Office of the State Auditor Presentation

Legal Compliance Update

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I. "Best Value" Procurement

A. Authority/Types of Contracts.

In 2007, the Minnesota Legislature authorized counties, cities and other government entities to use a "best value" procurement process. 2007 Minn. Laws ch. 148, art. 3. Counties and cities will be able to use this process for construction, building alteration, improvement or repair and maintenance contracts. Minn. Stat. §§ 375.21, subd. 1b; 412.311, subd. 2 and 471.345, subds. 3a, 4a, and 5 (2007).

For counties and cities, the authority became effective on July 1, 2007. *See* Minn. Stat. §§ 16C.28, subd. 1a (2007). Other local units of government will be phased in over a number of years, as follows:

- Top 25% school districts by enrollment – July 1, 2007
- Top 50% school districts by enrollment – July 1, 2009
- Other School Districts – July 1, 2010
- Townships and other political subdivisions – July 1, 2010

Training. Personnel administering best value procurement procedures must be trained in RFP process for best value contracting for construction projects. [The League of Minnesota Cities (LMC) has indicated that it and other stakeholders will be working with the State Department of Administration on this training requirement for city personnel. *See* Minn. Stat. § 16C.03, subd. 19 (2007); LMC 2007 Law Summaries.]

B. Best Value Procurement.

1. Best value procurement is a process based on competitive proposals (as an alternative to bids) that awards the contract to "the vendor or contractor offering the best value, taking into account the specifications of the request for proposals, the price and performance criteria as set forth in [Minn. Stat. § 16C.02, subd. 4a] and described in the solicitation document." Minn. Stat. § 16C.28, subd. 1(a)(2) (2007).

2. The price and performance criteria mentioned in the previous paragraph may include, but are not limited to:
(1) the quality of the vendor's or contractor's performance on previous projects;
(2) the timeliness of the vendor's or contractor's performance on previous projects;
(3) the level of customer satisfaction with the vendor's or contractor's performance on previous projects;
(4) the vendor's or contractor's record of performing previous projects on budget and ability to minimize cost overruns;
(5) the vendor's or contractor's ability to minimize change orders;
(6) the vendor's or contractor's ability to prepare appropriate project plans;
(7) the vendor's or contractor's technical capacities;
(8) the individual qualifications of the contractor's key personnel; or
(9) the vendor's or contractor's ability to assess and minimize risks.

"Performance on previous projects" does not include the exercise or assertion of a person's legal rights. Minn. Stat. § 16C.02, subd. 4a (2007).

3. The solicitation document must state the relative weight of price and other selection criteria. The award must be made to the vendor or contractor offering the best value applying the weighted selection criteria. If an interview of the vendor's or contractor's personnel is one of the selection criteria, the relative weight of the interview must be stated in the solicitation document and applied accordingly. Minn. Stat. § 16C.28, subd. 1(c) (2007).

II. Ditch Fund Balance Deficits in Consolidated Conservation ("Con-Con") Counties

A. Background[1]

During the early 1900's, a substantial amount of land in northern Minnesota, considered unsuitable for agriculture, was included in a huge drainage ditch construction project. County bonds were issued to pay for the ditches and assessments were placed on the benefited properties. Unfortunately, the drainage systems often did not result in successful farms, and many farms went bankrupt due to unpaid ditch liens. The massive forfeitures threatened the financial collapse of the affected counties. To save the counties, the State of Minnesota stepped in; the State paid off the county ditch bonds in exchange for state ownership and DNR management of the lands.

The Minnesota Legislature created consolidated conservation (con-con) areas in 1929 in Beltrami, Lake of the Woods, and Koochiching counties. Aitkin, Mahnomen, and Roseau counties were added in 1931; and Marshall County in 1933.

The DNR now manages almost 2 million acres of tax-forfeited con-con land; this land has been classified for various purposes, such as forestry, wildlife and flood control. All income from these "conservation" lands was "consolidated" into one fund.

