Investment Policy
City of Surprise, Arizona

1.0 Mission Statement

It is the investment policy of the City of Surprise to invest public funds in a manner which will maintain the safety of principal, maintain liquidity to meet cash flow needs and provide competitive investment returns while conforming to all Federal, State and other legal requirements, primarily outlined in A.R.S. §35-323, governing the investment of public funds.

2.0 Investment Management Authority

Authority to manage the investment program of the City is granted to the Finance Director (hereinafter referred to as "the Finance Director") or designee and derived from the Arizona Revised Statutes (A.R.S.) §§35-321, 35-323.

2.1 Delegation of Authority:

The Finance Director shall have responsibility for the operation of the investment program and shall act in accordance with established written procedures and internal controls for the operation of the investment program consistent with this investment policy. Procedures should include references to: safekeeping, delivery vs. payment, investment accounting, repurchase agreements, wire transfer agreements and collateral/depository agreements. No person may engage in investment transactions except as provided under the terms of this policy and the procedures established by the Finance Director. The Finance Director shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials.

The Finance Director has the authority to manage internally or to delegate the management of the investment program to an investment adviser. If authority to manage all or a part of the investment program of the City is delegated to an investment adviser, the Finance Director is responsible for:

- Periodic investment portfolio reporting;
- Evaluating the performance of the externally managed portfolio;
- Monitoring investment adviser's compliance with the investment policy;
- Conveying the investment needs of the City to the investment adviser;
- Developing investment strategy with the investment adviser.

2.2 Investment Policy Adoption

The City of Surprise's investment policy shall be adopted by resolution by the City Council. The policy shall be reviewed on an annual basis by the Finance Director, or the Finance Committee when applicable, and any modifications made to the Investment Policy must be approved and adopted by the City Council.

2.3 Internal Control

The Finance Director shall establish a system of internal controls, which shall be documented in writing. The internal controls shall be designed to prevent loss of funds arising from fraud, employee error, misinterpretations by third parties, unanticipated changes in financial markets or imprudent actions by employees and officers of the City.

The City is subject to annual independent review of its internal controls by an external auditor. This review will provide internal control by assuring that policies and procedures are being complied with. Such review may also result in recommendations to change operating procedures to improve internal control.

2.4 Policy Considerations

Exemption – Any investment currently held that does not meet the guidelines of this policy shall be exempted from the requirements of this policy. At maturity or liquidation, such monies shall be reinvested only as provided by this policy. Any deviation from the preceding policy shall require the prior specific written authority of the City Council or City Manager.

3.0 Scope

This investment policy applies to all funds of the City.

The City will consolidate cash and reserve balances from all funds in order to maximize investment earnings and to increase efficiencies with regard to investment management pricing, safekeeping costs and administration costs, except for cash in certain restricted and/or special funds, which are exempted from this policy. Investment income will be allocated to the various funds based on their respective participation and in accordance with generally accepted accounting principles.

3.1 Funds included in Policy

These funds are accounted for in the City's Audited Annual Financial Report and include:

- ❖ General Fund
- ❖ Special Revenue Funds (unless otherwise excluded in section 3.2.1 below)
- ❖ Debt Service Funds
- ❖ Capital Project Funds
- ❖ Permanent Funds
- ❖ Enterprise Funds

- Private Purpose Trust Funds
- Pension Trust Funds
- Agency Funds
- Any new fund created by the City Council unless specifically exempted by the Council.

Funds set aside to defease City debt in conjunction with an advance refunding agreement, will be invested in accordance with State statutes and appropriate bond documents and as the trustee bank holding such funds deems necessary.

Investment income will be allocated to the various funds based on their respective participation and in accordance with generally accepted accounting principles.

3.2.1 Funds Excluded From This Policy

The following funds are excluded from this policy and shall adhere to the related bond covenants and federal guidelines.

- Special Revenue Fund
  - Municipal Property Corporation Fund - Bond Proceeds
- Revenue Bonds issued to finance certain construction projects.

4.0 Prudence

Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

The standard of prudence to be used by investment officials shall be the *"prudent person"* and/or *"prudent investor"* standard and shall be applied in the context of managing an overall portfolio. Investment officers acting in accordance with written procedures and this investment policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and the liquidity and the sale of securities are carried out in accordance with the terms of this policy. (Source: GFOA Sample Investment Policy)

5.0 Investment Policy Objectives

The primary investment objectives of the City in order of priority are:

- Safety
- Liquidity
- Optimal Yield

These objectives are defined below:

5.1 Safety

Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective will be to prudently mitigate credit risk and interest rate risk. It is understood by the City that no investment is completely free of risk.

5.1.1 Credit Risk

The City will seek to mitigate credit risk, which is defined as the risk of loss due to the failure of the security issuer or backer. Mitigating credit risk is to be accomplished by:

- Limiting investments in the portfolio to the asset classes designated as acceptable in A.R.S. §35-323. When possible, analysis of the credit worthiness of all individual debt issuers held in the portfolio should be conducted on an annual basis in an effort to guard against investing in weak or deteriorating credit situations;
- Pre-qualifying the financial institutions, broker/dealers, and investment advisers with which the City will do business in accordance with Section 13.
- Diversifying the investment portfolio so that the impact of potential losses from any one individual issuer held in the portfolio will be limited. Specific diversification parameters will be noted in Section 9.0 Concentration and Diversification.

5.1.2 Interest Rate Risk

The City will seek to mitigate interest rate risk, which is defined as the risk that the market value of securities held in the portfolio will decline due to increases in market interest rates subsequent to their purchase. This mitigation will be accomplished by:

- Structuring the investment portfolio so that securities mature concurrent with the anticipated cash requirements for ongoing operations, thereby avoiding, as much as possible, the need to sell securities into an adverse market environment prior to maturity;
- Investing funds primarily in shorter-term securities or similar investment pools and limiting the average maturity of the portfolio in accordance with the needs of the City;
- Utilizing external research and advice regarding the current interest rate outlook and global economic condition to optimize portfolio duration strategy.

5.2 Liquidity

The investment portfolio shall remain sufficiently liquid to meet anticipated cash flow requirements. This is to be accomplished by structuring the portfolio so that securities mature concurrent with anticipated cash flow needs (static liquidity). Furthermore, because all possible cash demands cannot be anticipated, the portfolio should consist of securities for which there are active secondary markets (dynamic liquidity)

5.3 Optimal Yield

Return on investment is of lesser importance compared to the safety and liquidity objectives described above. The investment portfolio shall be designed to optimize the yield the City obtains from the portfolio taking into account the criteria of the investment policy, the dynamic liquidity needs of the City and the current interest rate outlook/economic condition. Securities shall generally be held until maturity with the following exceptions:

- A security with declining credit may be sold early to minimize loss of principal.
- Liquidity needs of the portfolio require that the security be sold
- Securities may be sold to better reposition the portfolio in accordance with better market opportunities

6.0 Authorized and Suitable investments

6.1 Eligible investments for public monies.

A.R.S. §35-323A defines eligible investments available for the City to invest in as follows:

6.1.1. Certificates of deposit in eligible depositories.

6.1.2. Interest bearing savings accounts in banks and savings and loan institutions doing business in this state whose accounts are insured by federal deposit insurance for their industry, but only if deposits in excess of the insured amount are secured by the eligible depository to the same extent and in the same manner as required under this article.

6.1.3. Repurchase agreements with a maximum maturity of one hundred eighty (180) days

6.1.4. The pooled investment funds established by the state treasurer pursuant to § 35-326.

6.1.5. Obligations issued or guaranteed by the United States or any of the senior debt of its agencies, sponsored agencies, corporations, sponsored corporations or instrumentalities.

6.1.6. Bonds or other evidences of indebtedness of this state or any of its counties, incorporated cities or towns or school districts.

6.1.7. Bonds, notes or evidences of indebtedness of any county, municipal district, municipal utility or special taxing district within this state that are payable from revenues, earnings or a special tax specifically pledged for the payment of the principal and interest on the obligations, and for the payment of which a lawful sinking fund or reserve fund has been established and is being maintained, but only if no default in payment on principal or interest on the obligations to be purchased has occurred within five years of the date of investment, or, if such obligations were issued less than five years before the date of investment, no default in payment of principal or interest has occurred on the obligations to be purchased nor any other obligations of the issuer within five years of the investment.

6.1.8. Bonds, notes or evidences of indebtedness issued by any county improvement district or municipal improvement district in this state to finance local improvements authorized by law, if the principal and interest of the obligations are payable from assessments on real property within the improvement district. An investment shall not be made if:

> 6.1.8.1 The face value of all such obligations, and similar obligations outstanding, exceeds fifty per cent of the market value of the real property, and if improvements on which the bonds or the assessments for the payment of principal and interest on the bonds are liens inferior only to the liens for general ad valorem taxes.
>
> 6.1.8.2 A default in payment of principal or interest on the obligations to be purchased has occurred within five years of the date of investment, or, if the obligations were issued less than five years before the date of investment, a default in the payment of principal or interest has occurred on the obligations to be purchased or on any other obligation of the issuer within five years of the investment.

6.1.9. Commercial paper of prime quality that is rated "P1" by Moody's investor's service or rated "A1" or better by Standard and Poor's rating service or their successors. All commercial paper must be issued by corporations organized and doing business in the United States.

6.1.10. Bonds, debentures and notes that are issued by corporations organized and doing business in the United States and that are rated "A" or better by Moody's Investor Service or Standard and Poor's rating service or their successors.

6.2 Ineligible Investments

Investment types which are prohibited include:

- ❖ Inverse Floaters
- ❖ Interest Only Securities
- ❖ Interest bearing securities that have a possibility of not accruing current income
- ❖ Bearer-form securities

All other investments are thereby prohibited from consideration for investment. The City may desire to be more conservative in its investment portfolio and restrict or prohibit certain of the investments listed above in section 6.1.

6.3 Investment Rating Downgrade

The City may from time to time be invested in a security whose rating is downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO). In the event of a downgrade, the designated investment manager shall report the downgrade to the Finance Director or designee. In the event of a downgrade below the minimum credit rating criteria permitted by this investment policy, the designated investment adviser shall immediately report the downgrade and the action to be taken to the Finance Director. The Finance Director or designee shall report to the City Council, at their next regularly schedule meeting, both the downgrade and the action that has been taken.

6.4 Investment Selection

The City, if working directly with broker/dealers, shall transact all security purchases and sales through a competitive process, require the solicitation of at least three bids from an approved broker/dealers list. Securities selected for purchase or sale shall optimize the investment objectives of the overall portfolio. For each security purchased, the City shall accept the offer with the lowest price (highest yield) provided it meets the safety and liquidity requirements; for each security to be sold, the City shall select the bid, which generates the highest sales price.

Personnel involved with each purchase/sale shall document and retain written records of each transaction, including the name of the financial institutions solicited, rates quoted and any special considerations that had an impact on the decision. If the lowest priced security (highest yield) was not selected for purchase, an explanation describing the rationale shall be included in this record.

The investment adviser shall exercise its best efforts and discretion in negotiating the best security transaction executions available at the time, without regard to any broker designations or preferences for the exclusive benefit of the City.

6.5 Government Sponsored Investment Pools

Prior to the City being involved in a government sponsored investment pool, the Finance Director shall perform a review of the pool and its policies and procedures. The list of issues shall include but is not limited to:

- Securities – Government pools may invest in a broader range of securities than the City may invest in; it is important to be aware of and comfortable with the securities that will be purchased.
- Interest – Interest is not reported in a standard format; it is important to know how interest is quoted, calculated, and distributed in order to make comparisons with other investment alternatives
- Security – will help determine if security measures are designed to help safeguard funds from loss of principal and loss of market value
- Operations – will help determine whether this pool meets the City's operational requirements
- Statements – it is important for the City to receive statements monthly so the pools records of activity and holdings are reconciled.
- Bond Proceeds – it is important to know whether the pool accepts bond proceeds and whether the pool qualifies with the U.S. Department of Treasury as an acceptable commingled fund for arbitrage purposes.

6.6 Repurchase Agreements

Repurchase agreements may be utilized when all of the following conditions are met:

- The term of the repurchase agreement shall be for 180 days or less
- The City or investment adviser, if applicable, shall have properly executed a Master repurchase agreement with each firm with which it enters into Repurchase Agreements
- Repurchase agreements shall only be made with counterparties that are primary dealers of the Federal Reserve Bank of New York rated AAA by two nationally recognized rating agencies.
- The market value of securities that underlay a Repurchase Agreement shall be valued at 102% or greater of the funds borrowed against those securities and the value shall be viewed weekly unless market conditions warrant daily valuations. Each time there is a substitution of collateral, the market value must be calculated and the City notified of the substitution.

- ❖ Collateral shall be limited to obligations of the U.S. Government and its agencies and U.S. Government sponsored enterprises
- ❖ Collateral shall be delivered to a third party custodian and the City shall obtain a perfected first security interest in all collateral.

7.0 Collateralization

Collateralization is required on repurchase agreements. In order to anticipate market changes and provide a level of security for all funds, the collateralization level will be (102%) of market value of principal and accrued interest. Collateral shall be limited to obligations of the U.S. Government and its agencies and U.S. Government sponsored enterprises

Securities will be registered in the name of the City of Surprise. Collateral will always be held by an independent third party with whom the City has a current custodial agreement. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the custodian and retained.

The right of collateral substitution is granted.

8.0 Safekeeping and Custody

Delivery vs. Payment - All trades of marketable securities will be executed by delivery vs. payment (DVP) to ensure that securities are deposited in an eligible financial institution prior to the release of funds.

Safekeeping - Securities will be held by a custodian selected by the City and evidenced by safekeeping receipts. The safekeeping institution shall annually provide a copy of their most recent report on internal controls (Statement of Auditing Standards No. 70, or SAS 70).

9.0 Concentration and Diversification

It is the policy of the City to diversify its investment portfolios. The Investments shall be diversified to eliminate the risk of loss resulting from over concentration of assets in a specific maturity, issuer or class of securities.

At the time of purchase, a maximum of 5% of the market value of the portfolio may be invested in debt issued by any single entity. Debt issued and backed by the United States Treasury or Government Sponsored Entities (GSE's) are exempt from this concentration criteria.

10.0 Minimum Acceptable Credit Quality

At the time of purchase, all corporate securities must have a minimum rating by at least one of the Nationally Recognized Statistical Rating Organizations (NRSRO's), which typically include Standard & Poor's, Moody's and Fitch Rating Agencies. The short-term rating shall not be lower than the City of Surprise current General Obligation (G.O.) Bond Rating and the long-term rating shall not be lower than one grade higher than the City of Surprise G.O. bond rating. (see Exhibit 1 for commensurate ratings)

In no case shall the rating be lower than "A" as required by A.R.S. §35-323, as amended.

11.0 Maturity Parameters

A.R.S. §35-323A allows for a maximum maturity of five years of all public monies in eligible investments. The City shall match investments with anticipated cash flow requirements and will not directly invest in securities maturing more than 5 years from the settlement date.

❖ Funds Maximum Maturity:	5 Years
❖ Maximum Maturity for Repurchase Agreements:	180 Days
❖ Portfolio Duration Target:	To be defined by the Finance Director/ Investment Adviser
❖ Portfolio Duration Range:	+ / – 20% of the Portfolio Duration Target

12.0 Ethics and Conflicts of Interest

City employees involved in the investment process shall refrain from personal business activities that could conflict with the proper execution and management of the investment program or which could impair their ability to make impartial investment decisions. Employees and investment officials shall disclose, within sixty (60) days, any material interests in financial institutions with which they conduct business. They shall further disclose any large personal financial/investment positions that could be related to the performance of the investment portfolio. Employees and officers shall refrain from undertaking personal investment transactions with the same individual with which business is conducted on behalf of the City.

13.0 Authorized Financial Institutions and Brokers/Dealers

The Finance Director or designee shall maintain a list of authorized broker/dealers and financial institutions which are approved to provide investment services. When the City is investing directly with Brokers/Dealers or through an Investment Adviser, investment transactions shall only be conducted with financial institutions, selected by credit worthiness, that are licensed, as may be required by law, to do business in Arizona. Primary government securities dealers or broker-dealers, engaged in the business of selling government securities, shall be registered in compliance with section 15 or 15C of the Securities Exchange Act of 1934 and registered pursuant to A.R.S. §44-3101, as amended.

It shall be the responsibility of the broker-dealer or investment adviser to provide the following as applicable:

- Audited, most recent annual financial statements within six months of the close of the fiscal year;
- Most recent unaudited quarterly financial statements;
- Proof of National Association of Security Dealers certification;
- Proof of Arizona registration (as needed);
- Registration with Securities and Exchange Commission (Form ADV, Part 2)
- A signed letter acknowledging that they have read and agree to abide by the investment policy.

An annual review of the financial condition and registrations of each approved financial institutions, broker/dealers and/or investment adviser will be conducted by the Finance Director.

14.0 Performance Standards

The investment portfolio will be designed with the objective to obtain a (rate of return) market average rate of return throughout budgetary and economic cycles, commensurate with the investment risk constraints and cash flow needs of the City.

14.1 Benchmark (Market Yield)

The basis used by the Finance Director to determine whether market yields are being achieved shall be to identify a benchmark that is comparable to the portfolio's investment duration. The benchmarks shall be reflective of the actual securities being purchased and risks undertaken, and the benchmarks shall have a similar weighted average maturity as the portfolio.

The performance of an actively managed portfolio on behalf of the City will be expected to at least match the performance of the Local Government Investment Pool (LGIP) of the State of Arizona during any one-year period.

Occasionally, based on the liquidity needs and the portfolio strategy of the City it may be reasonable and desirable to measure portfolio performance against a total return benchmark. After consultation with the external manager, the Finance Director will determine this benchmark.

15.0 Reporting

The Finance Director shall produce for the governing body of the City or their designee an investment report at least quarterly. The purpose of the report is to enable the City to ascertain whether investment activities during the reporting period have conformed to the investment policy. The report should include:

- A list of individual securities held at the end of the reporting period;
- The realized and unrealized gains or losses in the portfolio;
- The duration of the portfolio and of each security held in the portfolio;
- The maturity date of each security held in the portfolio;
- The book value and market value of each security in the portfolio;
- The percentage of the total portfolio market value that each security represents;
- The yield to maturity of the portfolio and of each security held in the portfolio;
- The periodic interest earnings of each security held in the portfolio;
- The credit quality of each security held in the portfolio;
- A periodic summary of portfolio transactions, including fees incurred for external management and custody services.

Custodian Reconciliation – The report of investment holdings shall be reconciled within 30 days of the close of each month to the City's custodian bank. Discrepancies shall be reported to the Finance Director.

16.0 Guideline Glossary

Asked: The price at which securities are offered.

Bankers' Acceptance (BA): A draft or bill or exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill, as well as the issuer.

Bearer form
Describes issue form of security not registered on the issuing corporation's books, and therefore payable to its bearer.

Benchmark: A comparative base for measuring the performance or risk tolerance of the investment portfolio. A benchmark should represent a close correlation to the level of risk and the average duration of the portfolio's investments.

Bid: The price offered by a buyer of securities. (When you are selling securities, you ask for a bid.) See Offer.

Broker: A broker brings buyers and sellers together for a commission.

Certificates of Deposit (CD): A marketable receipt for funds deposited in a bank or thrift institution for a specific time period at a stated rate of interest.

Collateralized Mortgage Obligations (CMO's): Pass-through securities collateralized by residential mortgages for which prepayments are segmented to allow for more predictable cash flows. Issuers are primarily FNMA and FHLMC (Freddie Mac).

Commercial Paper: An unsecured promissory note (maturities 1-270 days) issued by banks, corporations, public entities and finance companies.

Comprehensive Annual Financial Report (CAFR): The official annual report for the City of Surprise. It includes five combined statements for each individual fund and account group prepared in conformity with GAAP. It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and a detailed Statistical Section.

Corporate Notes and Bonds: Corporate debt instrument. Maturities range from nine months to 30 years.

Coupon: (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

Dealer: A dealer, as opposed to a broker, acts as a principal in all transactions, buying and selling his own account.

Debenture: A bond secured only by the general credit of the issuer.

Delivery versus Payment: There are two methods of delivery of securities: delivery versus payment and delivery versus receipt. Delivery versus payment is delivery of securities with an exchange of money for the securities. Delivery versus receipt is delivery of securities with an exchange of a signed receipt for the securities.

Diversification: Dividing investment funds among a variety of securities offering independent returns.

Federal Credit Agencies: Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, e.g. S&L's, small-business firms, students, farmers, farm cooperatives, and exporters.

Federal Deposit Insurance Corporation (FDIC): A federal agency that insures bank deposits, currently up to $100,000 per deposit.

Federal National Mortgage Association (FNMA): FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

Floating Rate Securities: Corporate or Federal Agency debt in which the periodic coupon is reset based upon a formula stated at the time of issue.

Funds Maximum Maturity: The longest acceptable time to maturity that any one security in the portfolio may have at the time of purchase.

Government National Mortgage Association (GNMA or Ginnie Mae): Securities influencing the volume of bank credit guaranteed to GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, and other institutions. Security holder is protected by full faith and credit of the U.S. Government. Ginnie Mae securities are backed by the FHA, VA or FMHA mortgages. The term "pass-throughs" is often used to describe Ginnie Maes.

Interest-only strip (IO)
A security based solely on the interest payments from a pool of mortgages, Treasury bonds, or other bonds. Once the principal on the mortgages or bonds has been repaid, interest payments stop, and the value of the IO falls to zero.

Inverse floater
A derivative instrument whose coupon rate is linked to the market rate of interest in an inverse relationship.

Inverse floating-rate note
A variable-rate security whose coupon rate increases as a benchmark interest rate declines.

Investment Adviser: An investment firm with demonstrated expertise in the management of investment portfolios that acts as a fiduciary for client assets and held to the "Prudent Expert" standard of care; registered with and regulated by the SEC under the Investment Advisers Act of 1940 and compensated on the basis of assets under management, not transactions.

Liquidity: A liquid asset is one that can be converted easily and rapidly into cash without substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow and reasonable size can be done at those quotes.

LGIP: Local Government Investment Pool (LGIP): The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

Market Value: The price at which a security is trading and could probably be purchased or sold.

Maturity: The date upon which the principal or stated value of an investment becomes due and payable.

Maximum Maturity for Repurchase Agreements: The longest acceptable time to maturity that any one repurchase agreement in the portfolio may have at the time of purchase.

Money Market: The market in which short-term debt instruments (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

Municipal Obligations: Taxable or tax-exempt municipal securities typically secured by general governmental funds from tax revenue or a municipally operated enterprise.

Offer: The price asked by a seller of securities.

Portfolio: Collection of securities held by an investor.

Portfolio Duration Target: Duration is the weighted average maturity of a portfolio's cash flows, where the present values of the cash flows serve as the weights. Thus, portfolio duration target is a pre-determined duration at which a portfolio is expected to be maintained.

Portfolio Duration Range: An acceptable range in which the actual portfolio duration can deviate from the Portfolio Duration Target.

Primary Dealer: A group of government securities dealers who submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC)-registered securities broker-dealers, banks, and a few unregulated firms.

Prudent Person Rule: An investment standard. In some states the law requires that a fiduciary, such as a trustee, may invest money only in a list of securities selected by the custody state—the so-called legal list. In other states the trustee may invest in a security if it is one which would be bought by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of capital.

Repurchase Agreements: Standardized, simultaneous purchase and sale of the same security by approved brokers/dealers. Repurchase Agreements are, in effect, short-term (overnight) loans collateralized by securities. Two types of collateral are authorized: U.S. Treasury securities and U.S. Government Agency securities

Safekeeping: A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held in the bank's vaults for protection.

Secondary Market: A market made for the purchase and sale of outstanding issues following the initial distribution.

Securities & Exchange Commission: Agency created by Congress to protect investors in securities transactions by administering securities legislation.

SEC Rule 15C3-1: See Uniform Net Capital Rule.

Structured Notes: Notes issued by Government Sponsored Enterprises (FHLB, FNMA, SLMA, etc.) and Corporations that have imbedded options (e.g., call features, step-up coupons, floating rate coupons, and derivative-based returns) into their debt structure. Their market performance is impacted by the fluctuation of interest rates, the volatility of the imbedded options and shifts in the shape of the yield curve.

Uniform Net Capital Rule: Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness to liquid capital of 15 to 1; also called *net capital rule* and *net capital ratio.* Indebtedness covers all money owed to a firm, including margin loans and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

U.S. Federal Agency Securities: Debt obligations issued by agencies of the U.S. government such as the Federal National Mortgage Association (FNMA) and the Federal Farm Credit Bank (FFCB). While not explicitly guaranteed by the government, the securities are generally traded with an "implied" guarantee.

U.S. Treasury Bills: A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

U.S. Treasury Bonds: Long-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities of more than 10 years.

U.S. Treasury Notes: Medium-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities from two to ten years.

Yield: The rate of annual income return on an investment, expressed as a percentage.

(a) **Income Yield** is obtained by dividing the current dollar income by the current market price for the security.

(b) **Net Yield or Yield to Maturity** is the current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond.

Exhibit 1:

The relationship between long-term ratings and short-term ratings using Standard & Poor's, Moody's and Fitch rating conventions is as follows:

Long-Term Rating		
S&P	MOODY'S	FITCH
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
BB+	Ba1	BB+
BB	Ba2	BB
BB-	Ba3	BB-

Short-term Ratings		
S&P	MOODY'S	FITCH
A-1+	P-1	F-1+
A-1	P-2	F-1
A-2	P-3	F-2
A-3	NP	F-3
B	WR	C