could use them as a way to offload mortgages and other debt instruments from their balance sheets and place them into non-regulated SIVs. This allowed the banks to expand their own loan portfolios while continuing to earn from the SIV both a management fee and a potential profit from the credit spread if they retained an equity interest. (This is why an SIV is often referred to as a “shadow bank.”) The list of banks sponsoring SIVs includes Citigroup (New York), Dresdner Bank (Germany), Standard Chartered Bank

(London), and Rabobank (The Netherlands).

There are risks with this structure however, and one of those risks is **solvency**. Without strict capital requirements, the value of the mortgages and other credit instruments the SIV purchases (the assets) could fall below the value of the notes and commercial paper it has sold (the debt raised to finance the assets). The second major risk is **liquidity**. The risk of borrowing short-term and lending long term could create a shortage of cash if the borrower cannot refinance. This might force the SIV into selling its assets at depressed prices. With the rapid decline in housing prices and the turmoil in the credit markets beginning in 2007, solvency and liquidity created major headwinds for all SIVs. Based on the characteristics of SIVs outlined above these types of investments do not appear to be consistent with the County’s priorities of safety and liquidity.

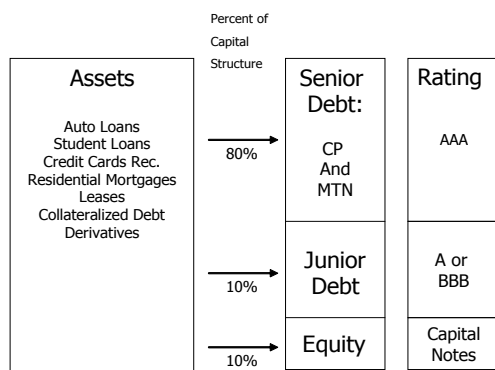
### Orange County’s SIVs

Orange County began investing in SIVs about ten years ago. With additional commitments in 2007, the County had over \$800 million in medium-term notes of SIVs representing about 14% of the entire portfolio. Shown in Figure 3 are the market values of those investments over the past year taken from the County’s financial reports. Other than for Whistlejacket (described further in this report) and Sigma, the decline in market values during the period shown is entirely due to principal payments received from the SIVs.

Figure 2

### Typical SIV Structure

- Invests in highly-rated asset-backed debt securities
- Issues debt in the form of commercial paper (CP) or medium-term notes (MTN)



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**Figure 3 - Orange County Investments In Structured Investment Vehicle Holdings**

Market Value				
	December 2007	June 2008	December 2008	
CC (USA) Inc.	\$ 97,000,000	\$ 100,000,000	\$ 100,000,000	
Five Finance, Inc.	113,031,000	65,000,000	-	
K2 (USA) LLC	199,751,000	50,000,000	50,000,000	
Sigma Finance Inc.	169,487,000	75,000,000	-	
Tango Finance Corp.	160,050,000	165,000,000	50,000,000	
Whistlejacket Capital LLC	69,117,000	67,221,000	49,715,000*	
<b>Total</b>	<b>\$ 808,436,000</b>	<b>\$ 522,221,000</b>	<b>\$ 249,715,000</b>	

\* December, 2008 derived by applying 80% market value factor to principal consistent with year-end value described in Note 5B of 2008 CAFR.

Two SIVs were of particular interest to members of the Grand Jury because each had recently encountered problems making interest payments and had suffered ratings declines.

### Whistlejacket

Whistlejacket Capital, LLC was created by Standard Chartered Bank, a London-based bank with significant banking operations world-wide. Medium-term notes of Whistlejacket Capital were purchased by the County in January and July of 2007 amounting to \$80 million. The investment, with its AAA rating from S&P, was believed to be safe and secure by the County, and it offered an opportunity to further diversify into asset-backed securities. But Whistlejacket was highly leveraged and faced liquidity issues with the downturn in real estate markets. Rating agencies began lowering the ratings on asset-backed securities, such as Whistlejacket, as more and more collateralized debt obligations (CDOs, which are pools of fixed income assets sometimes

held within SIVs) were defaulting on their payments to investors. Whistlejacket went into receivership under British law in February, 2008, after the market value of its investments fell to less than half the value of its start-up capital. The accounting firm of Deloitte & Touche was appointed receiver for the failing fund. Today, the bottom line for the County is that Whistlejacket is worth substantially less than its original cost, and there is virtually no market in which to sell it. *(The Grand Jury recently learned that an auction of Whistlejacket's assets was held at the end of April, 2009 under the direction of the investment banking firm, Goldman Sachs. Because the bid price at that auction of 67% of the principal (excluding cash held for distribution) fell below the County's reserve price, the Treasurer chose an alternative option of rolling over the Whistlejacket investment into a note issued by a new company. According to what the Grand Jury learned, the new note will carry no interest rate but will make cash dis-*

*tributions when available as determined by the manager of the fund, Goldman Sachs. The new company called "Serpentine Funding Limited" expects to "wind-down" its assets over the next four years.)*

Other red flags besides the leverage caused the Grand Jury concern about the process under which these investments were reviewed and evaluated.

