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OCC Tightens Regulatory Requirements for STIFs

Overview

The U.S. Office of the Comptroller of the Currency ("OCC") adopted a final rule on October 9, 2012 that revises the requirements imposed on national banks' short-term investment funds ("STIFs").[1] In particular, the final rule enhances current requirements imposed on STIFs under Regulation 9 ("STIF Rule").[2] Although STIFs are similar to money market funds ("money funds") registered under the Investment Company Act of 1940, as amended ("1940 Act"), and the two products faced similar issues during the 2008 financial crisis, up until this point, STIFs have escaped additional regulations like those imposed on money funds as part of the 2010 amendments to Rule 2a-7 under the 1940 Act (the "2010 Amendments").[3] This OnPoint discusses the amended STIF Rule and highlights similarities and differences between the amended Rule and Rule 2a-7.

BACKGROUND ON STIFS AND THE AMENDED STIF RULE

A STIF is a type of collective investment fund ("CIF"), which, like an investment company, pools together investments for participants who then own participating interests in the pool (analogous to investment company shares) rather than the assets of the fund directly. However, CIFs (including STIFs) are excluded from regulation under the 1940 Act.[4]

As of June 30, 2012, STIFs held approximately $118 billion in investments according to the Adopting Release. STIFs are operated by bank trust departments that pool investments to purchase short-term securities and are offered to accounts for personal trusts, estates or employee benefit plans that are exempt from taxation under the Internal Revenue Code. A STIF is established pursuant to a plan that details the terms under which the bank manages and administers the STIF's assets (the "STIF Plan"). Under OCC regulations, STIFs, like money funds, are permitted to use amortized cost accounting to value their assets while other CIFs, like non-money fund investment companies, must use mark-to-market accounting to value participating interests. In order for a STIF to use amortized cost accounting, current regulations mandate that the STIF Plan require the bank managing the STIF to: (i) maintain a dollar-weighted average portfolio maturity of 90 days or less; (ii) accrue on a straight-line or amortized basis the difference between the cost and anticipated principal receipt on maturity; and (iii) hold the fund's assets until maturity under usual circumstances.[5] The amended STIF Rule tightens these restrictions and imposes new restrictions on STIFs.

As short-term investment products that use amortized cost accounting to seek to maintain a stable price per participating interest, STIFs are similar to money funds. In fact, the two products faced similar issues during the 2008 financial crisis as a result of the "flight to quality."[6] As a result, in October 2010, the Report of the President's Working Group on Financial Markets specifically recommended that bank regulators consider strengthening STIF regulations.[7]

The OCC proposed the STIF Rule on April 16, 2012 and, after receiving only nine comment letters, adopted the changes to the STIF Rule substantially in the form initially proposed.[8] In the Adopting Release, the OCC noted that the amended STIF Rule is "informed by Rule 2a-7" but differs from Rule 2a-7 due to differences between money funds and STIFs, in particular because money funds "are a retail investment offering, while

STIFs are offered only to authorized fiduciary accounts." The amendments to the STIF Rule become effective on July 1, 2013, which is over three years after the effective date of the 2010 Amendments.

OVERVIEW OF CHANGES TO THE STIF RULE

Dollar-Weighted Average Portfolio Maturity

The amended STIF Rule requires that banks sponsoring STIFs apply the same dollar-weighted average portfolio maturity ("WAM") requirements that are required by Rule 2a-7 for money funds, limiting a STIF's WAM to 60 days or less (previously 90 days or less). The Adopting Release explains that the WAM limitation aims to provide greater assurance that the STIF will continue to maintain a stable net asset value ("NAV") per participating interest by decreasing a STIF's exposure to the risks related to longer term investments, including higher levels of price volatility, interest rate risk, liquidity risks and wider credit spreads. With respect to the calculation methodology for determining a STIF's WAM, the amended STIF Rule generally applies the same methodology as provided in Rule 2a-7, including the eight maturity-shortening provisions found in paragraph (d) of Rule 2a-7 relating to floating rate securities, variable rate securities, repurchase agreements and certain other securities.

Dollar-Weighted Average Portfolio Life Maturity

The amended STIF Rule restricts the dollar-weighted average life maturity ("WAL") of a STIF's portfolio to 120 days or less. This new requirement is intended to limit the extent to which a STIF can invest in longer-term securities that may expose the STIF to increased liquidity and credit risk. The WAL requirements under the amended STIF Rule mirror those added to Rule 2a-7 as part of the 2010 Amendments, including the calculation methodology.[9]

Quality and Concentration

The amended STIF Rule requires a STIF Plan to include a provision for the adoption of portfolio issuer qualitative standards and concentration limits. In the Adopting Release, the OCC stated that bank fiduciaries are expected to "identify, monitor and manage issuer concentrations and lower quality investment concentrations, and to implement procedures to perform appropriate due diligence on all concentration exposures."

