INVESTING PUBLIC FUNDS:
LEGAL ASPECTS OF THE CURRENT FINANCIAL CRISIS

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How has the current financial crisis affected the legal underpinnings of the investments typically utilized for the investment of public funds by state and local governments? I will first review specific changes that have taken place recently, followed by a more global view of the legal landscape.

SPECIFIC CHANGES

FDIC Insurance. The basic rule in effect prior to recent changes was that a government investing in an insured institution located in the same state is insured by the Federal Deposit Insurance Corporation ("the FDIC") up to $100,000 for all demand deposits combined (checking accounts bearing no interest) plus up to $100,000 for all time and savings deposits combined (such as NOW accounts, money market accounts, savings accounts, interest bearing checking accounts and certificates of deposit); and a government investing in an insured institution located out-of-state is insured by FDIC up to $100,000 for all accounts combined. 12 C.F.R. 330.15.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (described below) increased the FDIC insurance limit from $100,000 to $250,000, including for government deposits. This increase is temporary and will expire on December 31, 2009. See, www.fdic.gov/news/news/financial/2008/fil08102a.html.

On October 14, 2008, the FDIC announced that all non-interest bearing transaction deposit accounts are fully insured for the entire amount. These are mainly payment-processing accounts, such as payroll accounts. Institutions may opt out of this program. This change is also temporary and will expire on December 31, 2009. See, www.fdic.gov/news/news/press/2008/pr08100.html.

The FDIC stated that the purpose of this program is to strengthen confidence and encourage liquidity in the banking system.

Money Market Mutual Funds. Unlike bank deposits, shares of money market mutual funds traditionally have not been guaranteed by the FDIC or any federal agency.

On September 19, 2008, the U.S. Treasury Department (the "Treasury") announced a temporary Guarantee Program for the money market mutual fund industry (www.ustreas.gov/press/releases/hp1147.htm). Money market funds are eligible for the Guarantee Program if they are registered with the Securities and Exchange Commission (the "SEC"), regulated under Rule 2a-7 of the Investment Company Act of 1940 http://www.law.uc.edu/CCL/InvCoRls/rule2a-7.html), and seek to maintain a stable net asset value ("NAV") of $1.00 per share.

Eligible funds which wished to participate in the Guarantee Program were required to apply by October 8, 2008. You should check your fund's website to see if they have elected to participate.

The insurance provided by the Guarantee Program extends only to the total value of a shareholder's account in a participating fund as of the close of business on September 19, 2008.

This is a temporary program. Its initial term was scheduled to end three months after September 19, 2008. The Secretary of the Treasury (the "Secretary") may extend the program through September 19, 2009. The Secretary recently extended the program to April 30, 2009 (http://www.treas.gov/press/releases/hp1290.htm). FINRA has a very good explanation of the program at www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P117136.

The Treasury stated that the purpose of the program is to maintain confidence in the money market fund industry in order to protect the integrity and stability of the global financial system.

On September 22, 2008, the Internal Revenue Service (the "IRS") released Notice 2008-81 (www.irs.gov/pub/irs-tege/n-08-81.pdf). This notice states that governments may invest their bond proceeds in tax-exempt money market mutual funds participating in the Guarantee Program without violating the prohibition against federal guarantees of tax-exempt bonds under Section 149(b) of the Internal Revenue Code.

Partial Federal Ownership of Private Institutions. Many governments in the United States are authorized by state law to invest in obligations issued by financial institutions and private companies. These obligations can include notes, certificates of deposit and commercial paper.

On October 3, 2008, Congress passed and President Bush signed the Emergency Economic Stabilization Act of 2008 (the "Act") (http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf) under which the Secretary is authorized to create a Troubled Asset Relief Program ("TARP") to purchase troubled assets from any financial institution. The authority given under the Act terminates on December 31, 2009.

On October 14, 2008, the Treasury announced a voluntary Capital Purchase Program under which the Treasury will purchase up to $250 billion of senior preferred shares of qualifying U.S. controlled banks and savings associations and holding companies that apply by November 14, 2008 (www.treas.gov/press/releases/hp1207.htm). Financial institutions that participate are required to follow a host of new "standards" on matters such as executive compensation and corporate governance. Nine major institutions were "convinced" by the Secretary to participate.