The Grand Jury reviewed a copy of the original Whistlejacket offering circular (published in 2005) provided by the Treasurer's Office. It was reported that Whistlejacket Capital is incorporated in Delaware and their sole business is the issuance of medium-term notes. It is wholly-owned by Whistlejacket Capital LTD that is incorporated in Jersey, one of the Channel Islands under the jurisdiction of the United Kingdom. The following are some additional key characteristics of this investment taken from the offering:

- The investment manager is Standard Chartered Bank. It receives a management fee plus the profit potential between the interest earned on the SIV's investments and the cost of the notes that are issued, if it chooses to retain an ownership interest. Standard Chartered Bank is an international bank incorporated in England.
- The notes are not registered "... under the Securities Act, the securities laws of any state of the United States or the securities laws of any other jurisdiction..."
- One of the four principal dealers of this private placement is Merrill Lynch, who was a defendant in an action brought by the County regarding the County's bankruptcy.

Various types of risks in these investments were also disclosed:

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- *“Holders will be exposed to credit risk relating both to Investments purchased by the Parent and to Derivatives entered into by the Parent with derivative counterparties.”*
- *“Since the Parent may buy assets and the Co-issuers may issue liabilities in a variety of currencies and interest rate benchmarks, Holders could be exposed to risks in fluctuations in interest and currency exchange rates.”*
- The potential liquidity issue of borrowing short and lending long, was disclosed: *“Holders are exposed to liquidity risks arising out of the funding by the Co-Issuers of longer-term assets with short or medium-term liabilities.”*
- Whistlejacket plans to make significant investments (up to 75% of total) in the structured finance industry. This means there will be potential investments in asset-backed securities, mortgage-backed securities, collateralized debt obligations, and credit derivatives.

The Grand Jury reviewed the June, 2008, portfolio report issued by the trustees of Whistlejacket, Deloitte & Touche. Included in the report was a balance sheet that shows a debt-to-capital ratio of 10 to 1. It also shows investments scattered across the world from the U.S. and United Kingdom to Turkey and Singapore. The bulk of the assets were highly rated (at the time of the report) with either AAA or AA ratings. The types of assets include auto loans, credit card loans, student loans, collateralized debt obligations and arbitrage CDOs.

In reviewing the background for Whistlejacket it becomes apparent that this SIV is full of complicated investments with certain risks that

should have been carefully evaluated. The Grand Jury believes that the Treasurer and the oversight committees who are charged with discussing, reviewing, monitoring and reporting these investments, need to fully understand their consequences before investing in them. They should evaluate how these investments comply with policy relative to foreign investments and the use of derivatives. Were any concerns expressed about the excessive leverage being used? The Grand Jury was interested in whom, if anyone, was asking these questions.

### **Sigma**

Sigma Finance, Inc. was first purchased in 2001 and peaked with a balance of \$175 million in 2007. Sigma was once the oldest and single largest investment vehicle of its kind and was managed by London-based Gordian Knot. The founders of Gordian Knot were two former employees of Citigroup who pioneered the first SIVs in the late 1980s. Sigma fell victim to the same forces as other SIVs and defaulted on its loans at the end of September, 2008. Fortunately for the County, the Treasurer was able to completely sell the remainder of the Sigma SIV in mid-September, 2008, for 91.5 cents on the dollar, incurring a \$6 million capital loss on the sale. It was speculated at the time that the eventual liquidation of Sigma’s assets would bring as little as 15 cents on the dollar. The Treasurer’s actions were timely to say the least, avoiding a potential loss of as much as \$65 million.

The Grand Jury reviewed an original offering circular from Sigma for medium-term notes. Some of the same risks found in the Whistlejacket documents appear again in the Sigma offering:

- Sigma Finance, Inc. is incorpo-

rated in Delaware for the sole purpose of issuing and selling debt securities. It is a wholly-owned subsidiary of Sigma Finance Corporation which is incorporated in the Cayman Islands.

- The principal objectives of Sigma are to invest in *“bonds, notes, debentures, certificates of deposit and debt securities of all kinds, entering into options, futures and other types of hedging transactions, borrowing and raising money in any currency, granting security over its assets to secure borrowings, and carrying on other incidental activities.”*
- Among the services provided by Gordian Knot under the management contract are *“arranging for Sigma to enter into options, futures and other derivatives transactions in order to hedge Sigma’s exposure to interest rate and currency risk.”*
- Sigma was borrowing short and lending long, the same maturity mismatch as existed with Whistlejacket.
- Merrill Lynch was listed as a primary dealer in medium-term notes of Sigma..