In their capacities as drainage authorities, the seven affected counties constructed and maintained drainage systems for several decades. To fund the drainage systems, the counties levied assessments against benefited lands, including the state-owned con-con lands.[2]

During the 1980s the state disputed assessments made by some of the counties against the con-con lands, arguing that the assessments exceeded the benefits to the land. In 1992 the state, after attempting to work with the counties, indicated it would pay assessments

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[1] This background is adapted from (1) the Report of the Administrative Law Judge, *In the Matter of the Proposed Permanent Rules Relating to Drainage Projects Impacting State-Owned Lands in consolidated Conservation Areas, Minnesota Rules Chapter 6115*, Sept. 17, 2007, (2) *Marshall County v. State*, 636 N.W.2d 570 (Minn. Ct. App. 2001), and (3) materials on the DNR website: www.dnr.state.mn.us.

[2] *Marshall County*, 636 N.W.2d 570, at 573. Under Minnesota law, the drainage authority must maintain a drainage system once it is established. Minn. Stat. § 103E.725 (2006). All costs of repair must be assessed against the property and entities befitted. Minn. Stat. § 103E.725 (2006).

for the previous ten years, but would not pay future assessments until a joint review of the benefits was completed. Finally, in 1993, the state stopped paying assessments on Marshall, Beltrami and Roseau county con-con lands for which benefits had not been re-determined.[3]

B. Court of Appeals Decision -- 2001

Marshall, Beltrami and Roseau counties and landowners sued to force the state to pay the assessments.[4] Ultimately, the Minnesota Court of Appeals ruled in favor of the state in 2001. The court ruled that the state had discretion to decide whether to pay assessments on con-con lands.[5]

The Court of Appeals recognized that under Minnesota law, the commissioner of the DNR was required to establish an administrative rule before January 1, 1986, to establish "criteria for determining benefits to state-owned lands . . . ."[6] The court ruled that the DNR's failure to promulgate a rule on ditch assessments within the statutory time frame "did not bar the department from subsequently declining to pay those assessments."[7]

C. Ditch Fund Deficits and Possible Help

The inability to collect ditch assessments from the state has caused deficit ditch fund balances in at least some of the counties.

In 2007, however, the DNR proposed a rule pursuant to the old statutory requirement.[8] A rulemaking hearing was held on the "need and reasonableness" of the proposed rule. After the hearing, the administrative law judge found that although the DNR proved the need and reasonableness of the rule in most respects, some defects need to be corrected. The administrative law judge suggested actions to correct the defects.[9]

Although the rulemaking process has not been completed, it is possible that a new permanent administrative rule could become effective soon that will help solve the long-standing ditch fund deficit problem in the affected counties.

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[3] *Marshall County*, 636 N.W.2d 570 at 573.
[4] *Marshall County v. State*, 636 N.W.2d 570 (Minn. Ct. App. 2001).
[5] Minn. Stat. § 84A.55, subd. 9 provided "[i]f the commissioner [of natural resources] finds after investigation that a project for the construction, repair, or improvement of a public ditch or ditch system . . . will benefit the lands . . . the commissioner may cooperate in the project . . . . The commissioner shall authorize the imposition of assessments for the projects . . . in any amounts the commissioner determines . . . ."
[6] Minn. Stat. § 84A.55, subd. 9.
[7] *Marshall County*, 636 N.W.2d 570 at 578.
[8] *See* Proposed Permanent Rules Relating to Drainage Projects Impacting State Owned lands in Consolidated Conservation Areas, 31 Minn. Reg. 1541 (May 7, 2007).
[9] *In the Matter of the Proposed Permanent Rules Relating to Drainage Projects Impacting State-Owned Lands in consolidated Conservation Areas, Minnesota Rules Chapter 6115*, Sept. 17, 2007.

III. County "Missing Heirs" Accounts

A. Minn. Stat. § 524.3-914

"If any asset of the estate has not been distributed . . . the court may direct the personal representative to deposit the same with the county treasurer . . . . If the money on hand exceeds the sum of $5,000, the court may direct the county treasurer to invest the funds, and the county treasurer shall collect the interest on these investments as it becomes due, and the money so collected or deposited shall be credited to the county revenue fund. *Upon petition to the court within 21 years after such deposit . . . the court may direct the county auditor to issue to the person entitled thereto the county auditor's warrant for the amount of the money so on deposit* *<u>including the interest collected</u>*. No interest shall be allowed or paid thereon, except as herein provided, and if not claimed within such time no recovery thereof shall be had. . . ."

