

OPINION NO. 99-026**Syllabus:**

Pursuant to R.C. 135.14(C), a subdivision, as defined in R.C. 135.01(L), may not enter into a repurchase agreement involving a mortgage-backed pass-through security issued by a federal government agency or instrumentality.

To: Jim Petro, Auditor of State, Columbus, Ohio

By: Betty D. Montgomery, Attorney General, March 22, 1999

You have requested an opinion concerning the propriety of investing public moneys in mortgage-backed securities. Specifically, you wish to know whether R.C. 135.14 authorizes a subdivision to enter into a repurchase agreement involving a mortgage-backed pass-through security issued by a federal government agency or instrumentality.

Before addressing your specific question, it is useful to review the general investment authority of a subdivision under R.C. 135.14. R.C. 135.14 regulates the investment of a subdivision's interim moneys.¹ Pursuant to R.C. 135.14(B), a subdivision may invest or deposit its interim moneys in the following: (1) United States treasury bills, notes, bonds, or

¹ For purposes of R.C. 135.14, the terms "interim moneys" and "subdivision" are defined as follows:

"Interim moneys" means public moneys in the treasury of the state or any subdivision after the award of inactive deposits has been made in accordance with section 135.07 of the Revised Code, which moneys are in excess of the aggregate amount of the inactive deposits as estimated by the governing board prior to the period of designation and which the treasurer or governing board finds should not be deposited as active or inactive depos-

any other obligation or security issued by the United States treasury or any other obligation guaranteed as to principal and interest by the United States; (2) bonds, notes, debentures, or any other obligations or securities issued by any federal government agency or instrumentality; (3) interim deposits in the eligible institutions applying for such deposits; (4) bonds and other obligations of this state; (5) no-load money market mutual funds consisting exclusively of obligations described in R.C. 135.14(B)(1) and (2) and repurchase agreements secured by such obligations; and (6) the Ohio subdivision's fund.

In addition, R.C. 135.14(E) authorizes a subdivision to enter into repurchase agreements secured by certain enumerated securities. R.C. 135.14(E) reads, in part:

The treasurer or governing board may also enter into a written repurchase agreement with any eligible institution mentioned in section 135.03 of the Revised Code or any eligible dealer pursuant to division (M) of this section, under the terms of which agreement the treasurer or governing board purchases, and such institution or dealer agrees unconditionally to repurchase any of the securities listed in division (B)(1) or (2) of this section.

The securities that a subdivision may use to secure a repurchase agreement include "United States treasury bills, notes, bonds, or any other obligation or security issued by the United States treasury or any other obligation guaranteed as to principal and interest by the United States[,]" R.C. 135.14(B)(1), and "[b]onds, notes, debentures, or any other obligations or securities issued by any federal government agency or instrumentality, including but not limited to, the federal national mortgage association, federal home loan bank, federal farm credit bank, federal home loan mortgage corporation, government national mortgage association, and student loan marketing association[,]" R.C. 135.14(B)(2). Because R.C. 135.14(B)(2) authorizes a subdivision to invest in securities issued by any federal government agency or instrumentality, a subdivision is authorized, pursuant to R.C. 135.14(E), to

its for the reason that such moneys will not be needed for immediate use but will be needed before the end of the period of designation.

...

... "Subdivision" means any municipal corporation, except one which has adopted a charter under Article XVIII, Ohio Constitution, and the charter or ordinances of the chartered municipal corporation set forth special provisions respecting the deposit or investment of its public moneys, or any school district or educational service center, a county school financing district, township, municipal or school district sinking fund, special taxing or assessment district, or other district or local authority electing or appointing a treasurer, except a county. In the case of a school district or educational service center, special taxing or assessment district, or other local authority for which a treasurer, elected or appointed primarily as the treasurer of a subdivision, is authorized or required by law to act as ex officio treasurer, the subdivision for which such a treasurer has been primarily elected or appointed shall be considered to be the "subdivision." The term also includes a union or joint institution or enterprise of two or more subdivisions, that is not authorized to elect or appoint a treasurer, and for which no ex officio treasurer is provided by law.

R.C. 135.01(F), (L).

enter into a repurchase agreement that is secured by a security issued by a federal government agency or instrumentality.

The authority of a subdivision to invest in repurchase agreements secured by securities issued by a federal government agency or instrumentality is not unlimited, however. To the contrary, R.C. 135.14 sets forth limitations on such authority. Specifically, this section prohibits a subdivision from, *inter alia*, investing in obligations or securities issued by a federal government agency or instrumentality that are not direct issuances of a federal government agency or instrumentality, R.C. 135.14(B)(2), investments classified as derivatives, R.C. 135.14(C), investments that do not mature within five years from the date of settlement, unless the investment is matched to a specific obligation or debt of the subdivision, R.C. 135.14(D), repurchase agreements whereby the subdivision agrees to sell securities owned by the subdivision to a purchaser and to repurchase unconditionally such securities from the purchaser, R.C. 135.14(E), and investments that can not reasonably be expected to be held until maturity, R.C. 135.14(F). Accordingly, before a subdivision may enter into a repurchase agreement that is secured by a security issued by a federal government agency or instrumentality, it must be determined whether any of the limitations set forth in R.C. 135.14 prohibit the transaction.

With this background in mind, let us now turn to your specific question concerning the authority of a subdivision to enter into a repurchase agreement involving a mortgage-backed pass-through security issued by a federal government agency or instrumentality. As stated above, R.C. 135.14(E) authorizes a subdivision to enter into a repurchase agreement involving a security issued by a federal government agency or instrumentality. *See* R.C. 135.14(B)(2). However, the authority of a subdivision to enter into a repurchase agreement secured by a security issued by a federal government agency or instrumentality is limited by R.C. 135.14(C), which prohibits a treasurer or governing board of a subdivision from investing in a security issued by a federal government agency or instrumentality if the security constitutes a derivative. R.C. 135.14(C) thus states, in pertinent part: "Nothing in the classifications of eligible obligations set forth in divisions (B)(1) to (6) of [R.C. 135.14] shall be construed to authorize any investment in a derivative, and no treasurer or governing board shall invest in a derivative."

R.C. 135.14(C) unequivocally prohibits a subdivision from investing in derivative instruments. In addition, this division affirmatively provides that the authority conferred upon subdivisions by R.C. 135.14(B)(2) to invest in obligations or securities issued by federal government agencies and instrumentalities may not be construed as a grant of authority to invest in derivative obligations or securities issued by federal government agencies and instrumentalities. R.C. 135.14(C) thus evidences a legislative intent to prohibit a subdivision from investing in an obligation or security issued by a federal government agency or instrumentality if such obligation or security constitutes a derivative. *See generally State v. Elam*, 68 Ohio St. 3d 585, 587, 629 N.E.2d 442, 444 (1994) ("[t]he polestar of statutory interpretation is legislative intent, which a court best gleans from the words the General Assembly used and the purpose it sought to accomplish. Where the wording of a statute is clear and unambiguous this court's only task is to give effect to the words used").

Accordingly, although R.C. 135.14(B)(2) authorizes a subdivision to invest in an obligation or security issued by a federal government agency or instrumentality, a subdivision may not invest in such obligation or security if the obligation or security constitutes a derivative, as defined in R.C. 135.14(C). R.C. 135.14(C). *See generally State v. Park*, 13 Ohio App. 3d 85, 86, 468 N.E.2d 104, 107 (Franklin County 1983) (sections of a statute that relate to the same subject are to be construed together so as to give full force and effect to the

legislative intent). Therefore, based on the language of R.C. 135.14(C), it is our conclusion that a subdivision may not enter into a repurchase agreement secured by a mortgage-backed pass-through security issued by a federal government agency or instrumentality if such security constitutes a "derivative," as defined in R.C. 135.14(C).

For purposes of R.C. 135.14(C), the term "derivative" means "a financial instrument or contract or obligation whose value or return is based upon or linked to another asset or index, or both, separate from the financial instrument, contract, or obligation itself."² See generally Cohen, *Financial Services Regulation: A Mid-Decade Review: Colloquium: The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 2000 (1995) ("[d]erivatives are most commonly defined as 'financial arrangements whose returns are linked to, or derived from, changes in the value of stocks, bonds, commodities, currencies', interest rates, stock indexes or other assets" (footnote omitted)); Symposium, *Regulation of Financial Derivatives: A Methodology for Mutual Fund Derivative Investments*, 1 Stan. J. L. Bus. & Fin. 237, 239 (1995) ("[t]he term 'derivatives' covers a broad array of financial instruments. They are perhaps best defined as instruments whose value is based upon (or 'derives' from) the value of an underlying asset, index, or reference rate" (footnote omitted)). An examination of the nature and characteristics of mortgage-backed pass-through securities issued by federal government agencies and instrumentalities indicates that such securities are derivatives, as defined by R.C. 135.14(C), and, therefore, not permissible investments under R.C. 135.14.

A pass-through security is "[a] security that passes through payments from debtors to investors." Scott, *Wall Street Words* 255 (1988). As stated in Fabozzi, *The Handbook of Mortgaged-Backed Securities* 30 (4th ed. 1995):

Pass-through securities are created when mortgages are pooled together and undivided interests or participations in the pool are sold. Normally, the mortgages backing a pass-through security have the same loan type (fully-amortizing level payment, adjustable-rate, *etc.*) and are similar enough with respect to maturity and loan interest rate to permit cash flows to be projected as if the pool were a single mortgage. The originator (or another institution which purchases this right) continues to service the mortgages, collecting payments and "passing through" the principal and interest, less the servicing, guarantee, and other fees, to the security holders. The security holders receive pro-rata shares of the resultant cash flows. A portion of the outstanding principal is paid each month according to the amortization schedule established for the individual mortgages. In addition, and this is a critical feature of mortgage pass-through securities, the principal on individual mortgages in the pool can be prepaid without penalty in whole or

² As a general matter, various legal and financial commentators have stated that the term "derivative" includes "standardized exchange-traded options and futures; individually negotiated over-the-counter (OTC) options, swaps, and forwards; structured notes with embedded options; and a wide variety of debt instruments, such as collateralized mortgage obligations (CMOs), that have payoff characteristics reflecting embedded derivatives, or have option characteristics, or are created by 'stripping' particular components of other instruments such as principal or interest payments." Symposium, *Derivative Securities: Risk Management of Financial Derivative Products: Who's Responsible for What?*, 21 Iowa J. Corp. L. 177, 177 n.1 (1995); accord Cohen, *Financial Services Regulation: A Mid-Decade Review: Colloquium: The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 2000-01 (1995); Symposium, *Regulation of Financial Derivatives: A Methodology for Mutual Fund Derivative Investments*, 1 Stan. J. L. Bus. & Fin. 237, 239-40 (1995).

in part at any time before the stated maturity of the security. This characteristic has important implications for the cash flow and market performance of the security, as will be explored in detail later.

Mortgage originators (savings and loans, commercial banks, and mortgage bankers) actively pool mortgages and issue pass-throughs. In most cases, the originator obtains the guarantee of one of three federally sponsored agencies: the Government National Mortgage Association (GNMA), or "Ginnie Mae"; the Federal National Mortgage Association (FNMA), or "Fannie Mae"; and the Federal Home Loan Mortgage Corporation (FHLMC), or "Freddie Mac". A significant volume of mortgages is directly purchased, pooled, and securitized by the agencies as well. A smaller amount of mortgages is securitized directly by private issuers.

Accord Fabozzi, The Handbook of Fixed Income Securities 17 (4th ed. 1995); Downs & Fowler, *Derivative Securities: Governmental Entities as End Users, Bankrupts and Other Big Losers*, 65 UMKC L. Rev. 483, 488 (1997).

Because mortgages serve as the collateral for a mortgage-backed pass-through security, the value or return of such a security is based upon the mortgages underlying the security. Fabozzi, *The Handbook of Fixed Income Securities* 16 (4th ed. 1995); Fabozzi, *The Handbook of Mortgaged-Backed Securities* 30 (4th ed. 1995). Changes in the amount or time of payment of the mortgages that comprise the pool of mortgages underlying a pass-through security affect the value of or return on the security. Fabozzi, *The Handbook of Fixed Income Securities* 16 (4th ed. 1995); Fabozzi, *The Handbook of Mortgaged-Backed Securities* 30 (4th ed. 1995). For example, the prepayment of principal on the individual mortgages underlying a mortgage-backed pass-through security affects the security's cash flow.³ Fabozzi, *The Handbook of Mortgaged-Backed Securities* 30 (4th ed. 1995).

The value of or return on a mortgage-backed pass-through security thus is based upon assets, *i.e.*, mortgages, that are separate from the security. Accordingly, mortgage-backed pass-through securities are derivatives, as defined by R.C. 135.14(C). *See generally* Note, *Prudence or Paranoia: Considering Stricter Regulation of the International Over-the-Counter Derivatives Market*, 5 Duke J. Comp. & Int'l L. 499, 501-02 (1995) ("[t]he value of derivatives can be based on ... home mortgages").

This conclusion is buttressed by various authorities on financial transactions that have acknowledged that mortgage-backed securities, which include mortgage-backed pass-

³ As stated in Fabozzi, *The Handbook of Mortgaged-Backed Securities* 49 (4th ed. 1995), if a mortgage-backed pass-through security "is purchased at a premium, faster than expected prepayments will reduce the yield: prepayments shorten the amount of time principal remains outstanding to earn above-market coupon payments, thereby lowering the total cash flows."

through securities,⁴ are derivatives.⁵ In addition, the Securities and Exchange Commission (SEC) in the reporting of quantitative and qualitative disclosures about market risk relies on a definition of "derivative financial instruments" that includes mortgage-backed securities. In this regard, the instructions to 17 C.F.R. § 229.305(b) (1998) define the term "derivative financial instruments" as follows:

Derivative financial instruments has the same meaning as defined by generally accepted accounting principles (see, e.g., FASB, *Statement of Financial Accounting Standards No. 119, "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,"* ("FAS 119") paragraphs 5-7 (October 1994)), and includes futures, forwards, swaps, options, and other financial instruments with similar characteristics[.] (Emphasis added.)

The instructions to 17 C.F.R. § 229.305(b) (1998) further define "other financial instruments" to include mortgage-backed securities. Accordingly, the SEC has recognized the derivative characteristics of mortgage-backed securities, and has defined such securities as "derivative financial instruments" for purposes of 17 C.F.R. § 229.305(b) (1998). See Symposium, *Derivative Securities: Risk Management of Financial Derivative Products: Who's Responsible for What?*, 21 Iowa J. Corp. L. 177, 177 n.1 (1995).

As stated above, pursuant to R.C. 135.14(C), a subdivision may not invest in an obligation or security issued by a federal government agency or instrumentality if such obligation or security constitutes a derivative. Because a mortgage-backed pass-through security is a "derivative" for purposes of R.C. 135.14(C), a subdivision is prohibited from investing in such a security.

Therefore, it is my opinion, and you are hereby advised that, pursuant to R.C. 135.14(C), a subdivision, as defined in R.C. 135.01(L), may not enter into a repurchase agreement involving a mortgage-backed pass-through security issued by a federal government agency or instrumentality.

⁴ A mortgage-backed pass-through security is a type of mortgage-backed security. Fabozzi, *The Handbook of Fixed Income Securities* 16 (4th ed. 1995); Fabozzi, *The Handbook of Mortgaged-Backed Securities* 29-30 (4th ed. 1995); Downs & Fowler, *Derivative Securities: Governmental Entities as End Users, Bankrupts and Other Big Losers*, 65 UMKC L. Rev. 483, 488 (1997).

⁵ Downs & Fowler, *Derivative Securities: Governmental Entities as End Users, Bankrupts and Other Big Losers*, 65 UMKC L. Rev. 483, 488 (1997); Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 Seton Hall L. Rev. 1, 26 (1994); Motes, Comment, A Primer on the Trade and Regulation of Derivative Instruments, 49 SMU L. Rev. 579, 583 (1996); Note, *Financial Innovation and Derivatives Regulation - Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992*, 1994 Colum. Bus. L. Rev. 73, 75 (1994); see also Symposium, *Regulation of Financial Derivatives: A Methodology for Mutual Fund Derivative Investments*, 1 Stan. J. L. Bus. & Fin. 237, 239-40 (1995). But see generally Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 Tex. L. Rev. 985, 999 (1995) ("I do not believe that asset-backed securities should generally be considered collectively with core derivatives and structured notes in the usual regulatory or public policy analysis").