The Grand Jury was unable to review a balance sheet of Sigma but it appears that, based on the descriptions above, the investments contained in this SIV, much like Whistlejacket, were scattered all over the world and also involved derivatives.

The use of derivatives, investments in international markets, and the potential lack of liquidity were warning signs for both of these SIV investments. In addition, further investigation also revealed that 56 of the 58 California counties chose not to invest in SIVs of any sort.

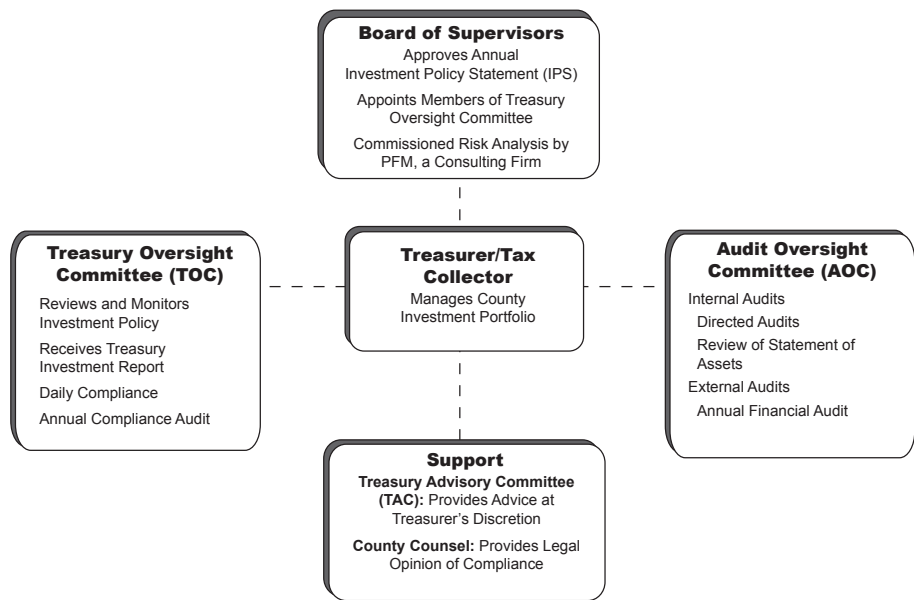
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Los Angeles County chose not to venture into the SIV arena because of their complexity, however San Diego County made a minor purchase of SIVs and shortly thereafter exited the investment. The Grand Jury strongly believes investing in SIVs was imprudent for the County because it was inconsistent with the County's primary objectives of safeguarding principal and the prudent investor standard described in the Government Code.

## Oversight of the Investment Pools

There are several entities within County government which function to varying degrees in an oversight or supporting role of the Treasurer in the management of the County's investment portfolios. These primarily include the Treasury Oversight Committee, the Treasury Advisory Committee, the Audit Oversight Committee, and the Board of Supervisors. Used in support of the oversight function are internal compliance audits, external financial audits fulfilled upon request from the Treasurer, or those required by law, such as financial and compliance audits. Outside consultants have also been used in the past to perform a risk analysis of the Treasurer's investments. All of these various entities shown in Figure 4 appear to present a comprehensive framework for the oversight of the Treasurer's actions. Given this, why were investments in SIVs allowed to begin with and why were they allowed to grow to such a significant level putting the County's funds at risk? How was the prudence of investments in SIVs evaluated? How effective is the oversight? To find out, the Grand Jury investigated further.

**Figure 4 Treasury Oversight**



## Treasury Oversight Committee (TOC)

The creation of the TOC is rooted in Orange County's 1994 bankruptcy. At that time Treasury Oversight Committees became required for each County by Government Code. More recently that requirement was removed. However, Section 27130 of the Government Code still recommends that each County have an oversight committee because "...the creation of County Treasury Oversight Committees will promote the public interest by involving depositors in the management of their funds and by enhancing the security and investment return on their funds by providing a more stable and predictable balance for investment by establishing criteria for the withdrawal of funds." Section 27131(a) of the Government Code recommends that the size of the committee be from 3 to 11 members and should be appointed from a pool consisting

of the County Treasurer, the County Auditor-Controller, a representative appointed by the Board of Supervisors, the County Superintendent of Schools, a second representative of the community colleges and school districts, a representative of the special districts, and up to five other members of the public. Further, it recommends that a majority of the public members should have expertise in public finance.

Since the TOC has such a critical role in the oversight of the Treasurer's activities, the Grand Jury conducted extensive research into the objectives of the Committee, how it performs in pursuing those objectives, its bylaws, and its overall effectiveness. The Grand Jury reviewed the TOC minutes for the past ten years, attended meetings as guests, and met with current and prior members of the Committee. It was discovered that, for the most part, there have been just three members (County CEO, Auditor-



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Controller, and Superintendent of Schools) for the past year and a half. Only recently, in December, 2008, were two new members added to the Committee representing the public.

The TOC bylaws state in Rule 6 that the Committee will consist of five members including the County Auditor-Controller, the CEO, the County Superintendent of Schools, one representative of the special districts, and one member of the public. However, in Rule 8 it states that the BOS may reduce the Committee to three members. During a time when the financial markets were collapsing under the weight of sub-prime loans and the economy began a rapid decline, the TOC could have used a few more members with the expertise to insure the County's funds were safe and liquid. Nevertheless, the Grand Jury found, based on its interviews and review of the Committee minutes, there did not appear to be a very high level of urgency to add to the Committee's membership.

The bylaws consist mostly of procedural and administrative rules, but Rule 27 defines what the TOC is actually mandated to do. It specifically states that, "*The Committee shall review and monitor the annual investment policy prepared by the Treasurer in accordance with Section 27133.*" The Grand Jury believes the Committee is carrying out the responsibility of reviewing and monitoring the IPS but is not doing so in a timely manner. The 2007 IPS was approved by the BOS in February of that year. The Board of Supervisors re-affirmed the IPS without modification in December, 2007. Given the deterioration in the economy and its potential impact on the County's investments, it seems imprudent that the Board

of Supervisors was not presented with a revised IPS for approval until December, 2008. If the TOC had expedited the necessary policy changes by setting appropriate deadlines for doing so, there would have been more time to act accordingly in this rapidly changing investment climate.

Rule 27(e) of the TOC bylaws state a requirement that "*...the Treasurer provide the Committee with an investment report as required by the Board of Supervisors.*" The Grand Jury believes that this means the TOC should review that investment report thoroughly and understand the activities that occurred in the month or quarter. It should question those activities, discuss them, challenge them, and assure itself that policies are being prudently applied, consistently and correctly. The information is readily available from the Treasurer with a comprehensive investment report posted monthly on the Treasurer's website. However, the Grand Jury learned in several interviews and meetings that reviewing policy was the limit of the TOC's oversight. Some on the Committee stated their function is not to question but to "trust" the Treasurer. Members of the TOC should realize that their value is in their independence and if they don't ask the tough questions, who will? How can they say they are fulfilling their obligation if they don't question the Treasurer's actions? If they had known that they were overseeing investments tied to student loans in Finland or that monthly interest payments were linked to the successful use of derivatives, or that in the event of default they might not be protected by U.S. law, would they have allowed investments in SIVs?

In more recent meetings attend-

ed by members of the Grand Jury, the TOC has become more engaged in their oversight role. The past two quarterly meetings have been much more active and the addition of the two new public members has contributed to more substantive discussion. The current state of the economy and the volatile financial markets have injected a new sense of concern about the safety and liquidity of the County's investments. In order for these kinds of activities to continue, the bylaws of the TOC should be changed to reflect a more expanded role with specific expectations of its members. Members should be expected to review the Treasurer's monthly investment report and question the major investment decisions, as well as the strategies being employed, to insure that plans to safeguard the principal are fully understood. The Grand Jury also believes public membership on the TOC should increase to four members instead of just two. All four public members should be technically competent in finance and investment principles. This will achieve a better balance between County and public members and serve to enhance the Committee's expanded role in the oversight of the investment pools. The Grand Jury acknowledges that it is difficult to recruit and retain public members due to conflict-of-interest laws that limit involvement by investment experts. Nonetheless, increasing the effort to expand public membership in such a critical area would be worthwhile.

The Grand Jury is not advocating the TOC get involved in the day-to-day operations of the Treasurer. That would be in violation of Section 27137 of the Government Code. The expectation is that the TOC scrutinize what occurred dur-

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ing the period, challenge the investment decisions, examine the current market conditions, test compliance with policy, and modify policy when necessary.

### **Treasury Advisory Committee (TAC)**

The TAC can best be described as an ad hoc committee that meets quarterly at the discretion of the Treasurer. Members of the TAC are experts, or have an academic background, in public finance and institutional investing. The purpose of the TAC is to provide advice to the Treasurer on an as-needed basis. Meetings are not subject to the Brown Act, therefore no minutes and no records of meetings are required.

There are benefits in getting outside opinions and advice from experts and the structure and meetings of the TAC are appropriate. However, in addition to its regular quarterly meetings, the Treasurer should schedule an annual joint meeting between the TAC and the TOC. In the interviews the Grand Jury had with members of the TOC, TAC, BOS, and others, there was confusion around the purpose of the TAC, who its members are, how often they meet, and the advice they have given. By having an annual meeting, the Treasurer can clear up this confusion and thus assure others that the Treasurer's Office is getting valuable advice from financial experts.