B. Unclaimed Property Act

Does money in the county missing heirs account eventually have to be reported to the state under the Unclaimed Property Act? (Minn. Stat. § 345.31 et. seq.)

No. A 1978 AG Op (Op. Atty Gen 349-d, April 17, 1978) says the county can keep missing heirs money that is unclaimed after 21 years -- the money is not (initially or after the 21-year period) subject to the Unclaimed Property Act, Minn. Stat. § 345.31 et. seq. No legislative change since 1978 would change this result.

C. Interest

Counties should keep track of interest on missing heirs accounts in case a petitioner shows up within 21 years and the court directs payment of the money "<u>including the interest collected</u>." A county cannot just keep the interest by transferring it to the general fund each year.

IV. Automated Clearing House (ACH) Transitions/Back Room Conversion

A. Background

Before the Federal Check 21 Act became effective in October 2004, the Office of the State Auditor required that public entities obtain their cancelled checks from their depository banks. Our objective was to protect the investigatory and evidentiary aspects of the original checks. Now that the Federal Check 21 Act has gone into effect and as more banks are technologically able to take advantage of the Act, public depositors may not be able to obtain original checks.

Neither the Check 21 Act nor state law prescribes the method banks must use to return (or not return) paid checks to their customers. Some banks return original paper checks, some provide optical images, while others simply identify the check numbers and amount

paid in the monthly statement. Whether a public depositor receives back any version of its check—whether original, substitute, photocopy or optical image—is really determined by the contract it has with its depository. The Check 21 Act not only leaves this decision up to individual banks, it also does not restrict their ability to charge customers for substitute checks or other services. Therefore, each public entity will need to make a cost-risk analysis of the various options banks and credit unions may be offering regarding the return of paid checks, optical images and substitute checks.

B. Electronic Check Conversion/Back Office Conversion

Back office conversion is a process of check conversion that is part of the Automated Clearing House (ACH) Network. The following description is from a Federal Reserve Board pamphlet on electronic check conversion:

> **"Can electronic check conversion occur if I mail a check to pay a bill?**
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> Yes. For example, let's assume that each time you get your insurance bill, it includes a notice. The notice tells you that if you mail a check, you authorize your insurance company to use information from that check to make an electronic payment from your account. If you then send a check, you have agreed to electronic check conversion. *Unlike what happens when you make a purchase at a store, however, you won't receive a receipt. <u>Your check won't be returned to you with your account statement from your financial institution</u> because the transaction was processed as an electronic fund transfer, not as a check transaction.*"[10]

If a vendor uses back office conversion it does not even return the check to the bank. For this reason, your bank will not be able to return the original check or give you a copy.

C. GFOA Recommended Practice – Bank Account Fraud Prevention (2007)

"Newer forms of fraud have developed that take advantage of technological progress. These include unauthorized Automated Clearing House (ACH) drafts, multiple electronic deposits of the same check, and electronic intra-bank transfers. The Uniform Commercial Code has clearly stated that the liability for fraudulent items lies with the depositor, not the bank. Included with the law are significantly short lead times for the depositor to identify and report fraudulent items, especially if electronic account reporting is used."[11]

The GFOA promotes "positive pay" as an important fraud prevention tool. It also recommends that governments consider nineteen specific steps to protect themselves

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[10] http://www.federalreserve.gov/pubs/checkconv/checkconv.pdf. *Emphasis Added.*
[11] Government Finance Officers Association Recommended Practice, Bank Account Fraud Prevention (2007) (CASH), approved by the GFOA's Executive Board on March 2, 2007.

against bank account fraud. A copy of the GFOA Recommended Practice is attached to these materials.

V. Certificate of Deposit Account Registry Service (CDARS)

A. Background

We have reviewed the CDARS program several times with regard to custodial credit risk. Our conclusion remains that CDARS is a permitted investment for Minnesota local government entities and that there is custodial credit risk present because of the way Certificates of Deposit (CDs) are held in the CDARS program.

