

REPORT DIGEST

MANAGEMENT AUDIT OF THE

ILLINOIS SCHOOL DISTRICT LIQUID ASSET FUND PLUS

Released: May 2005



State of Illinois
Office of the Auditor General

WILLIAM G. HOLLAND
AUDITOR GENERAL

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SYNOPSIS

The Illinois School District Liquid Asset Fund Plus (ISDLAF+) is an Illinois common law trust that was created in 1984 pursuant to provisions of the Illinois School Code. The ISDLAF+ offers shares in a manner similar to a money market mutual fund. Participants can choose from two different classes of shares (Liquid Class or the MAX Class). As of September 2004, the ISDLAF+ had approximately 400 participants including township treasurers, school districts, and community colleges and pooled funds totaling approximately \$586 million.

Conflicts of Interest – Prior to July 2004, neither Trustees nor service providers for the ISDLAF+ were required to file conflict of interest statements or disclosure forms with the Fund. In July 2004, the ISDLAF+ Board of Trustees approved a motion requiring each voting Trustee to annually submit to the Secretary, copies of their economic interest disclosure forms that are filed annually with their respective county clerks. The motion also required Trustees to complete a Conflict of Interest Disclosure Statement. As of April 15, 2005, the Fund provided auditors with Conflict of Interest Disclosure Statements for all ten of the current voting Trustees and copies of the Statements of Economic Interest filed with the respective county clerks for nine of the ten Trustees. However, the July 2004 motion did not provide guidance regarding the types of relationships considered potential conflicts and the reporting process. Furthermore, service providers and contractors with the Fund are not required to file a disclosure with the ISDLAF+ Board.

Fund Performance - The ISDLAF+ Multi-Class Series performance for the period October 2002 through December 2004 was comparable to other similar funds, including other states' school district liquid asset funds and governmental pool indices. When compared to the Illinois Treasurer's Office Illinois Funds, the ISDLAF+ performed slightly better than the Illinois Funds in the **gross** rate comparison (i.e., before expenses are deducted); however, the Illinois Funds performed better than the ISDLAF+ in the **net** rate comparison (after expenses).

Management Controls - The ISDLAF+ has established a system of management controls for the monies invested by participants in the pooled funds of the Multi-Class Series. These include written investment policies, quarterly reporting to the Board of Trustees, weekly compliance reporting to the audit committee, and regular performance comparisons.

Matter for Consideration - Because it is unclear whether the Public Funds Investment Act specifically authorizes investment in banker's acceptances, we have included a Matter for Consideration for the Illinois General Assembly to consider defining the term "direct obligations of any bank" in the Public Funds Investment Act.

REPORT CONCLUSIONS

The Illinois School District Liquid Asset Fund Plus (ISDLAF+ or the Fund) is an Illinois common law trust that was created in 1984 pursuant to provisions of the Illinois School Code. The Fund offers shares in a manner similar to a money market mutual fund in which participants can choose from two different classes of shares. As of September 2004, the ISDLAF+ pooled funds totaled approximately \$586 million.

The Declaration of Trust contains provisions that discuss the Fund and certain affiliates and their interests. The provisions contained in the Declaration of Trust generally allow for Trustees to have business interests similar to those of the Fund or to be interested in a transaction, provided the interest is disclosed and the action authorized by a majority vote of unaffiliated Trustees or a majority of participants. The Declaration of Trust contains a clause that allows the By-Laws of the Fund to contain more restrictive conflict of interest provisions. However, the By-Laws do not contain more restrictive provisions.

Prior to July 2004, neither Trustees nor service providers for the ISDLAF+ were required to file conflict of interest statements or disclosure forms with the Fund. In July 2004, the ISDLAF+ Board of Trustees approved a motion requiring each voting Trustee to annually submit to the Secretary, with a copy to the Fund counsel, copies of their economic interest disclosure forms that are filed annually with their respective county clerks. The motion also required Trustees to complete a Conflict of Interest Disclosure Statement. As of April 15, 2005, the Fund provided auditors with the Fund's Conflict of Interest Disclosure Statements for all ten of the current voting Trustees and copies of the Statements of Economic Interest filed with the respective county clerks for nine of the ten Trustees. However, the motion did not provide guidance regarding the types of relationships considered potential conflicts and the reporting process. Furthermore, service providers and contractors with the Fund are not required to file a disclosure with the ISDLAF+ Board.

The Illinois State Treasurer's Office and four liquid asset funds in other states were contacted to determine whether they had relevant conflict of interest reporting policies and procedures. The Treasurer requires all employees to disclose all matters that could reasonably be expected to interfere with the employee's duties, as well as requires certain employees to file a Statement of Economic Interests with the Secretary of State (similar to the Statement of Economic Interests the ISDLAF+ Trustees file with their respective county clerks and now with the Secretary of the Board). One of the four other states' funds contacted had also established specific policies defining what types of relationships constitute a conflict of interest.

The ISDLAF+ Multi-Class Series performance for the period October 2002 through December 2004 was comparable to other money market types of funds investing public funds. We compared 7-day annualized average yields for the ISDLAF+ with school district liquid asset funds in several other states. We also compared the ISDLAF+ with money market and governmental pool indices and the 4-week Treasury bill.

The ISDLAF+ Multi-Class Series consists of a Liquid Class, which offers daily liquidity, and a MAX Class, which generally requires a minimum deposit of 14 days. Over the past two years, ISDLAF+'s Liquid Class had a slightly lower net return than two of the three indices presented; however, it had a higher net return than that of two of the three other states' liquid asset funds presented. The ISDLAF+ MAX Class performance was comparable to the Standard and Poor's (S&P) indices and the 4-week T-bill and better than the iMoneyNet index. The MAX Class has been yielding approximately the same return as that of two of the three other states' liquid asset funds presented. When compared to the Illinois Treasurer's Office Illinois Funds, the ISDLAF+ performed slightly better than the Illinois Funds in the **gross** rate comparison (i.e. before expenses are deducted); however, the Illinois Funds performed better than the ISDLAF+ in the **net** rate comparison (i.e. after expenses).

Reports related to Fund performance are prepared and provided to the Trustees at each quarterly meeting. These reports contain average yield and return comparisons as well as a performance evaluation of the Multi-Class Series of the Fund. Although the Fund's Administrator prepares comparisons and provides them to Trustees at quarterly meetings, the ISDLAF+ annual reports distributed to Fund participants do not contain a performance comparison.

The ISDLAF+ has established a system of management controls for the monies invested by participants in the pooled funds of the Multi-Class Series. These include written investment policies, quarterly reporting to the Board of Trustees, weekly compliance reporting to the audit committee, and regular performance comparisons.

It is unclear whether the Public Funds Investment Act specifically authorizes investment in banker's acceptances. Although the Act includes a provision for the investment of funds in other investments constituting direct obligations of any bank, it does not define what these include. The Fund does invest in banker's acceptances, which an informal Attorney General opinion in 1997 determined were not permissible investments under the Public Funds Investment Act. We have included a Matter for Consideration for the Illinois General Assembly to consider defining the term "direct obligations of any bank" in the Public Funds Investment Act.

BACKGROUND

On April 22, 2004, Senate Resolution Number 171 was adopted directing the Auditor General to conduct a management audit of the Illinois School District Liquid Asset Fund Plus. The resolution asks the Auditor General to determine:

- Whether the Fund's provisions regarding conflicts of interest are sufficient and comparable to other pools investing public moneys;
- Whether the Fund's performance is comparable to other pools investing public moneys; and
- Whether controls are in place to adequately protect public moneys invested in the Fund. (page 3)

ILLINOIS SCHOOL DISTRICT LIQUID ASSET FUND PLUS

Illinois law allows township and school treasurers, community college districts, and educational service regions to join together in investing funds. Section 8-7 of the School Code permits township and school treasurers to join with other school districts, community colleges, and educational service regions for the purpose of investing funds (105 ILCS 5/8-7). A similar provision is included in the Public Community College Act, which permits community colleges to do the same (110 ILCS 805/3-47).

The Illinois School District Liquid Asset Fund Plus (ISDLAF+) is an Illinois common law trust that was organized for the purpose of combining available investment funds so as to enhance the investment opportunities available to school districts and to increase the investment earnings accruing to the benefit of the respective school districts. A Declaration of Trust that governs the operations of the ISDLAF+ was adopted by the Fund's Board of Trustees and legally filed. The Fund was created March 26, 1984. In addition, the Trustees have formally adopted an Information Statement that also governs the ISDLAF+ operations and includes management and investment policies.

**The Fund was
created March 26,
1984.**

The Fund offers shares in a manner similar to a money market mutual fund. Participants can choose from two different classes of shares with the pooled funds of the Multi-Class Series. These include the Liquid Class and the MAX Class. The Liquid Class is a money market type of investment that offers daily liquidity and check-writing privileges. The MAX Class generally requires that a participant hold the shares for a minimum of 14 days. If MAX Class shares are redeemed early, the participant may be charged a penalty equal to 7 days interest at the current daily rate on the value of the redemption.

Digest Exhibit 1 presents the total net assets, investment income, and expenses of the ISDLAF+ Multi-Class Series as of the end of each fiscal year. The net assets for the Fund have ranged from approximately \$410 million in fiscal year 2002 to almost \$640 million in fiscal year 2003.

The Fund invests in high-quality, short-term debt instruments guaranteed by the full faith and credit of the United States, certain U.S. government agency obligations, commercial paper, bank obligations, and other obligations permitted by Illinois law, particularly the Public Funds Investment Act (30 ILCS 235).

Digest Exhibit 1 ISDLAF+ ASSETS, INVESTMENT INCOME, AND EXPENSES Fiscal Years 2002-2004 (as of September 30)			
	FY 2002	FY 2003	FY 2004
Total Net Assets	\$409,645,436	\$639,071,952	\$585,667,597
Investment Income	\$10,056,519	\$6,599,448	\$6,988,304
Expenses	\$2,016,055	\$2,375,099	\$2,422,759
Source: OAG analysis of ISDLAF+ annual reports.			

The majority of participants in the ISDLAF+ are school districts.

The Fund has approximately 400 participants including township treasurers, school districts, and community colleges. The majority of participants in the ISDLAF+ are school districts.

Management and Organization

The affairs and operations of the ISDLAF+ are governed and controlled by a Board of Trustees. Service providers hired by the Board perform all the day-to-day functions of the Fund. The service providers include an Investment Advisor, Administrator, Distributor, and Custodian. There is also a Subadvisor and a subcontractor for consulting and marketing. Several of these services are provided by related entities. Although the organization of school district liquid asset funds in other states varies, it is not uncommon for these types of funds to have the same service provider as the administrator and advisor of the fund like the ISDLAF+. (pages 3-10)

CONFLICTS OF INTEREST

The Declaration of Trust contains provisions that discuss the Fund and certain affiliates and their interests. The provisions contained in the Declaration of Trust generally allow for Trustees to have business interests similar to those of the Fund or to be interested in a transaction, provided

the interest is disclosed and the action authorized by a majority vote of unaffiliated Trustees or a majority of participants. The Declaration of Trust contains a clause that allows the By-Laws of the Fund to contain more restrictive conflict of interest provisions. However, the By-Laws do not contain more restrictive provisions.

Prior to July 2004, neither Trustees nor service providers for the ISDLAF+ were required to file conflict of interest statements or disclosure forms with the Fund. In July 2004, the ISDLAF+ Board of Trustees approved a motion requiring each voting Trustee to annually submit to the Secretary, with a copy to the Fund counsel, copies of their economic interest disclosure forms that are filed annually with their respective county clerks. The motion also required Trustees to complete a Conflict of Interest Disclosure Statement. As of April 15, 2005, the Fund provided auditors with the Fund's Conflict of Interest Disclosure Statements for all ten of the current voting Trustees and copies of the Statements of Economic Interest filed with the respective county clerks for nine of the ten Trustees. However, the motion did not provide guidance regarding the types of relationships considered potential conflicts and the reporting process. Furthermore, service providers and contractors with the Fund are not required to file a disclosure with the ISDLAF+ Board.

Four liquid asset funds in other states were contacted to determine whether they had relevant conflict of interest reporting policies and procedures. Many of the other Government Investment Pools and School District Liquid Asset Funds that we reviewed had similar provisions regarding conflicts of interest as were found in the ISDLAF+'s Declaration of Trust. The ISDLAF+ Declaration of Trust provision, which calls for Trustees to disclose their interests, is not included in three of the four other states' school district liquid asset fund declarations of trusts that we reviewed.

One of the other states' funds responded that it had developed more specific policies. These policies included specific types of relationships that were considered conflicts of interest such as having a direct financial interest in any contractor, being an employee of any contractor, having low or zero interest loans from contractors, being involved in certain legal actions involving contractor organizations, or being an employee or having a contractual relationship with other similar funds.

The Illinois Treasurer's Employee Handbook requires employees of the Illinois Treasurer's Office to annually complete a Code of Ethical Conduct Investments and Loans Disclosure Form to disclose to the Office all matters that could reasonably be expected to interfere with the employee's duty to the Treasurer's Office, or with the employee's ability to render unbiased and objective advice, or create the appearance of

Prior to July 2004, neither Trustees nor service providers for the ISDLAF+ were required to file conflict of interest statements or disclosure forms with the Fund.

In July 2004, the ISDLAF+ Board of Trustees approved a motion requiring each voting Trustee to annually submit to the Secretary, with a copy to the Fund counsel, copies of their economic interest disclosure forms that are filed annually with their respective county clerks.

impropriety in the Treasurer's Office. Specific employees are also required to complete the Secretary of State's Statement of Economic Interests.

The new conflict of interest reporting requirement adopted by the Board in July 2004 requires more disclosure to the Board than in previous years. However, the reporting requirements could be more specific regarding the types of conflicts that need to be reported. Also, given the competitive nature of the financial services being provided to the ISDLAF+, service providers and contractors with the Fund should also be required to file a conflict or economic interest disclosure with the ISDLAF+ Board.

We recommended that the Illinois School District Liquid Asset Fund Plus should establish specific written policies and procedures regarding conflicts of interest including the types of relationships that should be disclosed as well as the process of reporting conflicts. Such policies and procedures should include not only Fund officials but also service providers and other contractors. (pages 15-23)

FUND PERFORMANCE

The ISDLAF+ Multi-Class Series performance for the period October 2002 through December 2004 was comparable to other money market types of funds investing public funds. We compared 7-day annualized average yields for the ISDLAF+ with school district liquid asset funds in several other states. We also compared the ISDLAF+ with money market and governmental pool indices and the 4-week Treasury bill, as well as the Illinois Treasurer's Illinois Funds.

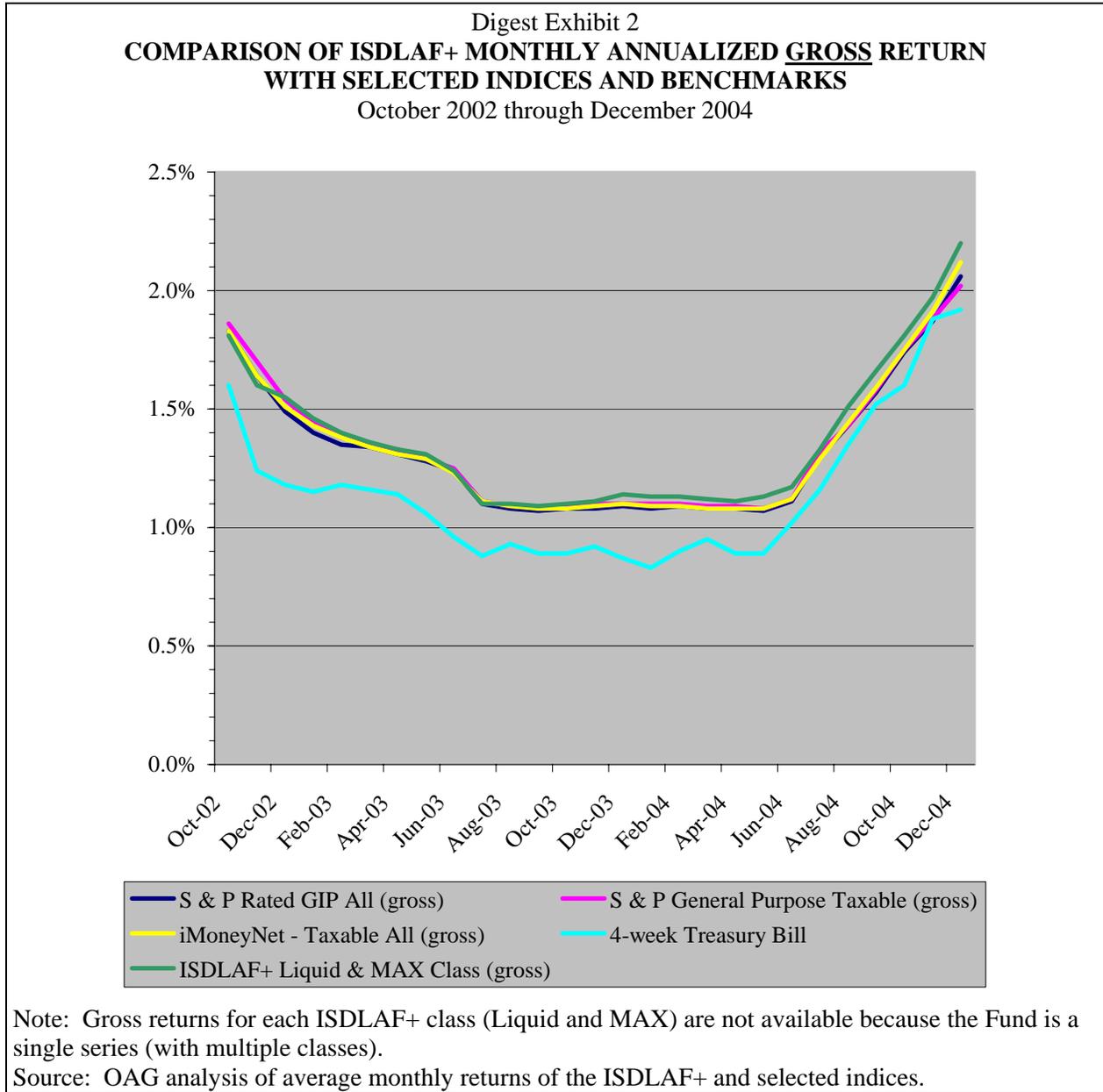
The ISDLAF+ Multi-Class Series performance for the period October 2002 through December 2004 was comparable to other money market types of funds investing public funds.

