



INVESTMENT POLICY

(CASH RESERVE FUND)

Investment Service for
Texas Local Governments

I. STATEMENT OF PURPOSE AND OBJECTIVE

ORGANIZATION

The Texas Short Term Asset Reserve Program ("*TexSTAR*") is a local government investment pool organized under the authority of the Interlocal Cooperation Act, Chapter 791, Texas Government Code, and the Public Funds Investment Act, Chapter 2256, Texas Government Code (the "*PFIA*"). *TEXSTAR* was created in April 2002 by contract among its participating governmental units and is governed by a board of directors (the "*Board*").

J.P. Morgan Investment Management Inc. ("*JPMIM*" or the "investment manager"), Hilltop Securities Inc. ("*HTS*"), and Hilltop Securities Asset Management, LLC ("*HSAM*") serve as administrators for *TEXSTAR* under an agreement with the *TEXSTAR* board of directors (the "*Board*"). *JPMIM* provides investment management, *HTS* provides marketing and distribution, and *HSAM* provides participant and administrative services. Custodial, fund accounting and depository services are provided by JPMorgan Chase Bank, N.A. and/or its subsidiary J.P. Morgan Investor Services Co. Transfer agency services are provided by DST Asset Manager Solutions, Inc. ("*DST*" or the "*Transfer Agent*"). Each of *JPMIM*, *HTS*, *HSAM*, *DST* and JPMorgan Chase Bank, N.A. may provide certain services, including those described herein, through the use of subcontractors and/or delegates.

OBJECTIVE

The purpose of *TEXSTAR* is to offer a safe, efficient and liquid investment alternative to local governments in the State of Texas so that they may benefit from and realize a higher investment return by utilizing economies of scale and professional investment expertise. It is the policy of *TEXSTAR* to invest pooled assets in a manner which will provide for preservation and safety of principal and competitive investment returns while meeting the daily liquidity needs of the participants. Specifically, the primary investment objectives of *TEXSTAR* in order of priority are:

- preservation of capital and protection of principal,
- maintenance of sufficient liquidity, and
- yield.

This Investment Policy establishes investment strategies, policies, and procedures intended to assure that these objectives are met.

FUNDS

The Board may establish separate Funds with separate investment portfolios within *TEXSTAR* from time to time. Initially, *TEXSTAR* will maintain a Cash Reserve Fund (also referred to as the "*Fund*"). Unless otherwise stated, this Investment Policy applies to the Cash Reserve Fund.

II. STANDARD OF CARE

The TexSTAR Cash Reserve Fund shall be designed and managed in accordance with the following prudent person standard of care:

Investments shall be made with the judgment and care, under prevailing circumstances, that a person of prudence, discretion and intelligence would exercise in the management of the person's own affairs, not for speculation, but for investment, considering the probable safety of capital as well as the probable income to be derived.

This prudent person standard shall apply to the management of all TexSTAR Funds.

III. AUTHORIZED INVESTMENTS

The TexSTAR Cash Reserve Fund shall be invested only in the following:

GOVERNMENT SECURITIES

The Fund may be invested in obligations, including letters of credit, of the United States or its agencies and instrumentalities, including the Federal Home Loan Banks, and obligations, the principal and interest of which are unconditionally guaranteed or insured by, or backed by the full faith and credit of, the United States or its agencies or instrumentalities, including obligations that are fully guaranteed or insured by the Federal Deposit Insurance Corporation or by the explicit full faith and credit of the United States, *except* the following:

1. Obligations whose payment represents the coupon payments on the outstanding principal balance of the underlying mortgage-backed security collateral and pays no principal;
2. Obligations whose payment represents the principal stream of cash flow from the underlying mortgage-backed security collateral and bears no interest;
3. Collateralized mortgage obligations that have a stated final maturity date of greater than 10 years; and
4. Collateralized mortgage obligations the interest rate of which is determined by an index that adjusts opposite to the changes in a market index.

REPURCHASE AGREEMENTS AND REVERSE REPURCHASE AGREEMENTS

The Fund may be invested in fully collateralized repurchase agreements having a defined termination date and secured by the delivery of cash or obligations, including letters of credit, of the United States or its agencies or instrumentalities, including the Federal Home Loan Banks. TEXSTAR may also borrow against its investments through a reverse repurchase agreement meeting the foregoing standards and the other conditions described herein. The repurchase and reverse repurchase agreement transactions shall be placed only with primary government securities dealers, as recognized by the Federal Reserve or financial institutions doing business in the State of Texas. All such transactions must be

governed by a master repurchase agreement in form approved by The Securities Industry and Financial Market Association ("SIFMA").

MONEY MARKET MUTUAL FUNDS

The Fund may be invested in no-load money market mutual funds which meet the requirements of the PFIA and which (1) are registered with and regulated by the United States Securities and Exchange Commission (SEC), (2) provide a prospectus and other information required by the Securities Exchange Act of 1934 or the Investment Company Act of 1940, (3) comply with SEC Rule 2a-7, (4) include in their investment objectives the maintenance of a stable net asset value of \$1 per share, and (5) invest only in obligations of the United States, its agencies and/or instrumentalities or repurchase agreements collateralized by obligations of the United States, its agencies and/or instrumentalities.

IV. PROHIBITED INVESTMENTS

The TexSTAR Cash Reserve Fund *may not* be invested in commercial paper.

The TexSTAR Cash Reserve Fund *may not* be invested in derivatives.

For the purposes of this Investment Policy, the definition of derivatives includes instruments which have embedded features that alter their character or income stream or allow holders to hedge or speculate on a market or spreads between markets that are external to the issuer, or are not correlated on a one-to-one basis to the associated index or market.

Prohibited derivatives *include* the following:

1. Arrangements in which an investor has swapped the natural cash flows or some portion of the natural cash flows of an instrument for a different set of cash flows (i.e., interest rate swaps).
2. Over-the-counter/exchange-traded options or futures (i.e., option contracts, futures contracts, etc.).
3. The following instruments: collateralized mortgage obligations, inverse floating rate notes, range index notes, non-money market index-based notes, dual index notes, index amortizing notes, inverse multi-index bonds, stepped inverse index bonds, and inverse index bonds.

Instruments that are *not* considered derivatives by the preceding definition and are authorized investments, if described in Part III, are as follows:

Treasury bills, Treasury notes, Treasury bonds, Treasury strips, repurchase agreements, agency notes with a defined maturity and fixed coupon rate, money market index variable rate notes (i.e., floating rate notes tied to money market indices such as three- or six-month Treasury bills, one-, three-, and six-month London Interbank Offering Rate ("LIBOR"), federal funds, the one-year constant maturity

Treasury rate, or a prime rate or a commercial paper composite rate) and step-up notes.

In addition to commercial paper and derivatives, the TEXSTAR Cash Reserve Fund may not invest in certificates of deposit or any other investments that are not authorized by Part III.

V. POLICY GUIDELINES AND STRATEGY

PORTFOLIO STRUCTURE AND COMPOSITION

The TexSTAR Cash Reserve Fund portfolio shall be designed and managed to ensure that it will meet all the requirements necessary to maintain a AAAm rating (or the equivalent) by a nationally recognized rating service. The weighted average maturity of the TexSTAR Cash Reserve Fund portfolio shall be limited to: (1) a maximum of sixty (60) days when calculated utilizing the period remaining until the date on which, in accordance with the terms of each security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made, and may utilize the interest rate reset date for variable rate notes (VRN) or floating rate securities; and (2) a maximum of one hundred twenty (120) days as calculated taking into account the period remaining until the date on which, in accordance with the terms of each security, the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made. Specific portfolio composition and maturity limitation guidelines shall be guided by the following general parameters.

Portfolio Composition:

The composition of the Fund shall be limited as follows. Limitations shall be applied by comparing the amortized cost of the Fund's investments at the time of purchase. Investments need not be sold to maintain continuing compliance with composition limits, unless required by TEXSTAR's general investment objectives.

US Government Securities, Agencies and Instrumentalities

The Fund portfolio may be comprised of one hundred percent (100%) obligations of, unconditionally guaranteed or insured by, or backed by the full faith and credit of the United States or its agencies or instrumentalities, including the Federal Home Loan Banks.

Repurchase Agreements

One hundred percent (100%) of the Fund may be invested in repurchase agreements.

Term Repurchase Agreements

Not more than twenty-five percent (25%) in aggregate of the total market value of the Fund may be invested in term repurchase agreements.

Reverse Repurchase Agreements

TEXSTAR is permitted to enter into reverse repurchase agreements for investments in the Fund totaling not more than one third (1/3) of the book value of the Fund's total assets. Reverse repurchase agreements will be used primarily to enhance Fund return.

Money Market Mutual Funds

A maximum of ten percent (10%) of the Fund may be invested in any one money market mutual fund, and the Fund's investment in any one money market mutual fund may not exceed ten percent (10%) of the total assets of that money market mutual fund.

Variable Rate Notes

A maximum of 60 percent (60%) of the Fund may be invested in eligible variable rate notes.

Maturity Limitations:

Government Securities, Agencies and Instrumentalities

The maximum final stated maturity for any securities that are obligations of or guaranteed or insured by the United States government, its agencies or instrumentalities shall be limited to 397 days for fixed rate securities and 25 months for variable rate notes.

Repurchase Agreements

The maturity of repurchase agreements shall not exceed ninety-five (95) days unless the repurchase agreements have a put option that allows the fund to liquidate the position at par (principal plus accrued interest) with no more than 7 days notice to the counterparty.

Reverse Repurchase Agreements

Money received under the terms of a reverse security repurchase agreement shall be used to acquire additional authorized investments. The authorized investments acquired must mature not later than the expiration date stated in the reverse repurchase agreement. The term of a reverse repurchase agreement may not exceed ninety (90) days.

PURCHASES

The broker-dealers used for TEXSTAR shall be those approved by the Board. Settlement of all transactions, except investment pool funds and mutual funds, shall be conducted on a delivery versus payment (DVP) basis.

COLLATERALIZATION AND SAFEKEEPING

All repurchase agreements shall be fully collateralized as required by the PFIA. The market value of collateral shall be equal to at least one hundred and two percent (102%) of the total amount payable to TEXSTAR under the repurchase agreement, including accrued interest, and shall be checked daily.

All book entry securities, whether purchased outright or under repurchase agreements, shall be held in a custodial account at the Federal Reserve Bank. The Custodian or sub-custodian shall keep accurate records reflecting TEXSTAR's ownership of the securities.

All securities not held in book entry form shall be held by the Custodian or its agent. Third party institutions must issue original safekeeping receipts to the Custodian.

INVESTMENT OFFICERS

The Board shall designate one principal Investment Officer and may designate one or more additional Investment Officers to serve solely when the principal Investment Officer is not available. To the fullest extent allowable by law, the Investment Officers are authorized to delegate to the investment manager the authority to deposit, withdraw, invest, reinvest, transfer and otherwise manage the assets of the Fund.

The Investment Officer shall attend at least one training session from an independent source approved by the Board or a designated investment committee containing at least 10 hours of instruction relating to the officer's responsibilities under the Public Funds Investment Act within 12 months after taking office or assuming duties; and attend an investment training session not less than once in a two-year period that begins on the first day of TexSTAR's fiscal year and consists of the two consecutive fiscal years after that date, and receive not less than 8 hours of instruction relating to the officer's responsibilities under the Public Funds Investment Act from an independent source approved by the Board or a designated investment committee.

If the Investment Officer has a personal business relationship with a business organization offering to engage in an investment transaction with the Fund, they shall file a statement disclosing that personal business interest. If the Investment Officer is related within the second degree by affinity or consanguinity, as determined under State law, to an individual seeking to sell an investment to the Fund, the Investment Officer shall file a statement disclosing that relationship. A statement required under this section must be filed with the Texas Ethics Commission and the Board. For purposes of this section, an Investment Officer has a personal business relationship with a business organization if: (1) the Investment Officer owns 10 percent or more of the voting stock or shares of the business organization or owns \$5,000 or more of the fair market value of the business organization; (2) funds received by the Investment Officer from the business organization exceed 10 percent of the Investment Officer's gross income for the previous year, or (3) the Investment Officer has acquired from the business organization during the previous year investments with a book value of \$2,500 or more for the personal account of the Investment Officer.

At least quarterly, the Investment Officer shall cause to be prepared by the investment adviser and shall review and sign a written report concerning the investment transactions of the Fund for the preceding quarter, describing in detail the investment position of the Fund as of the date of the report. Each report shall be presented to the Board at the next meeting following preparation of a report.

AUTHORIZED PERSONNEL

The investment manager must deliver to TEXSTAR a written acknowledgment that the investment manager has received and reviewed the TexSTAR Cash Reserve Fund Investment Policy and has implemented reasonable procedures and controls in an effort to preclude investment transactions that are not authorized by the Investment Policy, except to the extent that this authorization requires interpretation of subjective investment standards. All investment manager personnel authorized to buy and sell investment instruments, send and receive securities, make fund transfers and other types of related investment transactions shall be directly supervised by senior management personnel of the investment manager.

DOCUMENTATION

Reasonable documentation and a thorough audit trail shall be maintained for all investment transactions consistent with the Board approved records management program.

DIVERSIFICATION AND SUITABILITY

The TEXSTAR Cash Reserve Fund portfolio shall be designed with the protection of principal and maintenance of sufficient liquidity to all participants as the highest priority. After consideration of safety and liquidity, the portfolio shall be designed to achieve a competitive rate of return for participants. The Fund will use iMoneyNet Institutional Government Money Fund as a benchmark of performance. The risk-return relationship shall be maintained and controlled through this Investment Policy and the TEXSTAR Operating Procedures. Adequate collateralization and delivery versus payment procedures shall be utilized at all times in an attempt to minimize risk.

Diversification by market sector and security types, as well as maturity, may be used in an attempt to protect the TEXSTAR Cash Reserve Fund against market and credit risk as well as aiding in liquidity requirements.

TEMPORARY CASH HOLDINGS

To respond to unusual market conditions in a prudent manner, TexSTAR may be required to hold all or most of its total assets in cash, including for the purpose of assuring sufficient liquidity or due to the lack of eligible securities, among other circumstances. This may result in a lower yield and prevent the Fund portfolio from meeting all its investment objectives.

DETERMINATION OF NET INCOME AND NET ASSET VALUES

The net interest income of the Portfolio shall be determined each business day, and consists of (i) the sum of (a) interest accrued, (b) discount earned (including both original issue and market discount), and (c) realized capital gains (amortized over a period not to exceed 30 days) less (ii) the sum of (a) amortization of premium, (b) the estimated expenses of the Portfolio applicable to that distribution period, and (c) realized capital losses (amortized over a period not to exceed 30 days). All net income of the Portfolio so determined is declared as earnings to Participants each day. Earnings accrue throughout the month and are distributed as of the close of business on the last business day of the month. On the first business day of the following month, the earnings are reinvested as additional Units at the current Net Asset Value (expected to be \$1.00), unless the Participant has elected to have them paid out. If the entire balance in an account is withdrawn during the month, the accrued distributions will be paid on or before the first business day of the following month.

The Net Asset Value per Unit of the Portfolio is calculated each business day by adding the amortized book value of the Portfolio securities and other assets, deducting accrued expenses and arrearages, and dividing by the number of Units outstanding. The result of this computation will be rounded to the nearest whole cent.

CONSTANT DOLLAR OBJECTIVE

The objective of the TexSTAR Cash Reserve Fund is to maintain a stable value of \$1.00 per unit (rounded to the nearest whole cent). Although all securities in the Fund shall be marked to market daily using the fair value method, amortized cost, which generally

approximates the market value of securities, is utilized. The Board, in its discretion, may elect to cease utilizing amortized accounting and to commence utilizing the fair value method at any time. To the extent that the Board elects to utilize a net asset value per share determined by using available market quotations in lieu of amortized accounting, the Fund will reflect market fluctuations and any unrealized gains and losses resulting from those fluctuations on a daily basis.

If, upon a daily calculation, the investment manager finds that the deviation between the amortized cost and market-determined values or the deviation between market-determined values and \$1.00 per unit of the Portfolio's assets exceeds \$0.0030, it shall promptly notify the Board. In the event that the deviation of market-determined values from amortized cost or \$1.00 per unit exceeds \$0.0040, the Board shall direct the investment manager to take such action, if any, as it determines is necessary to eliminate or reduce to the extent reasonably practicable any dilution or unfair result to existing participants. Notwithstanding the foregoing, absent contrary instructions from the Board, the investment manager shall cause the subject investments to be sold promptly to attempt to bring the deviation back within the desired value band. However, the \$1.00 per unit value is not guaranteed or insured by TEXSTAR or the administrators. There can be no assurance that the Fund will maintain a stable net asset value of \$1.00.

MONITORING MARKET PRICE AND RATINGS

Through the administrators, TEXSTAR shall account for all Fund transactions and shall mark to market the Fund portfolio holdings of TEXSTAR on a daily basis through the use of independent or affiliated commercial pricing services or third party broker-dealers. The market prices shall be checked daily for current data and validity of information. In addition, a reasonability test shall be performed in order to determine if the prices received are within a set tolerance range. In the event that any of the prices fall outside of the set tolerance range, then these prices shall be investigated. The investment manager will periodically monitor the credit ratings of the investments in which the Fund invests and, to the extent required under the PFIA, shall take all prudent measures to liquidate any investments of the Fund that fail to meet any minimum rating requirement for such investments set forth in the PFIA.

VI. ADMINISTRATIVE CONSIDERATIONS

PARTICIPATION AGREEMENTS

Each participant must have a fully executed application on file with TEXSTAR before investing in TEXSTAR.

DEPOSIT AND WITHDRAWAL DEADLINES

See separate TEXSTAR Operating Procedures for detailed deposit and withdrawal deadlines.

REPORTING AND DISCLOSURE

Each participant must obtain and should review the TEXSTAR Cash Reserve Fund Information Statement before investing. TEXSTAR will furnish investment confirmations and a monthly report disclosing certain information to participants in accordance with the Texas Public Funds Investment Act. Additional information is available on the TEXSTAR web site, www.texstar.org, or by calling TEXSTAR Participant Services at 1-800-TEXSTAR (1-800-839-7827).

TEXSTAR is audited annually by an independent auditor.

AUTHORIZED DEALERS

The investment manager shall maintain a list of primary dealers and brokers authorized to provide investment services to TEXSTAR.

ETHICS AND CONFLICTS OF INTEREST

Each administrator is required to maintain a code of ethics which requires its employees working with TexSTAR to place the interests of TexSTAR before their personal interests and to avoid any actual or potential conflicts of interest. Each administrator must promptly report any material non-compliance with such requirements to the Board.

JPMIM acts as a fiduciary when providing investment management services to TexSTAR. JPMIM may order the purchase of investments from either itself, HTS or their affiliates only on terms and conditions approved by a majority of the Participant members of the Board.

JPMIM has provided the following disclosures concerning its practices:

JPMIM and/or its affiliates (“JPMorgan Chase”) perform investment services, including rendering investment advice, to varied clients. JPMIM, JPMorgan Chase and its or their directors, officers, agents, and/or employees may render similar or differing investment advisory services to clients and may give advice or exercise investment responsibility and take such other action with respect to any of their other clients that differs from the advice given or the timing or nature of action taken with respect to another client or group of clients. It is JPMIM's policy, to the extent practicable, to allocate, within its reasonable discretion, investment opportunities among clients over a period of time on a fair and equitable basis. One or more of JPMIM's other client accounts may at any time hold, acquire, increase, decrease, dispose, or otherwise deal with positions in investments in which another client account may have an interest from time-to-time.

JPMIM, JPMorgan Chase, and any of its or their directors, partners, officers, agents or employees, may also buy, sell, or trade securities for their own accounts or the proprietary accounts of JPMIM and/or JPMorgan Chase. JPMIM and/or JPMorgan Chase, within their discretion, may make different investment decisions and other actions with respect to their own proprietary accounts than those made for client accounts, including the timing or nature of such investment decisions or actions. Further, JPMIM is not required to purchase or sell for any client account securities that it, JPMorgan Chase, and any of its or their employees, principals, or agents may purchase or sell for their own accounts or the proprietary accounts of JPMIM, or JPMorgan Chase or its clients.

JPMIM and its related persons may recommend securities to clients that JPMIM and its related persons may also purchase or sell. As a result, positions taken by JPMIM and its

related persons may be the same as or different from, or made contemporaneously or at different times than, positions taken for clients of JPMIM. As these situations may involve potential conflicts of interest, JPMIM has adopted policies and procedures relating to personal securities transactions, insider trading and other ethical considerations. These policies and procedures are intended to identify and mitigate actual and perceived conflicts of interest with clients and to resolve such conflicts appropriately if they do occur. The policies and procedures contain provisions regarding preclearance of employee trading, reporting requirements and supervisory procedures that are designed to address potential conflicts of interest with respect to the activities and relationships of related persons that might interfere or appear to interfere with making decisions in the best interest of clients, including the prevention of front-running. In addition, JPMIM has implemented monitoring systems designed to ensure compliance with these policies and procedures.

HTS and HSAM have provided the following disclosures concerning their practices:

Certain employees of HTS and HSAM may also serve as officials of TexSTAR. Employees of HTS and HSAM who are also officials of TexSTAR must still abide by the code of ethics required of each Administrator.

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