B. How CDARS works

1. Overview

CDARS is a program where a local bank or broker will place the government entity's funds in CDs issued by banks participating in the program. In the case of local banks, a public entity deposits its funds with a local bank and the amount on deposit, in excess of FDIC deposit insurance, is placed into CDs issued by other banks in the program. As a result, the local bank avoids the cost of pledging collateral to protect the government entity's deposit in excess of FDIC coverage. In the case of local brokers, the amount given to the broker is simply placed in CDs like any other investment.

The CDARS program is set up so that the bank issuing the CD does not know the identity of the owner of the CD. The Bank of New York (BNY) acts as the agent of the issuing bank and the agent of the local bank or broker. CDs are issued in the name of the BNY, and are held at the BNY in the name of the local bank or broker. The local bank or broker maintains records indicating the ownership of the CDs by the government investor. FDIC coverage flows through the chain of title to the government entity owner.

If a government entity wants a direct deposit CD with the issuing bank they must withdraw from the CDARS program. Then a deposit CD will be issued directly to them by the issuing bank.

2. One-Way and Two-Way Transactions

A confusing aspect of CDARS that does not affect their legality or the custodial risk analysis is the two types of CD purchase transactions available: One way and two way (reciprocal transaction).

a. Many states require public entities to deposit funds locally. The two-way program is designed to deal with these local statutory requirements. When a government entity's excess deposit is placed in CDs issued by other banks, certificates of deposit in the same amount are purchased from the government entity's local depository. Thus, the local depository can

represent to a public entity that the funds it deposits will be available locally. Several state attorney generals have reviewed the CDARS program and given an opinion that it is consistent with state laws requiring local deposits.

b. In Minnesota there is no such local deposit requirement. Therefore, both the two-way transaction and the one-way transaction are available to Minnesota local units of government.

3. Deposit v. Investment

Because both state law and GASB Statement No. 40 (regarding custodial risk classification) treat CDs that are investments differently from CDs that are deposits, a determination must be made whether the CDs used in the CDARS program are deposits or investments

Our determination is that they share more aspects of an investment than they do a deposit. Unlike deposits, CDARS CDs share the following characteristics of investments:

- There is no direct relationship between the issuing bank and the owner of the CD. In fact the issuing bank is prevented from knowing the identity of the owner of the CD. CDARS contracts are carefully constructed so that, like normal investments, only the local bank or broker has any contractual relationship with or any duty to the government investor.

- CDARS CDs are “held” by the BNY in the “name” of the local bank or broker. Deposit CDs cannot be “held” by anyone nor can deposit CDs be held in the name of anyone else but the depositor.

- The local bank or broker can redeem or “cash out” the CD with no approval from or notice to the government investor.

The question was raised whether CDARS CDs though investments were not “securities” for custodial risk purposes. The Comprehensive Implementation Guide (CIG) identifies certain investments as not being “securities” and thus not subject to custodial credit risk.[12]The CIG clearly indicates that the reason mutual fund shares and guaranteed investment contracts are not “securities” subject to custodial risk, is because of the direct relationship between the investor and the obligee.[13] With CDARS there is no direct contractual relationship between the CD owner and the bank issuing the CD. In fact, under the CDARS contracts, the issuing bank cannot find out who owns the CD.

[12] For instance mutual funds and guaranteed investment contracts (GICs) though investments are not “securities” for custodial risk purposes.

[13] For mutual funds the CIG states: “The relationship between the investor in an open-ended mutual fund and the investment company is a direct contractual relationship.” (CIG 1.48.2) *Emphasis added*. Regarding GICs, the Comprehensive Guide states: “[GICs] are not exposed to custodial risk because they are direct contractual investments.” *Emphasis added*.

Similarly, the direct relationship that exists between a depository bank and the CD owner of a deposit CD is not present with CDARS CDs. Our conclusion is that because CDARS CDS lack these direct relationships, they are subject to custodial credit risk.

4. Custodial Risk Analysis

CDARS CDs are issued in the name of the BNY by the issuing bank, and held by the BNY in the local bank's or broker's name. Since the local bank or broker is the "counter-party" under custodial credit risk analysis, CDARS CDs are held by the counter-party's agent (BNY) in the counter-party's name and are therefore subject to custodial credit risk. If the local broker has SPIC coverage to that extent custodial credit risk will be negated.

