



# The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

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AUDITOR

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2008-2106-170

July 8, 2008

Domenic J. Sarno, Mayor  
City of Springfield  
Springfield City Hall  
36 Court Street  
Springfield, MA 01103

Dear Mayor Sarno:

At your request and as authorized by Chapter 11, Section 12, of the Massachusetts General Laws, we performed a special-scope audit of the investment practices in the City of Springfield (City). Our audit was initiated for the purpose of determining the extent of compliance with applicable municipal finance laws and other guidance pertaining to the City's investments. In addition, our intent was also to evaluate and report on adherence by the City to its own applicable fiscal policies and procedures and internal controls regarding investments and recommend any areas that could be strengthened and made more efficient or effective.

Our audit was not conducted for the purpose of expressing an opinion on the City's investment practices. Our audit was made in accordance with generally accepted government auditing standards for performance audits. Our review identified and evaluated the fiscal policies, procedures, and investment practices employed by the City for investing funds as well as the procedures and responses by the Finance Control Board (FCB) and City officials in monitoring, providing oversight, and instituting remedial procedures to protect its investments.

Our review consisted of, but was not limited to, the following:

- Reviewing applicable laws, regulations, and policies relating to the City's investment practices.

- Examining the oversight roles of the FCB and City officials specifically pertaining to the selection, monitoring, and oversight of investments within the City.
- Reviewing and examining the job functions and responsibilities of various City officials as they pertain to investments.
- Meeting with various current and former City and state officials.
- Examining City procedures, including related internal controls pertaining to investment practices and activities during the period July 1, 2005 through February 29, 2008.
- Reviewing a list of the investments the City maintained as of February 29, 2008.
- Examining pertinent independent audit reports and management letters of the City of Springfield.

During our review we met with FCB and City officials and representatives, and interviewed various other state and municipal officials as deemed necessary to discuss both City and municipal investment practices, for the purpose of:

- Gaining an understanding of what types of investments are allowed by state law and relevant City policies and procedures.
- Ascertaining what procurement policies and procedures as well as contracts were in effect for the City with respect to banking and investment services.
- Reviewing the procedures and processes employed by various responsible officials in establishing a selection process for the procurement of investments.
- Ascertaining what changes in policies and procedures the City is considering for future investment decisions.

To meet our objectives, we reviewed certain events and transactions of investment-related activity that transpired prior to and during fiscal years 2007 and 2008 through February 29, 2008.

### **Massachusetts Municipal Investment Requirements and Restrictions**

Criteria for guidance on investing municipal funds are found in a number of sources. Provisions of Chapter 44 of the Massachusetts General Laws, in general, define the parameters of City finance and fiscal banking and investment practices. Chapter 44, Section 55, provides that a municipality:

*. . . may invest such portion of revenue cash as he [treasurer] shall deem not required to pay expenses until such cash is available and all or any part of the proceeds from the issue of bonds or notes, prior to their application to the payment of liabilities incurred for the purposes for which the bonds or notes were authorized.*

Section 55 also enumerates the types of investments that may be made including bank certificates of deposit, obligations issued or unconditionally guaranteed by the United States Government with a maturity date of one year or less, repurchase agreements, or money market funds registered with the Securities and Exchange Commission. A municipal official who invests in these types of investments will not be held personally liable for any loss of money due to the failure of the institutions (MGL Chapter 44, Section 55A).

Lastly, Section 55B provides that excess municipal funds:

. . . shall be invested in such a manner as to require the payment of interest on the money at the highest possible rate reasonably available, taking account of safety liquidity and yield. All officers of a city, town district or regional school district who control the investment of such funds shall invest them prudently, consistent with the provisions of sections fifty-four and fifty-five.

In addition to the laws cited above, the Massachusetts Collectors and Treasurers Association has issued a Treasurers Manual to serve as a reference tool that provides common practices for the day-to-day operations at a treasurer's office. Chapter 11 of that Manual entitled "Effective Cash Management" provides guidance on investments that correlates with the provision of the General Laws cited in the previous paragraph. In addition, local ordinances and policies and procedures can be adopted, which can become more restrictive and more specific than legal requirements.

### **City Investment Policies and Procedures**

Our review found that, prior to the takeover and tenure of the FCB, the City had inadequate, fragmented, piecemeal written procedures or informal policies and procedures in place for its overall cash management and investment functions. Clearly defined comprehensive policies and procedures are necessary to provide guidance, structure, and direction to establishing and enacting a process as to how the City should enter into its cash management and investment decisions and selections, as well as monitoring activities.

In order to lay the foundation for efficient and effective government, the FCB revised, reviewed, and adopted uniform **City of Springfield Fiscal Policies and Procedures** (effective February 28, 2006). The

FCB recognized that a “bedrock element of local government is its finances” including recognizing the prominent influence that finance has over how the City prioritizes its activities and guides its decision-making processes. These fiscal policies and procedures are the standards and guidelines by which the City’s financial operations are to be managed at a citywide and departmental level. The mainframe work of these policies as identified from the document, are stated, in part, as follows:

*The City has developed these fiscal policies to advance the following goals:*

- *Prudent and proactive fiscal management*
- *Appropriate use of City funds and assets*
- *Compliance with all applicable laws and regulations*
- *Clear and appropriate roles and responsibilities of City finance staff*
- *Providing a vehicle for continuous dialogue regarding fiscal best practices*

***Expectation:*** *This document provides the City’s management and staff with a blueprint of sound financial management practices. Every City department will follow these fiscal policies so that all departmental budgets are proactively managed and controlled. These policies apply to all funding sources and City assets. Finally, this document is an explicit policy of the Mayor, Finance Control Board, and Chief Financial Officer (CFO) and, as such is formal notification of required behavior.*

***Scope:*** *The City of Springfield functions under a network of local, state and federal laws, and regulations that closely govern any use of funds and property. As part of the City structure, each department, program and service area is responsible for identifying and adhering to the mandates that pertain to its operations and funding sources. In addition to law, there are fiscal best practices that apply to employee roles and responsibilities related to financial activities as well as other financial practices. This document draws heavily from both applicable law and financial best practices.*

***Basic fiscal responsibility and propriety:*** *To guarantee on-going fiscal soundness and integrity, all finance-related management and staff with the City will adhere to all applicable laws, regulations and policies that govern the City’s finances and use of funds. Department heads and finance staff are responsible for being aware of, and adhering to, all laws, regulations, policies and best practices applicable to their areas of service. The City of Springfield is committed to the proper and legal use of public funds and assets. If encountered, City employees are encouraged to report any such behavior to their department head. It is the department head’s responsibility to take the appropriate action to investigate the concern and to notify the City Solicitor of said concerns. In the event an employee is unable to report the activity to their department head or they remain concerned, employees may contact the Chief Financial Officer or the City Solicitor directly.*

The City’s Fiscal Policies and Procedures document contains a very short policy statement on investment of public funds, consistent with the Chapter 44, Section 55B and the Massachusetts

Collector's and Treasurers Association, Treasurers Manual language, outlined under **Management of Funds Policy 02-05**, which states:

*The City will manage its funds in a prudent and diligent manner with an emphasis on safety of principal, liquidity, and financial return on principal.*

One important key item not thoroughly defined at the time of initial implementation of these Fiscal Policies and Procedures in February 2006 was identified under **Cash Handling Policy 10-05**, which states:

*The City is developing policies related to Cash Management.*

This matter is discussed in greater detail in the section of our report covering investment activities and transactions.

With the likelihood of more funds becoming available and in concert with the adoption of these recently updated fiscal policies and procedures, the City's CFO and the FCB's Deputy Executive Director initiated proactive steps, in July and August of 2006, intended to support and clarify the City's investment objectives and policies. In order to effect these initiatives, the Deputy Executive Director of the FCB and the City's CFO decided that the City needed assistance from outside firms to help create and then effectively manage a portfolio of greater investments. These initiatives were subsequently outlined and defined in two draft documents.