### **Audit Oversight Committee (AOC)**

The purpose of the AOC is to oversee the maintenance of the County's internal control structure primarily through the activities of the Internal Audit Department. It also oversees the quality of financial reporting through oversight

of the public accounting firm providing the external audit of the County's consolidated financial statements. Membership on this committee overlaps in part with the TOC by including the CEO, the Treasurer, and the Auditor-Controller. Numerous audits have occurred over the past year, some required according to Government Code and others at the discretion of management. The Grand Jury finds routine audits of the investment pools including financial audits, compliance audits, and cash audits, to be a good practice and also a good source of information for this study.

Section 26920 of the Government Code requires a quarterly review of the Statement of Assets in the County treasury. Part "b" of this section requires that at least annually an audit must be performed and an opinion expressed as to whether the Treasurer's Statement of Assets is presented fairly and in accordance with generally accepted accounting rules. An Internal Auditor's letter dated June 11, 2008, was issued under this requirement for the Statement of Assets of December 31, 2007. It was issued with a qualified opinion stating "*We were unable to obtain sufficient appropriate audit evidence to support Treasury Management's valuation of the fair market value of two Whistlejacket Capital LLC Structured Investment Vehicle medium term notes with a stated fair value of \$69,117,440 and two Sigma Finance Inc. Structured Investment Vehicle medium term notes with a stated fair value of \$70,987,050 described in Note 2 to the financial statements.*" The Grand Jury concluded that not only was the County making controversial investments in SIVs, they were unable to substantiate the mark-to-

market accounting values used for the Sigma and Whistlejacket investments. Later the Grand Jury learned that not until December, 2008 was new information provided to the auditor that supported the values reported in the December, 2007 report. In the meantime, readers of the financial reports included on the Treasurer's website could be misled as to the value of the SIVs. Delays in addressing any audit exceptions or qualified opinions by the responsible parties should not be tolerated. In this case the values should have been revised to reflect an amount that could be substantiated and the Statement of Assets reissued with corrected numbers, if necessary. Nothing less is acceptable.

### **PFM Asset Management**

The Board of Supervisors commissioned PFM Asset Management to perform a risk analysis of the County's investment pools. Its scope was comprehensive in that they would evaluate all investments in the pools, including the SIVs, review the IPS, the organization, the investment processes, staffing requirements, oversight, reporting, and accounting, through interviews and document review. PFM issued a report at the end of January, 2008. It was highly complimentary in saying that the portfolios were of high quality, and the liquidity was "*more than adequate.*" PFM was impressed with the due diligence and felt that the County's investments were "*being managed in a thoughtful, prudent manner.*"

In addition, PFM made some recommendations for changes to the IPS, including many that were incorporated into the revised policy that was finally approved this past December. However, the report contained a questionable conclusion. PFM stated that "*No portfolio*

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*holdings are impaired or in present danger of becoming impaired.”* PFM either discounted current conditions or overlooked the fact that the Treasurer was already in the process of marking down the value of the Whistlejacket SIV from \$80 million to \$69 million as reflected in the Statement of Assets for December 31, 2007, issued later in 2008. It appears that PFM did not test for proper accounting of the SIVs; otherwise it may have reached the same conclusion as the internal audit opinion noted earlier that raised questions about the support for the \$69 million value assigned to Whistlejacket at year-end. PFM also avoided addressing any issues around compliance of SIV investments with policy. PFM later acknowledged that it is a consulting firm only and are neither accountants nor legal experts on compliance issues. It was also discovered that PFM never met with members of the TOC or the TAC and that its principal background work for this report consisted of interviewing Treasury staff and researching related documents.

The Grand Jury believes that on balance it is worthwhile to periodically retain outside experts to review the investment pools. However, the TOC should take the lead role in directing these activities, including the selection of an appropriate firm. They should also actively participate in the closing meeting when the final report is presented. These changes will introduce greater independence to the process, possibly improve its effectiveness, and more readily reveal any shortcomings in the results.

### **Compliance Audits and Financial Audits**

Consistent with the Government Code, the County commissions

outside auditors to conduct compliance audits of the investment pools and financial audits of the Comprehensive Annual Financial Report (CAFR). The compliance audits are handled by Moreland & Associates which merged and became Macias Gini & O’Connell in early 2008. A review of two of its reports showed that the scope of the audit was limited. Their compliance audit for the year 2007 was limited to Government Code Sections 27130 through 27137 plus related provisions of the IPS. These code sections pertain to the administrative side of the TOC, its qualifying members, withdrawal procedures and the activities of the TOC. The related provisions of the IPS included the investment criteria in IPS Sections IV, V, and VI with specific reference to the maximum allowable percentage by type of security, allowable percentage per issuer, maximum term limits and credit ratings requirements. The second assessment was a quarterly report on compliance with certain agreed-upon procedures outlined in the IPS. It was limited in its compliance assessment as stated in its letter of April 16, 2008: *“We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on compliance with the IPS. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.”* Neither the annual compliance audit nor the quarterly compliance assessment that were reviewed appeared to have completely addressed compliance with the sections of the IPS related to prohibited investments. The Grand Jury believes that any future compliance audits incorporate all

aspects of compliance.

The firm of Vavrinek, Trine, Day & Co., LLP performs the annual financial audit of the CAFR. The CAFR is prepared under the direction of the Auditor-Controller and it contains all of the financial statements of the County as of the end of the most recent fiscal year. The most recent CAFR was released in mid-December 2008 for the fiscal year ended June 30, 2008. The report includes three and a half pages of disclosures surrounding the County’s SIV investments compared to virtually no discussion in the prior year’s report. This change in reporting is much more transparent and informative.

On page 93 in the notes to the financial statements included in the CAFR, the following appears: *“All SIV holdings were purchased in compliance with the IPS.”* The Grand Jury questioned the basis for this conclusion since none of the compliance audits or procedures that were reviewed was able to make such a blanket statement. It is presumed to come from an opinion letter issued November 10, 2008, by the Office of County Counsel. According to the letter, Counsel was responding to an opinion request by the Auditor-Controller as to whether the purchase of certain structured investment vehicles was in compliance with state law, specifically Government Code Section 53601 and the County’s 2007 IPS. The County Counsel’s opinion is somewhat vague in stating that the SIV appears to be facially compliant in that it meets the requirements of Government Code section 53601, subsection (k) and the provisions of the County’s 2007 IPS relating to medium-term notes. As a reminder, subsection (k) refers to the section of the Code that has to

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do with whether or not the investment is organized and operating within the United States. County Counsel qualified their opinion by stating that they were not investment professionals, nor had any experience in the sales, purchases or legal structure of complex financial instruments such as structured investment vehicles.

In summary, the statement of compliance in the CAFR appears to be supported by a County Counsel opinion letter, but with a qualifier. County Counsel could have just said the SIVs were compliant, but they did not. They said the SIVs were “*facially*” compliant. This unclear comment is another example of the controversial nature of the SIV investments.

### Conclusions

Because of the financial disaster in its recent past, Orange County should be expected to maintain a higher quality and safety standard in managing its investments. Instead, for the past ten years the Treasurer’s office invested in what we now know were high-risk SIVs allowing them to grow to a sizable proportion of the total portfolio. The Grand Jury found that no one questioned the reasons why this was allowed to happen. Although the SIVs were “*facially*” compliant with the County’s policies, these investments should have been reviewed and challenged.

- The IPS limits investments to companies organized and operating in the U.S. The County invested in SIVs that have no “operations” other than purchasing various credit instruments located all over the world.
- The SIVs issue securities that are not registered under the securities laws of the U.S.

- Derivatives are prohibited in the IPS, but the County invested in an SIV which states in its offering that it plans to use them.
- SIVs operate like a bank, however, their legal structure enables them to operate outside of banking regulations.
- SIVs borrow short and lend long creating a potential liquidity issue.
- The TOC was not doing an effective job of reviewing these and other investments.

The Grand Jury strongly believes that the investments in SIVs did not meet the standard of prudence for Orange County and for this reason greater oversight of the County’s investment pools is warranted.

The Grand Jury is confident that the creative minds of Wall Street will come up with something new in the future that will again challenge the financial discipline of Orange County. It will not be called an SIV or a CDO or a CLO. It will most likely offer an attractive yield with an AAA rating, and it may not be specifically addressed in the IPS. However, next time, with the changes recommended in this report designed to improve financial discipline and bring more robust oversight of the County’s investments, taking unnecessary risks with hard-earned public funds can be prevented.

### Findings:

In accordance with California Penal Code Sections 933 and 933.05, each finding will be responded to by the government entity to which it is addressed. The responses are to be submitted to the Presiding Judge of the Superior Court. The 2008-2009 Orange County Grand Jury has arrived at

the following findings:

F.1: In December, 2008, Standard & Poor’s issued its AAAM rating for the County’s two Money Market Funds. This rating does not apply to the County’s Extended Funds. In June, 2008, Moody’s issued a comparable high-quality rating that included the Extended Funds except for a separate fund that contained the defaulted Whistlejacket SIV.

F.2: The County investment policy prohibits investments in the commercial paper or medium-term notes of corporations that are not organized and operating within the United States. The policy also prohibits investments in derivatives.

F.2(a): Whistlejacket Capital, a SIV investment held within the County’s investment portfolio, was an investment vehicle incorporated in the state of Delaware. It was established by Standard Chartered Bank, one of the largest banks in the United Kingdom, and wholly-owned by Whistlejacket Capital Ltd, a firm incorporated in one of the Channel Islands under the jurisdiction of the United Kingdom.