There are several variables that may have an effect on fund comparisons. These include the size and composition of the portfolio, the weighted average maturity (WAM), investment strategy, investment restrictions, services offered, and the fees and expenses charged to participants. These variables may have an effect on a fund's yield. For example, the ISDLAF+ portfolio's WAM is managed at 60 days or less. A portfolio that allows a higher WAM has the potential to earn a higher yield. An ISDLAF+ official noted that funds rated by Standard and Poor's (S&P) allow for a better comparison because non-rated funds can have more liberal or aggressive investment policies.

Indices

The ISDLAF+ Multi-Class Series consists of a Liquid Class and a MAX Class. Over the past two years, the ISDLAF+'s Liquid Class, which offers daily liquidity, had a slightly lower net return than two of the three indices presented. The ISDLAF+ MAX Class (which generally requires a minimum deposit of 14 days) performance was comparable to the S&P

indices and the 4-week T-bill and better than the iMoneyNet index. Digest Exhibit 2 shows that there was little difference among the ISDLAF+ gross return and the indices.



Other States' School District Liquid Asset Funds

Over the past two years, ISDLAF+'s Liquid Class performance was better than two of the three other states' funds that are presented in Digest Exhibit 3.

We collected available yield data for other states' school district liquid asset funds for the period of October 2002 to December 2004. Digest Exhibit 3 shows the average 7-day yield comparisons for the Liquid and MAX Classes, respectively, among school district liquid asset funds in other states.

Digest Exhibit 3 AVERAGE OF 7-DAY YIELD FOR ISDLAF+ AND FUNDS IN OTHER STATES October 2002 through December 2004				
	ISDLAF+	Minnesota	Michigan	Nebraska
Liquid Class	0.84%	0.60%	0.67%	0.90%
MAX Class	0.99%	0.99%	1.02%	0.90%
Note: Nebraska's school district liquid asset fund has only one class of shares. Source: OAG analysis of daily 7-day yields.				

Over the past two years, ISDLAF+'s Liquid Class performance was better than two of the three other states' funds that are presented in Digest Exhibit 3. Nebraska's school district liquid asset fund has only one class of shares. This is why it had a higher return in the Liquid Class comparison, but the lowest return on average when compared to MAX Class returns. The ISDLAF+'s MAX Class has been yielding approximately the same return as that of the other two funds with both a Liquid and MAX class.

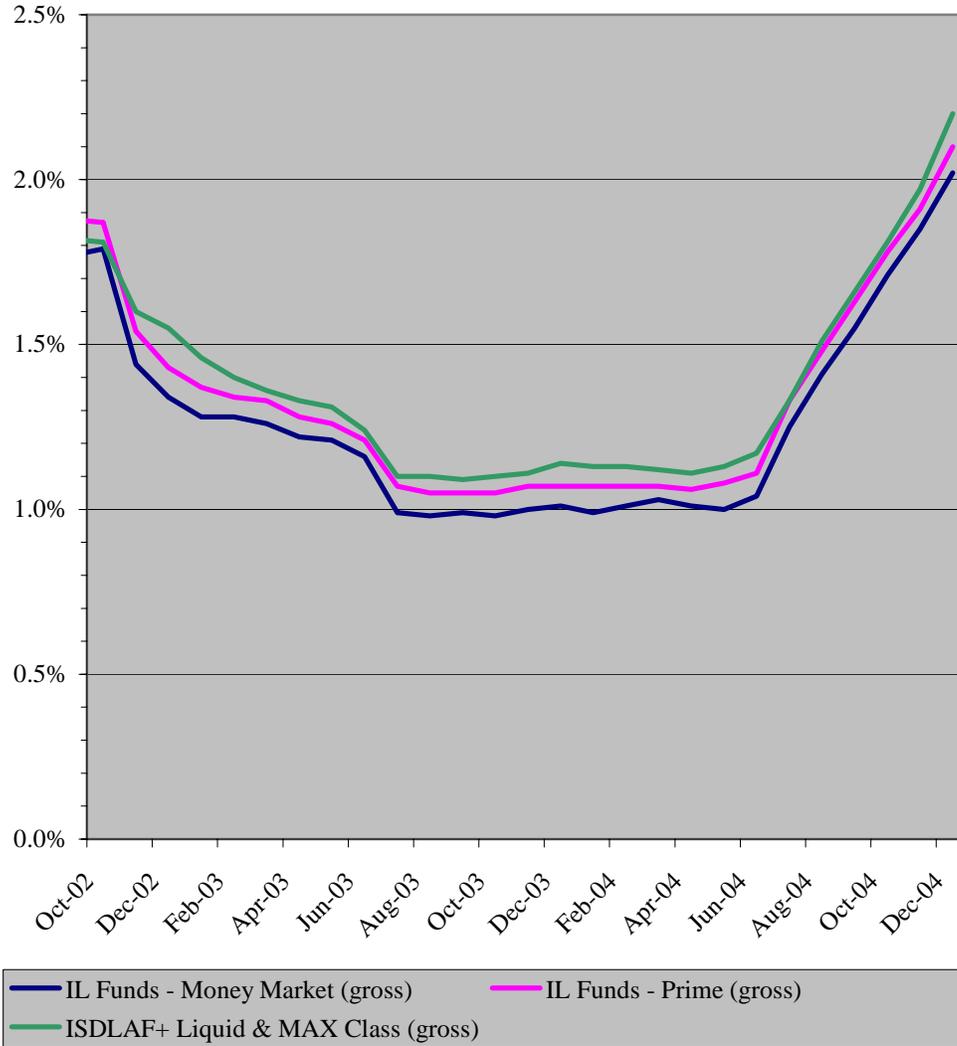
Illinois Treasurer's Illinois Funds

The ISDLAF+ performed slightly better than the Illinois Treasurer's Office Illinois Funds in the gross rate comparison; the Illinois Funds performed better in the net rate comparison.

In addition to the Fund's Investment Advisory Agreement, which calls for comparison of the ISDLAF+ to the Illinois Funds, a Fund official noted that the Board requests that the Fund be compared with the Illinois Treasurer's Office Illinois Funds. The ISDLAF+ uses the **gross** rate of return when comparing its Fund's performance to the performance of the Illinois Funds. The **gross** rate of return is the return on investments before expenses are deducted. The **net** rate of return is the return that investors realize on monies invested. The **net** return comparison takes into account expenses when calculating the average annualized monthly return.

When compared to the Illinois Treasurer's Office Illinois Funds, the ISDLAF+ performed slightly better than the Illinois Funds in the **gross** rate comparison (i.e. before expenses are deducted); however, the Illinois Funds performed better than the ISDLAF+ in the **net** rate comparison (after expenses). Digest Exhibit 4 shows a monthly average annualized **gross** return comparison between the ISDLAF+ and the Illinois Treasurer's Office Illinois Funds Money Market Fund and Prime Fund. Digest Exhibit 5 shows a comparison of the monthly average annualized **net** return for each class of the ISDLAF+ and Illinois Treasurer's Office Illinois Funds.

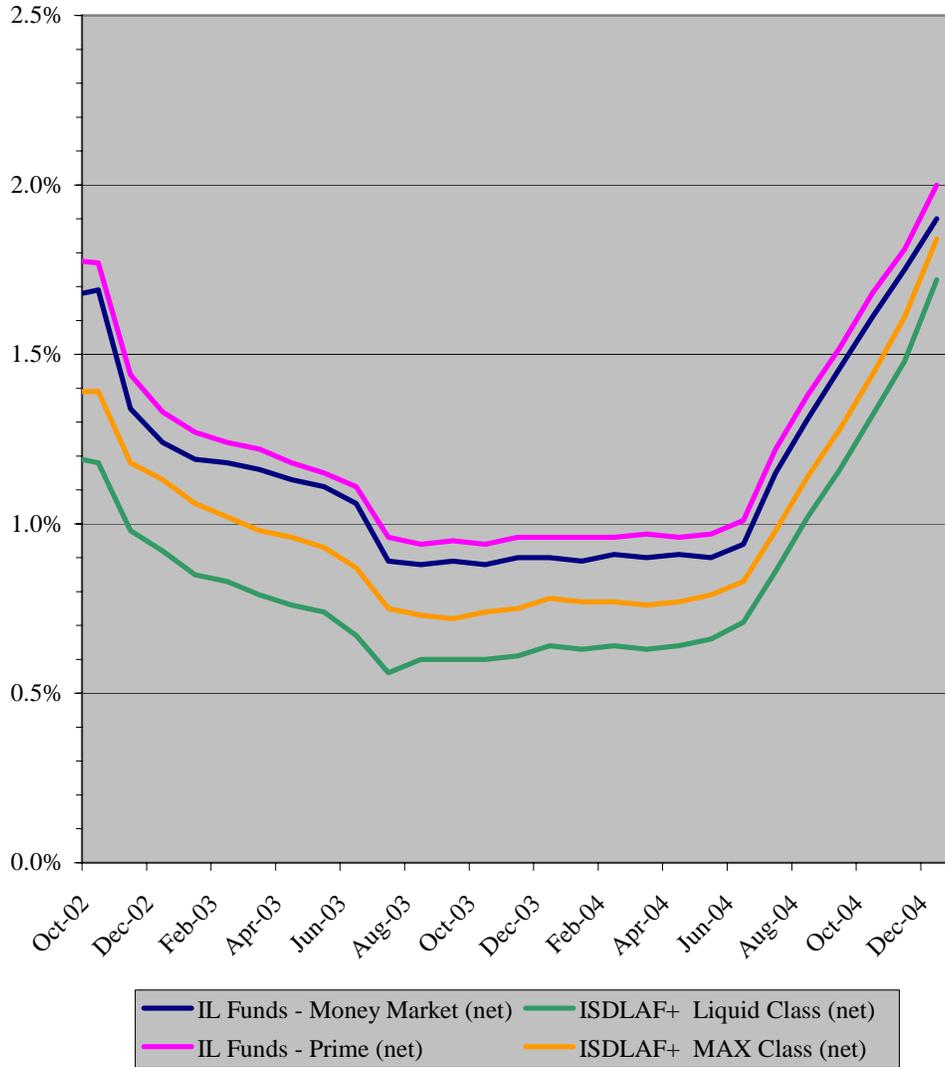
Digest Exhibit 4
COMPARISON OF ISDLAF+ AND ILLINOIS FUNDS
MONTHLY ANNUALIZED GROSS RETURN
 October 2002 through December 2004



Note: Gross returns for each ISDLAF+ class (Liquid and MAX) are not available because the Fund is a single series (with multiple classes).

Source: ISDLAF+ and the Illinois Treasurer's Office.

Digest Exhibit 5
COMPARISON OF ISDLAF+ AND ILLINOIS FUNDS
MONTHLY ANNUALIZED NET RETURN
 October 2002 through December 2004



Source: ISDLAF+ and the Illinois Treasurer's Office.

Performance Reporting to Participants

Reports related to Fund performance are prepared and provided to the Trustees at each quarterly meeting. These reports contain average yield and return comparisons as well as a performance evaluation of the Multi-Class Series of the Fund. Although the Fund's Administrator prepares comparisons and provides them to Trustees at quarterly meetings,

the ISDLAF+ annual report distributed to Fund participants does not contain a performance comparison.

We recommended that the Illinois School District Liquid Asset Fund Plus should include performance comparisons in the ISDLAF+ annual report distributed to Fund participants. (pages 25-37)

The ISDLAF+ annual report distributed to Fund participants does not contain a performance comparison.

MANAGEMENT CONTROLS

The ISDLAF+ has established a system of management controls for the monies invested by participants in the pooled funds of the Multi-Class Series. These include written investment policies, quarterly reporting to the Board of Trustees, weekly compliance reporting to the audit committee, and regular performance comparisons.

Digest Exhibit 6 SUMMARY OF RECOMMENDED MANAGEMENT CONTROLS FOR GOVERNMENT INVESTMENT POOLS	
Recommended Control	Adopted by ISDLAF+ in:
Full disclosure of pool objectives and policies	Declaration of Trust (as amended January 14, 1999) and Information Statement (October 1, 2002).
Adoption of formal and clear investment objectives	Declaration of Trust Article IV and the Information Statement.
Written and approved investment policies	Declaration of Trust and the Information Statement.
System of internal controls documented in an investment procedures manual that is reviewed and updated annually	Subadvisor (Federated) manual dated May 2004.
Investment Reports prepared at least quarterly	Reports are prepared for Trustees on a quarterly basis. Compliance reports prepared for the audit committee on a weekly basis.
Investment policies formally approved and adopted by the governing body and reviewed annually	Investment policies are contained in the Declaration of Trust and the Information Statement (see above). Although these policies as a matter of practice are not reviewed annually, the Trustees review authorized investments on a quarterly basis.
Series of benchmarks established against which portfolio performance should be compared on a regular basis	Information Statement contains a list of comparisons that may be used. The agreement with the Fund's Investment Advisor contains required comparisons.
Weighted Average Maturity (WAM) of less than 90 days	Information Statement investment policies require a WAM of 60 days or less.
Source: OAG analysis of recommended controls and ISDLAF+ policies.	

Digest Exhibit 6 summarizes the recommended management controls for government investment pools and the document or method by which the ISDLAF+ had implemented the control. When Standard and Poor's reviews pools for rating purposes, it closely considers the internal controls, including pricing policies, net asset value deviation procedures, depth of staff, stress testing capabilities, asset flow monitoring, trade ticket verification, systems backups and disaster recovery.

Banker's Acceptances

It is unclear whether the Public Funds Investment Act specifically authorizes investment in banker's acceptances. Banker's acceptances are short-term credit instruments most commonly used by persons or firms engaged in international trade. In general, banker's acceptances are time drafts drawn on and accepted by a bank.

It is unclear whether the Public Funds Investment Act specifically authorizes investment in banker's acceptances.

According to ISDLAF+ officials, a bank may hold the banker's acceptance in its portfolio or it may sell the banker's acceptance in the secondary market, usually at the rate of other money market instruments. Banker's acceptances that are sold in the secondary market are sold just like any other security, by order ticket. Banker's acceptances can be purchased in the secondary market from either the issuing bank or a dealer who has purchased the banker's acceptance from the bank.

In 1997 the Attorney General issued an Informal Opinion (I-97-022; August 25, 1997) that concluded that school districts are not authorized to invest their funds in banker's acceptances either directly or through investments in money market mutual funds. The general basis for the conclusion was that the Public Funds Investment Act does not specifically list banker's acceptances as an appropriate investment. The Informal Opinion lists at least six other unrelated acts related to investing public funds that specifically list banker's acceptances as an allowable investment.

The ISDLAF+ responded that the authority to invest in banker's acceptances is contained in Section 2(a)(3) of the Public Funds Investment Act (30 ILCS 235/2) in which it authorizes the investment of school district funds "*in interest-bearing savings accounts, interest-bearing certificates of deposit or interest-bearing time deposits or any other investments constituting direct obligations of any bank as defined in the Illinois Banking Act*" (emphasis added).

A review of the 2002 through 2004 annual reports shows that the ISDLAF+ Multi-Class Series portfolio had little or no outstanding investments in banker's acceptances for these years. The Fund held no outstanding banker's acceptances as of September 30, 2002 and 2003. For 2004, the Fund held approximately \$5.34 million in banker's acceptances

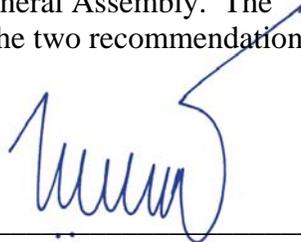
and \$1.4 million in bank notes or about one percent of the entire investment portfolio.

We reviewed the investment policies of other local government investment pools (LGIPs) and found that it is not uncommon for LGIPs to invest in banker's acceptances. Our review of school district liquid asset funds in other states also found that several of the funds' policies specifically allow for banker's acceptances as investments of the fund.

We included a Matter for Consideration that the General Assembly may wish to consider defining the term "direct obligations of any bank" in the Illinois Public Funds Investment Act. (pages 39-48)

RECOMMENDATIONS

The audit contains two recommendations to the ISDLAF+ and a Matter for Consideration by the Illinois General Assembly. The ISDLAF+ generally agreed to implement the two recommendations.



WILLIAM G. HOLLAND
Auditor General

WGH:MP
May 2005