This requirement differs from Rule 2a-7, which specifies stringent quality, diversification and concentration limits in addition to requiring generally that a money fund limit portfolio investments to securities that present minimal credit risk. Unlike the STIF Rule, Rule 2a-7 requires that money fund portfolio holdings qualify as "eligible securities," which are defined as short-term securities that are rated in one of the top two short-term debt ratings by nationally recognized statistical rating organizations or, if unrated, are of comparable quality.[10] Rule 2a-7 also restricts a money funds' ability to hold second tier securities to no more than 3% of the fund's total assets in the aggregate with no more than 0.5% of the fund's total assets in second tier securities of any issuer. Finally, a money fund is subject to the diversification requirements of Rule 2a-7, which limit the amount of the fund's assets that may be invested in the securities of a single issuer. Moreover, to the extent that a money fund does not have a policy to concentrate in an industry or group of industries, the fund is limited in its ability to concentrate its investments by Sections 8 and 13 of the 1940 Act.

Liquidity Standards

The amended STIF Rule requires the adoption of liquidity standards that include provisions to address contingency funding needs. The Adopting Release explains that these liquidity standards should delineate policies to manage a range of stress environments and that these polices should establish clear lines of responsibility and articulate implementation and escalation procedures. In addition, the Adopting Release states that the liquidity funding needs standards should be regularly tested.

Rule 2a-7's liquidity requirements are significantly more detailed than those in the amended STIF Rule. Rule 2a-7 contains a general liquidity requirement that requires money funds to hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions and any commitments made to fund shareholders. Rule 2a-7 also contains specific limitations on the acquisition of illiquid securities by money funds (no more than 5% of total assets) and imposes minimum daily and weekly liquidity requirements.[11]

Additionally, Rule 2a-7 mandates that money funds dispose of a portfolio security as soon as practicable in the event of a default or other specified events. The OCC expressly rejected a commenter's suggestion that the OCC adopt the Rule 2a-7 liquidity standards for STIFs, stating in the Adopting Release that the rules differ "in light of… a bank's fiduciary responsibility to a STIF and requirements limiting STIF participation to eligible accounts."

Disclosures to STIF Participants and the OCC

The amended STIF Rule requires that STIFs disclose portfolio holdings to participants and the OCC within five business days after each calendar month-end. The required disclosures must include: total assets under management, mark-to-market and amortized cost NAVs (both with and without capital support agreements) and the WAM and WAL as of the last business day of the calendar month. For each security held by the STIF, the bank is required to disclose to STIF participants and to the OCC for each portfolio security: (i) the name of the issuer; (ii) the category of investment; (iii) the CUSIP number or other standard identifier; (iv) the principal amount; (v) the maturity date for purposes of calculating WAM; (vi) the final legal maturity date (taking into account any maturity date extensions that may be effected at the option of the issuer) if different from the maturity date for purposes of calculating WAM; (vii) the coupon or yield; and (viii) the amortized cost value.

Rule 2a-7 subjects money funds to similar disclosure requirements. Rule 2a-7 requires that money funds disclose portfolio holdings on their websites on a monthly basis no later than five business days after a month's end. Money funds are also required to report their market-based NAVs and other portfolio holdings information to the SEC within five-business days after a month's end, although such reports do not become public until 60 days after submission to the SEC. The OCC stated in the Adopting Release that it rejected a comparable 60-day lag period for STIFs in favor of the five business day standard because STIF participants "are less likely than retail investors to become confused and alarmed by fund and security level disclosures five days after each month-end."

Notification after Certain Events

In order to permit the OCC to more effectively supervise STIFs that are experiencing liquidity or valuation stress, banks managing STIFs must notify the OCC prior to or within one business day after the occurrence any of the following events: (i) any difference exceeding $0.0025 between the NAV and the mark-to-market value of a STIF participating interest based on current market factors; (ii) any repricing of NAV by a STIF below $0.995 per participating interest; (iii) any distribution-in-kind to withdrawing holders of participating interests or segregation of portfolio participants; (iv) any delays or suspensions in honoring participating interest withdrawal requests; (v) any decision to formally approve the liquidation, segregation of assets or portfolios, or some other liquidation of the STIF; and (vi) the provision of financial support to a STIF by a national bank, its affiliate, or any other entity (which might be in the form of a cash infusion, credit extension, purchase of a defaulted or illiquid asset, or any other form of financial support) in order to allow the STIF to continue to maintain a stable NAV per participating interest. Banks may have to calculate the mark-to-market value of a STIF participating interest on a daily basis to comply with the notification requirement that is triggered by the difference between the NAV and the mark-to-market value of a STIF participating interest.

Rule 2a-7 also requires that money funds promptly notify the SEC when certain events occur. However, the particular events that require notice to be given differ somewhat from those listed in the amended STIF Rule. Rule 2a-7 requires notice where there has been a default with respect to one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or an event of insolvency with respect to an issuer of portfolio securities (or any put to which portfolio securities are subject) where immediately before default the securities accounted for 0.5% or more of the money fund's total assets. In addition, a money fund must notify the SEC whenever certain persons purchase a portfolio security from the money fund in reliance on Rule 17a-9.[12] A money fund is also required to notify the SEC when it has suspended redemptions under Rule 22e-3 and will be liquidating. Finally, money funds are required to report certain actions taken under Rule 2a-7 to the SEC on Form N-SAR.[13]

Primary Objective

Under the amended STIF Rule, a STIF Plan must have a primary objective that the STIF operate with a stable NAV of $1.00 per participating interest. There is no similar "primary objective" requirement in Rule 2a-

7 that requires that a money fund have a $1.00 NAV per share, although a money fund's board is required to determine that it is in the best interests of the fund and its shareholders to maintain a stable NAV and the fund may do so only as long as the board continues to believe that the stable NAV per share fairly reflects the fund's market-based NAV.

Shadow Pricing Procedures

The amended STIF Rule requires a bank managing a STIF to adopt shadow pricing procedures to calculate the extent of the difference per participating interest between mark-to-market NAV and the STIF's amortized cost value. The shadow pricing procedures must require the calculation to occur on at least a calendar week basis. However, as a practical matter, in order to comply with the event notification requirements discussed above, a bank may need to perform shadow pricing more frequently, at least if the mark-to-market value of a STIF's participating interests draws close to the $0.9975 level. If the difference exceeds $0.005 per participating interest, the bank must take action (such as suspending fiduciary account withdrawals) to reduce dilution of participating interests or other unfair results to participating accounts. The bank has discretion regarding what actions to take, but any such actions may not impair the safety and soundness of the bank.

Rule 2a-7 similarly requires that money funds maintain shadow pricing procedures. Many money funds monitor their market-based NAV per share on a daily basis. Under Rule 2a-7, if the deviation from the stable NAV exceeds $0.005, the board is required to consider appropriate action, which could include liquidating the money fund or valuing the fund's shares based on a marked-to-market value (*i.e.,* a floating NAV). Many money funds have in place procedures designed to heighten the scrutiny and oversight of the fund's portfolio if the market-based NAV per share drops below a certain level that is short of $0.005 (*e.g.,* $0.0025). However, unlike a bank operating a STIF, the 1940 Act does not permit a money fund board to temporarily suspend redemptions in the absence of a decision to liquidate the fund.

Stress Testing

The amended STIF Rule requires that banks managing STIFs adopt procedures for stress testing the STIF's ability to maintain a stable NAV for participating interests. According to the Adopting Release, these tests must occur at such intervals as determined by "an independent risk manager or committee responsible for the STIF's oversight" in light of current market conditions but must occur at least monthly. The OCC explained in the Adopting Release that such risk manager or risk committee members must be independent from the STIF's investment management.

The stress tests should include the following scenarios (or combination of scenarios): (i) a change in short-term interest rates; (ii) an increase in participant account withdrawals; (iii) a downgrade of or default on portfolio securities; and (iv) the widening or narrowing of spreads between yields on an appropriate benchmark the STIF has selected for overnight interest rates and commercial paper, and other types of securities held by the STIF. The results of the stress testing must be reported to the independent risk manager or committee members responsible for the STIF's oversight, and adverse stress testing results must be reported to the bank's senior risk management that is independent from the STIF's investment management.

Rule 2a-7 similarly requires stress testing but requires it to occur at such intervals as the money fund's board determines is appropriate. As a practical matter, many money funds typically conduct stress testing on a monthly basis. Rule 2a-7 also has similar hypothetical events that a money fund should stress test and requires that the results of all stress testing be reported to the fund's board.

Mark-to-Market Value Accounting

The amended STIF Rule also requires a bank managing a STIF to adopt procedures that provide that if a STIF's NAV falls below $0.995 per participating interest, the bank shall calculate, admit, and withdraw the STIF's participating interests at a price based on the mark-to-market NAV. This is intended to discourage withdrawals when a STIF's NAV falls below $0.995 per participating interest.

Rule 2a-7 does not specifically require that money funds convert to a market based NAV when its shadow NAV falls below $0.995, but, instead, requires that boards of money funds promptly consider what action, if any, should be taken. In practice, while Rule 2a-7 does not require a board to do so, in the absence of unusual circumstances, the board may convert a money fund to a floating NAV per share by abandoning the use of the amortized cost method, or may take steps to liquidate the fund if the fund's shadow NAV falls below $0.995. Rule 2a-7 requires every money fund to have the capacity to redeem and sell its shares at a price other than a stable price per share, while Rule 22e-3 permits a fund that has committed to liquidate to suspend redemptions.

Suspending Redemptions and Initiating Liquidation

The amended STIF Rule requires that a bank managing a STIF adopt procedures for suspending redemptions and initiating liquidation of the STIF as a result of redemptions. These suspensions are permitted when the bank has: (i) determined that the extent of the difference between the STIF's amortized cost per participating interest and its current mark-to-market NAV per participating interest may result in material dilution of participating interests or other unfair results to participating accounts; (ii) formally approved the liquidation of the STIF; and (iii) facilitated the fair and orderly liquidation of the STIF to the benefit of all STIF participants.

Similarly, Rule 22e-3, adopted with the 2010 Amendments, permits a money fund to suspend redemptions and payment of redemption proceeds if: (i) the fund's board (including a majority of independent board members) determines that the deviation between the fund's amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results; and (ii) the board irrevocably approves the liquidation of the fund. A money fund suspending redemptions must also notify the SEC by e-mail of its decision, before redemptions are suspended.

CONCLUSION

Although the OCC's amendments to the STIF Rule will likely strengthen the regulation of STIFs, the amended STIF Rule is still significantly less onerous in many respects than the regulations imposed on money funds under Rule 2a-7. The OCC reforms to STIFs come over two and a half years after more stringent reforms were adopted by the SEC with respect to money funds. While the Financial Stability Oversight Council, which includes, in addition to the SEC, the the Comptroller of the Currency and several other banking regulators, is contemplating proposals to require that the SEC consider additional reforms for money funds, an open question is whether comparable reforms of STIFs will be discussed in light of their similarities to money funds or whether the OCC will continue to maintain that additional regulation is not necessary because STIFs are distinguishable from money funds by reason of their fiduciary client base.

Footnotes

1. Short-Term Investment Funds, 77 FR 61229 (Oct. 9, 2012) ("Adopting Release") (PDF). The STIF Rule also applies to STIFs managed by Federal Savings Associations under regulations adopted by the Office of Thrift Supervision. However, as of June 30, 2012, there were no STIFs administered by Federal Savings Associations reported. *See* Adopting Release at 61230.

2. 12 CFR 9.18.

3. Money Market Fund Reform, SEC Release No. IC-29132 (Feb. 23, 2010). For a discussion of the 2010 Amendments, *see* *Dechert OnPoint* Amendments to the Regulatory Structure Governing Money Market Funds (March 2010) (PDF). For a more detailed discussion of the regulation of SEC registered money market funds, *see* Jack W. Murphy, Douglas P. Dick, Stephen T. Cohen and Brenden P. Carroll, Chapter 30: Money Market Funds, *Practising Law Institute Mutual Fund Regulation Treatise* (May 29, 2012) (PDF).

4. *See* Sections 3(c)(3) and 3(c)(11) of the Investment Company Act of 1940.

8. *See* Short-Term Investment Funds, 77 FR 21057 (Apr. 9, 2012) ("Proposing Release").

9. Certain commenters had requested that the OCC grandfather certain existing STIF holdings, but the OCC rejected this approach as part of the amended STIF Rule.

10. *See* 17 CFR 270.2a-7(a)(10).

11. Under Rule 2a-7, a taxable money fund is subject to requirements that 10% of its assets be invested in "Daily Liquid Assets" (that is, cash, U.S. Treasury securities and securities convertible into cash in one business day) and 30% of its assets be invested in "Weekly Liquid Assets." (that is, cash, U.S.Treasury securities, agency notes with remaining maturities of sixty days or less and securities convertible into cash, whether by maturity or through exercise of a demand feature, within five business days). Tax-exempt money funds must comply with the weekly liquid assets requirement. *See* 17 CFR 270.2a-7(c)(ii)-(iii).

12. