The Senate of Texas
Committee on State Affairs

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The Honorable Dan Morales
Texas Attorney General
P.O. Box 12548
Austin, Texas 78711-2548

RQ-605

Dear General Morales:

Recently, House Bill 1821 was passed by the 74th Legislature, Regular Session, amending the Public Funds Investment Act of 1987 (Investment Act). The Investment Act permits public funds investment pools, as defined by Section 2(c)(4) of HB 1821 to purchase, sell, and invest its funds under its control in United States Government Securities. Specifically, the Investment Act and HB 1821 permit public funds investment pools to purchase and sell these types of obligations through flexible low-risk strategies.

First, the Investment Act and HB 1821 allow public funds investment pools to purchase or sell U.S. Government securities. Such transaction is the outright purchase or sell of a U.S. Government security for settlement within one to five business days.

Second, the Investment Act and HB 1821 allow public funds investment pools to purchase or sell U.S. Government securities on a forward delivery basis. The terms "forward delivery" simply means the U.S. Government securities will be delivered at a future date beyond customary settlement time. Forward delivery transactions are frequently seen with repurchase agreements, reverse repurchase agreements, and the writing of covered contracts.

The Investment Act and HB 1821 permit public funds investment pools to purchase or sell a U.S. Government security on a forward delivery basis through repurchase (and reverse repurchase) agreements. A repurchase agreement is an understanding between a seller and a buyer, usually U.S. Government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and at a stated time in the future, usually within thirty days. A reverse repurchase agreement is an understanding between a government securities dealer and an investor, whereby the government securities dealer agrees to purchase a U.S. Government security and an investor agrees to repurchase such security at a later date.

P.O. Box 12068, Austin, Texas 78711 • 904 Sam Houston Building
(512) 463-0380 • FAX (512) 475-3743 • TDD (512) 475-3758

A substantially similar purchase or sell of a U.S. Government security on a forward delivery basis is through writing (selling) covered call contracts and writing covered put contracts. The writing of covered call contracts and covered put contracts is a conservative market strategy and enables an investor to reduce their risk associated with an increase in interest rates.

An investor who writes a covered call receives an income premium, a sum of money, and agrees to sell a U.S. Government security, already owned by the investor, at a future date and at an agreed price. The call writer is considered covered when the investor already owns the underlying U.S. Government security agreed to be sold under the covered call contract.

On the other hand, an investor who writes a covered put receives an income premium, a sum of money, agrees to buy a U.S. Government security at a future date and at an agreed price. The put writer is considered covered when the investor has a sufficient cash reserve equal to the total purchase price agreed to under the covered put contract.

IN EITHER CASE, THE INVESTOR IS CONSIDERED A COVERED WRITER

Covered call writing is considered conservative because the worst scenario that can happen is the investor has to sell the U.S. Government security which is authorized under the Investment Act and HB 1821. The best scenario that can happen is the investor profits from receiving the premium income and continues to have ownership of a U.S. Government security. Similarly, covered put writing is also a conservative strategy because the worst scenario that can occur is the investor has to purchase a U.S. Government security which is again authorized under the Investment Act and HB 1821. The best scenario that can occur is the investor profits from receiving the premium income.

The traditional notion was to buy a U.S. Government security and hold the investment to maturity, despite the periodic fluctuation of interest rates that may occur. However, history has repeatedly shown such investment concept does not effectively work. Today, investors use a flexible management strategy which enables them to adjust to changing economic times and conditions. An owner of U.S. Government security can achieve price protection by writing covered contracts. (See Appendix A,B, and C attached hereto for illustration purposes).

Would you please issue an opinion on the following question:

> When a public funds investment pool chooses to exercise its right to purchase or sell U.S. Government securities, may a public funds investment pool indirectly purchase or sell such securities through the writing of covered contracts?

If any further information or assistance is needed, please feel free to contact me or my staff.

Sincerely,

O.H. "Ike" Harris

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