F.2(b): Whistlejacket invested in debt instruments all over the world and used, and intended to use, derivative instruments to hedge against currency and interest rate risk.

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F.2(c): The County's investment in SIV's (specifically Whistlejacket), did not directly violate the language of the IPS or Government Code because each SIV was incorporated in the U. S. and the County was not directly investing in derivatives. However, the intent of the policies and laws governing prohibited investments should have been considered before making these investments. And, the TOC should have been more actively involved in scrutinizing these investments.

F.3: Findings pertaining to the revised December, 2008, IPS are:

a) The language used in Section III reads: "...the standard of prudence to be used by County investment officers shall be the prudent investor standard and shall be applied in the context of managing an overall portfolio." This suggests that the standard for measuring prudence is the performance of the entire portfolio, rather than risks associated with individual investments.

b) The language used in Section III describing how the Treasurer should invest with care and prudence includes: "...specifically including, but not limited to, the general economic conditions and the anticipated needs of the County and other depositors..." This phrase suggests that the County's budgetary requirements are dependent on yield to an

extent that could adversely influence the degree of care and prudence required.

c) The language used in Section II describing investments in the Extended Fund reads: "It will be invested primarily in high grade securities commensurate with achieving a higher yield, while also considering preservation of capital." This places an emphasis on yield before safety of principal. Also, the use of the word "primarily" permits investments in less than "high grade securities".

F.4: The TOC is not functioning as an oversight committee as it was originally intended and as set forth in its bylaws, and as a consequence, is not as effective as it should be.

F.5: The Treasury Oversight Committee (TOC) has been operating, for the most part, with only three members, all holding County positions, for most of 2007 and 2008. In December, 2008, two members representing the public were added. The Government Code recommends that the size of this committee be from 3 to 11 members.

F.6: The Treasurer produced financial statements with mark-to-market values for the County's investments in SIVs that were unsupported according to the County's own internal auditors.

F.7: PFM Asset Management, a consulting firm,

was hired in late 2007 to perform a risk analysis of the County's investment pools. In their report PFM concluded that the County's investments were of high quality and managed in a prudent manner. The firm also offered some suggested changes to the IPS that were later adopted. However, PFM reached a questionable conclusion about the Whistlejacket SIV by expressing an opinion that "No portfolio holdings are impaired or in present danger of becoming impaired." Evaluating investment compliance with the IPS was outside the scope of PFM's review. PFM limited its interviews and research to Treasury staff and Treasury documents.

F.8: A review of compliance audits by two outside firms that later merged (Moreland & Associates and Macias Gini & O'Connell) showed that the audits were limited in scope. Neither audit completely addresses the sections of Government Code and the IPS regarding prohibited investments.

F.9: The CAFR, released in December, 2008, states in the Notes to the Basic Financial Statement section that "the SIV investments were purchased in compliance with the IPS."

F.10: County Counsel issued a legal opinion in November, 2008, stating that the SIVs facially meet the requirements of Government Code section 53601, subsection

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(k) and the provisions of the County's 2007 IPS relating to medium-term notes. The opinion letter is qualified by stating that County Counsel has no experience or expertise in the legal structure of SIVs.

F.11: The investment in SIVs were imprudent for several reasons. Among them are: safety and liquidity, the highest priorities for the County's investments, were not adequately considered; the TOC never reviewed them; and, 56 out of 58 California counties chose not to invest in them.

F.12: There is confusion surrounding the purpose of the TAC, its membership, and the advice it gives to the Treasurer's Office at its quarterly meetings.

*Response to F-1 is required from the Treasurer-Tax Collector*  
*Responses to F-2, F-2(a), F-2(b) and F-2(c) are required from the Treasurer-Tax Collector and from the Board of Supervisors and requested from the Treasury Oversight Committee*

*Responses to F-3 (a), (b), (c) are required from the Board of Supervisors and the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

*Response to F-4 is requested from the Treasury Oversight Committee*

*Response to F-5 is requested from the Treasury Oversight Committee*

*Responses to F-6 are required from the Auditor-Controller and the Treasurer-Tax Collector*

*Response to F-7 is required*

*from the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

*Response to F-8 is requested from the Treasury Oversight Committee*

*Response to F-9 is required from the Auditor-Controller*

*Response to F-10 is required from the Auditor-Controller*

*Responses to F-11 are required from the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

*Response to F-12 is required from the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

In accordance with California Penal Code Sections 933 and 933.05, each recommendation will be responded to by the government entity to which it is addressed. The responses are to be submitted to the Presiding Judge of the Superior Court. Based on the findings, the 2008-2009 Orange County Grand Jury makes the following recommendations:

### Recommendations

R.1: The Treasurer-Tax Collector should establish measurable safety goals for both Money Market and all Extended Funds. (F-1)