In connection with the federal bailout of the insurer American International Group ("AIG"), the Federal Government took an 80% ownership interest in AIG.

As you can see, many of the bailouts involve the Federal Government taking an ownership interest in private enterprises.

THE BIG PICTURE

Traditional Theory of Public Investment Statutes. Each state has its own statutes that define the types of investments in which the state and its local governments may invest public funds. (I am focusing on general funds and bond proceeds in this article, not on pension moneys.) There are many approaches taken by the states in determining permissible investments, but there are a few basic assumptions that underlie these approaches.

First, there has been an assumption that the safest investment is one guaranteed by the United States Government. This would include securities issued by the U.S. Treasury or by the Government National Mortgage Association ("Ginnie Mae").

Second, there has been an assumption that the next safest investment is one backed up by a federal agency such as the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") or the Federal Home Loan Banks ("FHLBs"). There is no explicit, full guarantee by the Federal Government of these agencies' obligations, but the market has perceived an "implied" or "moral" obligation of the Federal Government to back up these agencies due to the critical nature of their missions in the overall economy.

Third, there has been an assumption that certain other investments are safe because they are collateralized by Federal Government or agency obligations. These would include properly collateralized certificates of deposit, investment contracts and repurchase agreements.

These first three assumptions, which are ultimately based on some connection, real or implied, to the credit of the Federal Government, are the justification for many of the permissible investments included under state investment statues.

Some states go beyond these three assumptions and permit investments with no real or implied federal guarantee. These additional investments are based on a fourth assumption: that ratings issued by nationally recognized rating agencies are a sufficient basis for determining the safety of an investment. Based on this assumption, some states permit governments to invest in money market mutual funds and in notes or bonds or commercial paper issued by financial institutions or private companies.

The World Turned Upside Down. So how have all these assumptions, which form the basis for state investment statutes, fared in the economic crisis of 2008?

The first assumption has been proven true …. the Federal Government is indeed seen as the safest credit. And yet, because the Federal Government is extending itself so much in this crisis, some concerns have been expressed about its long-run credit strength. See the comments of a Standard & Poor's representative about the United States' AAA credit rating in http://www.reuters.com/article/idUKN1752966920080917.

The second assumption has also proven true …. the Federal Government has stepped in and taken over Fannie Mae and Freddie Mac when they were at risk of collapsing. And yet, at some point in the future, will the Federal Government step in if other agencies are about to fail? Does the rescue of Fannie Mae and Freddie Mac make another such rescue more likely ("we did it before, so let's do it again") or less likely ("never again!")?

Because the Federal Government has stepped forward to take over Fannie Mae and Freddie Mac, the third assumption also appears to be true …. investments properly collateralized by Federal Government or agency obligations appear to be safe. And yet, this also depends on the Federal Government’s continued willingness to step in and support agencies.

But the fourth assumption has been proven false …. ratings have not been a good basis on which to judge the safety of money market mutual funds and securities issued by private parties. The terrible problems associated with asset based commercial paper are the most alarming example.

The ironic consequence of the failure of this fourth assumption is that the willingness of the Federal Government to guarantee or support obligations has reached beyond the "implicit" guarantee of federal agencies and has embraced the Federal Government propping up money market mutual funds and private financial institutions, even to the point of taking equity positions in those institutions.

Is there now an implicit assumption that, if things get bad enough, the Federal Government will back up debt instruments of any institution that is an integral part of the financial system, be it a money market mutual fund, a bank or an insurance company? Even if you believe that is true, how does an investor judge whether a particular institution is integral or expendable?

There are no answers to all these questions. Or rather, the answers will depend on how this crisis plays out over the long haul.

The bottom line is that, once this crisis abates, states need to reevaluate the assumptions which form the foundation of the statutes governing the investment of public funds. The basic approach should be a "conservative" one, with preservation of principal the primary concern. Ratings have proven to be unreliable. The implicit Federal guarantee, even though it has cast a very wide net in this crisis, is of uncertain reliability in the long run.

States will need to see what regulatory changes are implemented over time by the Federal Government and the securities regulators to protect the interests of all investors. The states will then need to determine which investments in that new regulatory world are appropriately “safe” for the investment of public funds.

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