The first draft document, prepared and distributed to the FCB, City Auditor, and City Treasurer on September 14, 2006, was intended to be a departmental policy issued by the City Treasurer (Treasurer) as a statement for governing the management of the City's operating cash investments in compliance with Chapter 44, Section 55B. On this same date the CFO stated in correspondence to the Deputy Executive Director of the FCB, the Treasurer and the City Auditor that:

*I think we should review this document and use this as a starting point for developing an investment policy for the city. Once we update and finalize an investment policy then I want to present it to the control board for approval.*

This document, entitled **City of Springfield, Statement of Objectives and Policies for Operating Cash Investments**, contained stated practices and philosophy including: investment objectives, asset

allocation and risk; implementation of investment policies; and cash management procedures. In addition, the document identified steps for implementation of the City's investment policies, which included certain requirements and key elements of the following: *Daily Operations Overview, Cash Flow Statements, The General Fund Cash Flow Cycle, Timing of Investments, Compensating Balance Agreements, Limits on Specific Investment Instruments such as: Repurchase Agreements, Certificates of Deposits, Other Limitations and Prohibitions, and Investment Reporting and Administration.*

The second draft document, **City of Springfield-Request for Qualifications-Cash Investment Advisory Services**, created by the FCB was intended to assist the City and the CFO through a procurement selection process in order to identify firms that would provide cash investment advisory services to the City with the belief that the City would receive the best financial return from an advisor who actively manages its portfolio and exercises sound judgment. This document, included the following sections: *Introduction, Background, Basis of Evaluation; Mandatory Questions for All Potential Advisors, Additional Services, Important Notes, Standards for Performance; General Provisions, Ownership of Information and Confidentiality, Insurance; Conflict of Interest Statement; Certificate of Non-Collusion and Tax Certification Affidavit.*

The City and the FCB further updated its Fiscal Policies and Procedures to include the **Financial Policies of the City of Springfield**, approved on June 19, 2007. These revised financial policies included a section entitled, **Policies Regarding Cash Management**, as follows:

***CM Policy 1: The City shall manage its cash resources in a prudent and diligent manner with an emphasis first on safety and principal, second on liquidity and third on financial return on invested cash. The City shall ensure investment managers who invest municipal funds operate in a manner consistent with these requirements. Cash Management Policy One requires the City and any organization investing on its behalf to invest the City's cash in a conservative manner, as required by Massachusetts General Law. The City should pursue maximum return on invested proceeds, but must do so in a way that balances other important considerations. Money in the accounts of the City is taxpayers' money, and it is prudent for this money to be invested in a manner that does not inappropriately risk principal...Cash Management Policy One seeks to minimize the risk of losing principal while preventing cash investments that would negatively impact cash flow and force unnecessary borrowing costs onto taxpayers. With these considerations in mind, the City may pursue maximum investment return subject to investment limitations***

*established by the Commonwealth of Massachusetts through the so-called "legal list" of investments.*

During the period of our review, these aforementioned fiscal policies and procedures and supporting draft documents were the primary guidance available to the City in making investment decisions and for executing investment transactions.

Our review noted that both Fiscal Policies and Procedures and departmental drafts of both investment objectives and investment advisory procurement selection process are designed to be generally compliant with laws, regulations, and sound business practices. They fundamentally define the need to address operational controls necessary to ensure that the City is effectively and efficiently operating within its current fiscal constraints. With additional refinements and upon implementation, these documents should provide a solid framework for the City to execute and document strong internal controls for cash management and investments.

### **Review of Investment Activities and Transactions**

As part of our review, we requested and received a listing of cash accounts and account balances for all City funds as of December 31, 2007 and February 29, 2008, which indicated that, on those dates, the City's bank and investment balances were \$191,626,178 and \$176,770,735 respectively.

A review of the account holdings as of December 31 2007 disclosed large investment holdings with UBS (\$146 million), Morgan Stanley, (\$21 Million), and TD BankNorth (\$12 Million). The largest portion of these funds (\$69.6 million) was invested in the UBS Select Prime Institutional Fund mutual fund. The second largest portion of the holdings was invested in federal government securities guaranteed by Federal Home Loan Banks (FHLB), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Farm Credit Bank. The balance of these funds was invested in various short-term certificates of deposit or equity mutual funds.

Our review noted that as of February 29, 2008, the above-referenced investments were liquidated (except approximately \$5 million) and a significant amount of the City's funds were shifted to the Massachusetts Municipal Depository Trust (MMDT), an investment pool for Massachusetts governmental

agencies under the control of the State Treasurer. As of February 29, 2008, the MMDT held \$140 million, or 87% of the City's investments.

It should be noted that the City, subsequent to December 31, 2007, increased its investments with Merrill Lynch and held \$14.6 million as of January 31, 2008, which, to a great extent, represents the recovery resulting from the previous year's temporary loss of a substantial portion of the City's investment in Merrill Lynch securities. The City recovered these investments losses with the assistance of the Massachusetts Attorney General. These recovered funds were included with the City's liquidation of investments transferred to MMDT in February 2008. Due to ongoing investigations relative to this matter and regarding investments with Morgan Stanley and UBS securities firms, we are limiting our comments concerning these matters. It is our understanding that these matters are being reviewed by a number of organizations, including the Massachusetts Attorney General's Office, the Secretary of State's Office, and the Securities and Exchange Commission.

We can, however, disclose that UBS reached an agreement with other Massachusetts cities and towns and the Massachusetts Turnpike Authority in May 2008, through intervention by the Attorney General, to return approximately \$37 million in investment principal and income from investment instruments similar to the types of funds that the City held with UBS prior to transfer to MMDT in February 2008.

In the years immediately preceding fiscal year 2006, the City was in a fiscal crisis and did not have excess funds to invest. As of June 30, 2006, City records indicated that there was \$47 million invested (\$27 million in bank certificates of deposit and \$20 million with an investment brokerage firm, Morgan Stanley, in three accounts). Beginning in fiscal year 2007 (July 1, 2006 to June 30, 2007) the City projected that more money would be available to invest as a result of financial reforms previously implemented. Changes in procedures have significantly increased the City's investment resources and increased cash flow. Additional funds were made available by enhancing revenues, stabilizing expenditures, and restructuring the City's fiscal and human resources departments. There was also an infusion of state funding in the form of a \$52 million loan. Coinciding with the development of fiscal policies and procedures and departmental drafts on investment objectives and advisory procurement

selection, FCB and City officials stated that, in their opinion, it would be prudent to invest excess funds to generate a higher rate of return. In August, 2006, the FCB's Deputy Executive Director, in discussions with key City financial officials, the CFO, and Treasurer, began exploring the need to expand City investments to maximize the increased funds accrued from its operations. The City Finance Department and the FCB determined that they should work with a number of firms to present information regarding how funds could be invested and what rates of return could be expected by the way.

An investment selection committee was formed consisting of the Deputy Executive Director of the FCB, the City's CFO, Treasurer, and City Auditor, and three pre-selected firms made presentations. Committee members stated that all firms were made aware of Massachusetts's investment requirements and restrictions and the firms were purportedly aware of the legal municipal requirements for investments. After the presentations, the committee determined that each firm appeared to have strengths and weaknesses based on their presentation. The committee decided to split funds with these three brokerage firms (UBS, Morgan Stanley, and Merrill Lynch) with the intent of reviewing performance in about a year. In response to this decision, the Treasurer opened investment accounts with these three brokerage firms to establish and coordinate investment activities. These decisions culminated with a major transfer of City funds on February 14, 2007, totaling \$82.5 million into brokerage accounts of these firms (Merrill Lynch \$27.7 million, Morgan Stanley \$27.4 million, and UBS \$27.4 million). The types of investments initially made included conservative money market funds, federal government guaranteed fixed income funds, and state guaranteed municipal bonds. However, even though other states or municipalities guaranteed some of the investments, they were "variable rate" obligations. Although they were liquid investments at the time, changing market conditions resulted in no buyers for variable rate obligations. If a holder of those instruments wanted or needed to sell the obligations, they couldn't receive their investment back until the obligation matured, often 20 to 30 years in the future. Fortunately, the City liquidated its variable rate obligations by transferring funds to MMDT prior to the collapse of the variable rate obligation market. Shortly after these funds were invested, Merrill Lynch notified the City Treasurer that they had another investment vehicle that could generate higher returns. The City Treasurer

informed us that he questioned whether the new investment vehicle would comply with Massachusetts laws, and was assured that it would by a Merrill Lynch official. A total of \$12.6 million in funds was eventually placed in investment accounts in April and May of 2007 to secure the purchase of this new investment, which ended up being the well-publicized Merrill Lynch investment that lost most of its value and became the subject of the current ongoing investigations. With respect to the City's formation of an investment selection committee, we believe that an investment committee is a good concept for overseeing investments. However we suggest that formal policies and procedures be adopted to strengthen its functions and transparency.

In addition, we found that upon the approval by the FCB of the *Policies Regarding Cash Management* in June 2007, the FCB Deputy Executive Director, in his oversight capacity, the CFO, Treasurer, and City Auditor, and members of the City's previously established investment selection committee did not hold a meeting or enter into any discussions about the impact and effect of these new policies on the investments held by the City at that time. One key element that should have been discussed is whether the investments the City held met the criteria of the following policy:

*Money in the accounts of the City is taxpayers' money, and it is prudent for this money to be invested in a manner that does not inappropriately risk principal and ... subject to investment limitations established by the Commonwealth of Massachusetts through the so-called "legal list" of investments*

Based upon our review, we have concerns as to whether the investment instruments selected by the City and maintained within the investment accounts at all three brokerage firms met the "legal list" criteria set forth in the City's policies. Further, as mentioned previously, we are not providing further details at this point so as not to jeopardize ongoing investigations. We do disclose that, through the City's legal actions and with the assistance of the Attorney General, the City's investment was subsequently fully recovered. In addition, we should note that during our audit, we identified investment losses that occurred in other municipalities throughout the Commonwealth at the same brokerage firms and others in which legal settlements have been reached or investigations are ongoing. In these instances at the other municipalities, investments, the same or similar to those in which the City of Springfield had invested, were found to be inconsistent with state law or in violation of established banking regulations. We did

find that due to operating system improvements the City Treasurer made, the City did have a timely cash reconciliation and review procedure in place during 2007 that had been absent in prior years. The Treasurer noticed that the Merrill Lynch investment had dropped in value during August 2007 and he approached the City's CFO, who in turn notified the FCB. The City's Fiscal Policies and Procedures-Basic Fiscal Responsibility and Propriety provides that the department head shall contact the CFO or City Solicitor, as follows:

*The City of Springfield is committed to the proper and legal use of public funds and assets. If encountered, City employees are encouraged to report any such behavior to their department head. It is the department head's responsibility to take the appropriate action to investigate the concern and to notify the City Solicitor of said concerns. In the event an employee is unable to report the activity to their department head or they remain concerned, employees may contact the Chief Financial Officer or the City Solicitor directly.*

We found that the Treasurer fulfilled the City's requirements to ensure that once a concern was identified, appropriate action was taken to investigate the substantial decrease in investments and to notify the CFO. The CFO reported this situation to the FCB, but the City Solicitor and the Mayor were not notified until months later.

### **Recommendations and Future Considerations**

The City, through the efforts of the FCB and City finance officials, has implemented substantial improvements in financial operating procedures over the past few years to address both the needs of the City and the current environment in which municipalities operate. Although much progress has been made, an additional refinement of policies and the implementation of adequate operational procedures will further improve the City's investment practices. To expedite these improvements, the City should implement specific departmental policies and procedures that clearly define and outline the roles and responsibilities of employees who handle cash and investments. Further, the City should implement proper oversight mechanisms to support effective application of these policies and procedures in order to protect and control its cash and investments. Upon full implementation, consistent application, efficient monitoring, and effective ongoing administrative oversight, the City will have the necessary controls and

fundamental precepts securely in place for sound fiscal practices to continue upon the dissolution of the FCB.