R.2: The Treasurer-Tax Collector should consider the intent and spirit of the IPS and Government Code in all investment decisions. (F-2, F-2(a), F-2(b), F-2(c), F-3)

R.3: The Treasurer should exit all SIV investments as soon as practicable. (F-2, F-2(a), F-2(b), F-2(c), F-3,)

R.4: The Board of Supervisors should consider the

following revisions to the December, 2008, IPS:

a) This language "...the standard of prudence to be used by County investment officers shall be the prudent investor standard and shall be applied in the context of managing an overall portfolio." should be clarified to mean that all individual investments meet the prudent investor standard. (F-3a)

b) The statement "...specifically including, but not limited to, the general economic conditions and the anticipated needs of the County and other depositors..." should be further clarified to describe that the County's budget needs will not impact the County's requirement to safeguard principal. (F-3b)

c) The language in the IPS "It will be invested primarily in high grade securities commensurate with achieving a higher yield, while also considering preservation of capital" should be clarified to show that yield is not a priority over safety, and that investments will only be made in high-grade securities. (F-3c)

R.5(a): The TOC should rewrite its bylaws to clarify its role in oversight, the activities it will conduct, and how its members are expected to participate. (F-4)

R.5(b): The investment report produced monthly by the Treasurer's Office should be reviewed by the TOC.

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The structure of the TOC meetings should allow for the Treasurer to be questioned as to the portfolio's performance, recent investment decisions, and the strategies being employed. Since financial markets and economic conditions can change rapidly, the TOC should fully understand at all times how the Treasurer intends to "safeguard the principal." (F-4)

R.6 a): The TOC should consider expanding to seven members including four members of the public. This will achieve a better balance between County and public membership and serve to enhance the Committee's expanded role in oversight of the investment pools. Since the Committee recently added two members of the public, two additional members of the public are recommended. (F-5)

b) While Section 27132 (1) of the Government Code requires at least two of the public members be well versed in public finance and investment techniques, all four of the public members should be so qualified. (F-5)

R.7: The Auditor-Controller should insure that financial statements prepared by the Treasurer's Office showing investment balances be regularly audited. In the event any future investment balances or values are called into question, there will be an immediate response or restatement consistent with

good accounting principles and practices. (F-6)

R.8: The TOC, in its expanded role, should direct the activities of consulting firms used to conduct independent reviews or risk assessments of the County's investment pools. This will increase independent and effective oversight and may help expose shortcomings in future reviews. (F-7)

R.9: The TOC should insure that an annual compliance audit be conducted that addresses all elements of the Government Code as well as the IPS. The audit should be conducted by a firm or firms that have legal as well as investment expertise in the types of investments included in the investment pools. (F-8, F-9, F-10)

R.10: There is a general tendency to over-rely on ratings issued by the major credit rating agencies. In these times when rating agency credibility is being called into question, it is recommended that Treasury staff conduct thorough and independent evaluations of prospective investments, rather than just relying on ratings issued by major credit agencies. Proper due diligence begins with a review of credit ratings; it doesn't end there. (F-11)

R.11: The Treasurer's Office should schedule an annual meeting between the TAC and the TOC to discuss the safety and quality of the investment pools, the cur-

rent investing climate and any issues previously raised with the Treasurer's Office. (F-12)

*Response to R-1 is required from the Treasurer-Tax Collector*

*Response to R-2 are required from the Treasurer-Tax Collector and the Board of Supervisors, and requested from the Treasury Oversight Committee*

*Response to R-3 is required from the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

*Responses to R-4 (a), (b), (c) are required from the Board of Supervisors*

*Response to R-5 (a), (b), (c) are requested from the Treasury Oversight Committee*

*Responses to R-6 (a), (b) are required from the Board of Supervisors and requested from the Treasury Oversight Committee*

*Responses to R-7 is required from the Auditor-Controller*

*Response to R-8 is requested from the Treasury Oversight Committee*

*Responses to R-9 is required from the Treasury Oversight Committee*

*Responses to R-10 is required from the Treasurer-Tax Collector*

*Response to R-11 is required from the Treasurer-Tax Collector and requested from the Treasury Oversight Committee*

### **Required Responses**

The California Penal Code specifies the required permissible responses to the findings and recommendations contained in the report. The specific sections are quoted below:

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### §933.05

1. For purposes of Subdivision (b) of Section 933, as to each grand jury finding, the responding person or entity shall indicate one of the following:

(1) The respondent agrees with the finding.

(2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefore.

2. For purposes of subdivision (b) of Section 933, as to each grand jury recommendation, the responding person or entity shall report one of the following actions:

(1) The recommendation has been implemented, with a summary regarding the implemented action.

(2) The recommendation has not yet been implemented, but will be implemented in the future, with a timeframe for implementation.

(3) The recommendation requires further analysis, with an

explanation and the scope and parameters of an analysis or study, and a timeframe for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.

(4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefore.