August 31, 2015

Director of Research and Technical Activities
Government Accounting Standards Board
Project No. 3-29
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft – Accounting and Financial Reporting for Certain External Investment Pools

Dear Board and Staff,

PFM Asset Management LLC (“PFMAM”) is pleased to respond to the Government Accounting Standards Board (“GASB”) invitation to comment on the exposure draft Accounting and Financial Reporting for Certain External Investment Pools which proposes guidance for certain external investment pools that elect to measure, for financial reporting purposes, all of their investments at amortized cost.

PFMAM is an investment advisor registered under the Investment Advisers Act of 1940. We are one of the largest investment advisors in the United States that specializes in advising state and local governments and non-profit institutional enterprises performing governmental-type roles.

For many of our investment management clients, their legislative and entity-specific investment policy requirements include reference to investing in "Rule 2a-7" SEC registered money market funds and can also include the necessity for the investments of operating or bond proceeds accounts to maintain a "$1.00 NAV". We appreciate GASB’s quick and proactive response to the impact of “2a-7 like” related standards in light of the 2014 SEC amendments to Rule 2a-7.

State and local governments manage large cash flows that are essential to providing societal needs. Cash inflows are typically generated from taxes, state/federal subsidies, fees and bond proceeds. Cash outflows encompass a variety of expenses including payroll, employee benefits, payments to operate water systems and transit systems and debt service. State and local governments use several different investment vehicles to manage their predictable cash flows.

Local government investment pools (LGIPs) may be authorized under state statutes and sponsored by the state or local governments, or may be set up through intergovernmental agreements known as joint powers agreements. These pools may invest only in securities otherwise allowed for individual governments in their respective state. In some states local governments are statutorily required to invest in a LGIP.

Now is the time that many government finance officers are considering shifting investments out of money market funds before the implementation of the SEC 2a-7 changes in October 2016 to
variable net asset values, or a floating NAV, for registered prime funds. It is also a time when many of the nation's largest banks do not necessarily want to hold public fund deposits, as new banking regulations have begun to raise the cost of public deposits. For instance, Basel III liquidity coverage ratio applies a 40% run-off rate to public funds making them very costly to the major banks. Additionally, money market supply excluding Treasuries, which has fallen over 40% during the past 7 years, may decline further in the coming years as financial institutions and GSE's continue to shrink their presence in the short-term funding markets. In this environment, it is becoming increasingly challenging for governmental entities to find suitable options for meeting their short-term investment needs without increasing investment risks.

Our belief is that GASB previously chose to reference the requirements of Rule 2a-7 as a way to adopt a set of standards that would be consistent with guidance for nonpublic institutions. The SEC requirements were meant to address a broad spectrum of investors that have far less certainty of cash flows, differing risk tolerances, and a wider variety of investment options. The 2014 amendments to Rule 2a-7 widens the divide between controls perceived as necessary to safeguard the national financial infrastructure versus those needed for public entities.

We offer the following general comments on the exposure draft:

Approach

The vast majority of public entities and LGIPs have a well-documented, prudent investment policy that is specific to their regulatory environment, the limits placed on them by those they serve, and their predictable cash flows. The exposure draft has many of the aspects of an investment policy and less attributes of accounting guidance.

PFMAM strongly believes that GASB should adopt a principles-based accounting guidance that allows for the unique context of pools operated by and for governmental entities based on the risk disclosures required by Statement 40 regarding Deposit and Investment Risk Disclosures.

Portfolio Quality Requirements

The exposure draft limits investments to the highest category of ratings as established by a nationally recognized statistical rating organization ("NRSRO"). This is both unduly restrictive and places much of the reliance for appropriateness of investments for inclusion in the portfolio on the NRSROs. Current SEC guidance contained in the 2014 amendments to Rule 2a-7 permit investments in the two highest categories. In addition, the Dodd-Frank Act requires every federal agency to review existing regulations that require the use of an assessment of the credit-worthiness of a security to remove any reference to, or requirement of reliance on credit ratings; and substitute a standard of credit worthiness as the agency shall determine as appropriate for such regulations. This movement away from reliance in credit ratings is a growing trend as the National Association

of Insurance Commissioners in May eliminated its reliance on credit ratings for certain types of securities\(^2\).

This reliance on only the highest NRSRO rating will be exacerbated in the future as the limited available choices to investment managers will further constrict as the availability of federal agency securities shrinks, limiting portfolio diversification.

NRSROs only assess credit risk without consideration of other risks, such as, market risk. Some blame for the credit crisis perhaps can be shared with the over reliance on NRSRO’s ratings, and investors lack of independent credit analysis. Instead we would urge GASB to require that the investment manager consider various objective and subjective factors, which may include NRSRO ratings, in determining whether a position presents only a minimal amount of credit risk and to adhere to their own reasonably designed and monitored credit assessment policies and procedures.