We suggest that the FCB and the City consider the following recommendations in order to help strengthen the City's investment procedures:

- The City should update its cash management and investment policies and procedures. We recommend that these policies include, but not be limited to the following:
  - The scope of the policy, including what funds are or are not covered by this policy. For example, some municipalities exclude debt service funds and trustee funds from the traditional cash management policies.
  - Delegation of authority to specifically delineate who is responsible for management of the City's investment portfolio, role of a selection committee if adopted, defining who is authorized to make periodic selections, conduct investment transactions, and who is responsible for establishing and maintaining the written procedures for cash and investment management.
  - Performance standards addressing not only safety, liquidity, and yield as they currently do, but expanded to include performance targets. Performance targets would probably not be written as an absolute percentage, but rather as a percentage of a recognized performance indicator for the types of investments applicable to that category of investment.
  - Internal controls, including a summary of the important controls applicable to the investment area.
  - Legal authority and limitations of investments that include the types of investments that may be made and any maximum time frames of investments.
  - Investment limitation per institution to help protect the City in the event of a financial institution failure. The City might consider limiting how much funds are invested with a particular institution. Additionally, policies in this area might consider limiting how much of the City's funds compose the institution's financial resources.
  - Reporting requirements to help ensure that the necessary reports are generated and reconciled to the appropriate records and made available to the appropriate parties.
  - Institute on-going formal monitoring activities of the City's investments, including periodic performance evaluations, so that informed decisions can be made on a timely basis. This shall include timely reporting to upper-level management.
  - Establish ethics and conflict of interest policies, and provide awareness training to ensure that officials and employees are aware of conflict of interest laws and City policies and to help ensure that investment decisions are made impartially.
- While reviewing current City cash management policies, the City should determine whether it desires to keep its current restriction of limiting investments to the so-called "legal investment list" items or whether they desire to allow more flexibility in investment vehicles.

- If the City is going to make investments through brokerage firms, we suggest that an evaluation of the firm be conducted to provide such services, which would include, at a minimum: the qualifications and expertise of the proposed firm; the experience the firm has in managing portfolios similar to the City's; the structure of the firm; the firm's ethical and professional standards; and costs of providing such services. Any such selection process should have clear documentation requirements outlined in the City's fiscal policies and procedures.
- The City may want to consider the use of an investment advisor, independent of servicing brokerage firms, to guide the City in assisting its finance officials in investment selection decisions. This may assist the City in ensuring safety, liquidity, and financial return on principal, accordingly to meet its strategy, goals, and objectives for maximizing revenue from its investments.
- The City should formulate a job description for the position of the City Treasurer, as no description currently exists for this position.
- In the event of any restructuring within the City's Finance Departments, consideration should be given to dividing the Collection responsibility to another high level Collector's position. This break would segregate the Treasurer's responsibilities more exclusively towards cash management, investment strategy, monitoring improvements, and related cash-control activities, including ensuring rapid reconciliations to ensure cash flow measurements and expectations are reported in a timely manner and documented for cash management improvements.
- The City should consider creating an independent Internal Audit function that would report to an appropriate level of city government. Although the City has a City Auditor, the responsibilities of this position are aimed more at determining whether departments are within spending limits, whether new programs or positions are funded, compliance with applicable accounting standards, and assisting the assembly data as part of the annual independent City audit. The Springfield City Auditor's responsibilities are similar in nature to what other municipality, city, or town auditor positions require throughout the Commonwealth, but the general public often misunderstands these responsibilities.

I hope this information will be helpful in your continued efforts to secure the financial stability and economic future of the City of Springfield. Should you have any questions or need further assistance concerning this or any other matters, please feel free to contact me.

Sincerely,



A. JOSEPH DeNUCCI  
Auditor of the Commonwealth