The question was raised whether a surety or fidelity bond required of banks under Minn. Stat § 48.12 would negate custodial risk. Our conclusion was that it would not. The Comprehensive Implementation Guide in question 1.46.1 states that in order for commercial insurance to be considered as protection from custodial credit risk, it has to have the same scope of coverage as the protection provided by SIPC. The Guide specifically states: "That is, the insurance would have to cover all types of broker dealer failures, not only certain types of losses (for example only losses from theft)." We reviewed a sample surety bond obtained by Minnesota banks to comply with this law. This surety bond did not have the same scope of coverage as SIPC for a number of reasons:

a. This surety bond covers losses sustained by the bank. SIPC covers losses sustained by customers of the bank.
b. The risks covered by the bank surety bond are limited to theft and forgery by the bank officers and employees, and not all risks of loss covered by SIPC. As stated in the quoted portion of Question 1.46.1 of the Comprehensive Implementation Guide, to be equivalent to SIPC, losses other than theft need to be covered.
c. There is a per occurrence deductible of $50,000 on the bank surety bond. There is no deductible on SIPC.
d. With SIPC there is a per account amount available to cover investments not with your broker when it fails. The surety bond is limited to a total amount. If losses at the bank from fraud exceed the bond amount, there may be nothing available to customers that sustained loss.

5. Conclusions

a. CDARS CDS are permissible investments under Minn. Stat. § 118A.04, subd. 5.
b. There is custodial credit risk present with CDARS CDs.
c. As investments, these CDs meet statutory requirements for investments. A broker certification under Minn. Stat. § 118A.04, subd. 9, must be signed by the local bank or broker. This subdivision

defines "broker" to be an agent of the government entity who transfers, purchases, sells, or obtains securities for, or on behalf of, a government entity." Because the local bank or broker through its participation in the CDARS program acts as the government entity's agent in obtaining CDs for the government entity, it is a "broker" under the statute and must sign a broker certification form.

VI. Rate Search Inc.

Rate Search Incorporated is a CD placement investment firm in St. Louis, Missouri. According to its website (Sept. 18, 2007), its founder and the organization:

> "scour the country for the highest FDIC-insured bank CD rates to be found. 'We only place insured deposits. Some of our clients have multiple millions to invest. So we network with many banks across the U.S. to keep your yields much higher than any local market can provide while remaining fully insured. It's really about taking your banking to a new level of efficiency.'"[14]

According to recent media accounts, it appears that several million dollars of CDs purchased or held by Rate Search are missing. "Rate Search can't account for certificates belonging to about 40 clients nationwide, including a religious order, cities, retirees and business associations, said . . . an attorney representing the company and its president . . . . The missing money totals about $4 million, out of about $25 million the company invested for all its clients [the attorney] said."[15]

The State Bar of Nevada sued Rate Search and a company that acted as its agent "to get back $300,000 in investment funds that may have been embezzled - and lawyers involved in the case say that's only a fraction of the money from various investors that's missing."[16]

According to newspaper accounts, at least one Minnesota city was notified by Rate Search that a portion of their $3.8 million in CDs was missing. Rate Search contacted the FBI and the U.S. Postal Inspection Service this summer; and its attorney is quoted referring to a "federal investigation."[17]

If CDs are fully insured by the FDIC they have no credit risk. However if the bank or broker that purchased the CD for you holds the CD, there may be custodial risk.

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[14] http://www.ratesearchinc.com/Rate%20Search%20Inc/Main%20Flash/Homepage.htm, *quoting* company president S. Luster (September 18, 2007).
[15] Sarah Lemagie, StarTribune (September 24, 2007).
[16] Brendan Riley, Associated Press (September 18, 2007).
[17] *See supra* note 12.