**Portfolio Liquidity Requirements**

The exposure draft requires that the portfolio have at all times 10% invested in daily liquid assets, 30% in weekly liquid assets and no more than 5% in illiquid assets. The ability of a LGIP to meet demand for withdrawals is a visible indicator of its viability. Conversely, too much liquidity is an inefficient use of funds and can unnecessarily restrict the investment income available to participants. For many LGIPs the minimum requirements in the exposure draft will result in excess liquidity, particularly when the investor is statutorily required to participate in the LGIP and has very limited alternatives or when there is a very predictable ebb and flow to asset levels. The exposure draft also does not distinguish between two forms of liquidity: funding liquidity and asset liquidity. One element of funding comes from the investors themselves; the risk being that investors redeem in greater numbers or more quickly than the LGIP’s assets ready liquidity can support. Asset liquidity, on the other hand, relates to the depth of financial markets and the ease with which a security or portfolio may be converted to cash. The exposure draft guidance is predicated on asset liquidity without regard to funding liquidity and should be amended to provide proper risk-adjusted controls for funding liquidity.

Illiquid investments are an important component of portfolio strategy. They offer a differentiated risk profile, i.e. FDIC certificates of deposit and the potential for higher returns. Because public entities have relatively known liabilities they have the ability to forgo current liquidity for the potential to earn higher returns by investing in less immediately liquid assets.

The portfolio must adhere to prudent requirements for portfolio liquidity. The liquidity should be sufficient so that the portfolio should not be required to sell assets (other than U.S. Treasury securities, bank deposits and redemptions of interests in liquid asset pools owned by the LGIP) in order to have cash available to meet redemption requests. Equally the portfolio should not be artificially restricted to lower earnings investments because GASB has chosen to dictate what it considers minimum investment policies. The permissive and restrictive investment policies of a

\(^2\) [http://www.naic.org/cipr_topics/topic_rating_agencies.htm](http://www.naic.org/cipr_topics/topic_rating_agencies.htm)
Pool should be guided by any applicable legislative requirements, the governance authority of each LGIP, and the objectives of the investors. The liquidity requirements adopted for the portfolio should take into account the overall context in which the LGIP operates, including: advance notice requirements, how frequently the LGIP is open for redemptions (e.g., daily, weekly, monthly), the history and anticipated future redemption patterns of participants, and the mandatory participation in the LGIP. A mandated floor that does not take into account the aforementioned factors may lead to insufficient liquidity or excessive liquidity depending on the factors unique to each LGIP.

We offer the following specific comments on the exposure draft:

**Guidance Text**

The exposure draft states that the portfolio “should acquire a security or other investment only if, after acquisition, the qualifying external investment pool would hold no less than 30 percent of its total assets in weekly liquid assets.” This parallels Rule 2a-7(b)5(iii)

The money market fund shall not acquire any security other than a Weekly Liquid Asset if, immediately after the Acquisition, the fund would have invested less than thirty percent of its Total Assets in Weekly Liquid Assets

The key difference is “should” denotes a guideline or recommendation while “shall” designates a requirement that is mandatory. I would suggest that the guidance be made clearer by adding the phrase “unless the external investment pool has documentation to support an alternative threshold”.

**Demand Feature**

Paragraph 15 states:

The maturity of an investment that is not a U.S. government security and for which the principal amount is due in more than 397 calendar days should be the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand.

However no guidance is provided that would restrict the demand feature or the reset date to be within the 397 day window. Such guidance should be added. This same comment is also applicable to paragraph 16.

**Maturity of Money Market Funds**

It is unclear after October 2016 if the external investment pool would need to take into consideration the impact of gates for registered money market when calculating the weighted average maturity and weighted average life of the portfolio. It would be helpful to have more explicit guidance in paragraph 18.
Portfolio Quality

There are currently ten NRSROs recognized by the SEC. It is burdensome and costly to retain the services of multiple vendors simply to have the ability to purchase US Treasury securities. As noted earlier in this letter SEC guidance permits the purchase of securities in registered money market funds that are rated in the two highest categories.

Paragraph 22 references the rating of a guarantee and Paragraph 23 references the rating of a conditional guarantee both of which rarely occur in the market. We believe each reference should be removed or further clarified to provide appropriate guidance.

Paragraph 26 is unclear as to FDIC guaranteed certificates of deposit because the depository may not meet criteria of the highest rating by a NRSRO nor would the FDIC. Similarly some deposits are guaranteed by the FHLB which as in the case of FDIC certificates of deposit would not meet the guidance criteria significantly limiting the investment options for portfolios. We believe this reference should be clarified to provide appropriate guidance on the intended risk limiting measure or removed in favor of guidance already provided by any applicable legislative requirements, or the governance authority of each LGIP.

Portfolio Diversification

Paragraph 29 requires securities with guarantees or subject to demands to be limited no more than 10 percent with any one issuer. This appears to be inconsistent with the 5 percent limit in the previous category. We believe each reference should be removed.

We would like to thank GASB for its efforts in preparing the exposure draft and for the opportunity to respond.

Respectfully submitted,

Debra Goodnight

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3 For additional information refer to the SEC Office of Credit Ratings at http://www.sec.gov/ocr