VII. Custodial Risk for CDs purchased through the Statewide Investment Pools

A. The Liquid Asset Fund, 4M Fund and Magic Fund

The Liquid Asset Fund, 4M Fund and Magic Fund are all government investment pools. They are joint powers entities created by government participants coming together and exercising a common power in this case the power to invest. Minn. Stat § 471.59 Each Fund has chosen to operate in a manner similar to a mutual fund with a portfolio of investments owned collectively by the participating government entities. As far as the investments in the pool, GASB has exempted them from custodial credit risk.

Each of these Funds also operates a direct investment program which includes Certificates of Deposit (CDs). Dain Rauscher operates the direct investment program for the 4M Fund, and PFM Asset Management operates the CD purchase program for the Liquid Asset Fund and the Magic Fund. The programs operate differently, but none have custodial credit risk present.

B. 4M Fund

Dain Rauscher obtains CDs for cities participating in the 4M Fund. This is a program in separate from the investment pool. The CDs in this program are investment CDs. Like those in the CDARS program, the issuing bank does not know who owns the CDs they have issued. These CDs are held by Dain Rauscher in an account for the individual city purchaser. There would custodial credit risk present except Dain Rauscher maintains SIPC and excess SIPC coverage for the benefit of its account holders. The presence of SIPC coverage negates custodial credit risk.

C. Magic Fund and Liquid Asset Fund

Counties and school districts participating in these Funds can purchase CDs through a program operated by PFM Asset Management. Here the CD is issued by the issuing bank in the name of the individual county or school district. These CDs are issued in amounts so that interest and principal are covered by FDIC insurance. As auditors we can call the issuing bank and confirm the existence and ownership of the CD because the county or school district is a depositor of record on the issuing bank's records. Since the issuing bank issues these CDs in the name of the government entity, no one else can "hold" these CDs nor can anyone else "hold" them in someone else's name. In this respect these CDs are different from CDARS CDs where the issuing bank has no idea who holds the CD, the CD is "held" by the Bank of New York in the name of the local bank.

CDs issued under these Fund programs are deposit CDs and as such they are only subject to custodial risk to the extent they are uncollateralized or uninsured. Because they are issued in amounts less than $100,000, they are fully insured and so no custodial risk is present.

VIII. Collateral Pools

Some public depositories are interested in pledging a pool of securities to cover their public deposits. One such proposal under review involves the Bank of North Dakota acting as the safekeeping bank.

A. Compliance Concerns

1. All requirements of Minn. Stat. §§ 118A.02-.03 need to be met including:

    a. The amount of the pool pledged to Minnesota government entities must equal 110% of the uninsured amount on deposit.
    b. There must be a written assignment that states that upon default and demand, pledged securities will be turned over to the government depositor.
    c. The depository must give written notice to government depositor of withdrawals and substitutions of collateral.
    d. Types of collateral must be consistent with Minn. Stat. § 118A.03 Subd. 2.
2. The treasurer may not be able to verify that the amount of collateral is correct at any given time.

B. Audit Concerns

1. In order to determine if sufficient collateral has been pledged, one needs to know the total uninsured amount on deposit by all government pledgees. The value of collateral in the pool needs to exceed this amount by 10%.
2. The factors to consider in determining custodial risk is present:

    a. Whether sufficient collateral is pledged – if this information is not available to the government entity this fact should be disclosed in the notes.
    b. Whether the custodian of the pool acts as the agent of the pool or the depository.
    c. Whether the custodian holds the collateral in the name of the pool.

C. Proceed cautiously with proposed pool arrangements.

We will post on our website any conclusions we come to about particular custodial pool arrangements.

IX. Bank Assignments of Collateral

Local government money on deposit in excess of federal depository insurance must be covered by a corporate surety bond or assigned collateral.[18] We have had issues with the collateral assignments designed and used by some banks. For example, one large bank's assignments formerly required written notice by mail to their San Francisco office and then three days to cure any default.

Under Minn. Stat. § 118A.03, subd. 4, "[t]he written assignment shall recite that, upon default, the financial institution shall release to the government entity on demand, free of exchange or any other charges, the collateral pledged."

The bank changed the assignment language to follow our state law. But it is not updating outstanding assignments. Treasurers should check the collateral assignments and if they have old assignment, they may need to get a new one.

[18] Minn. Stat. §§ 118A.01-.03 (2006).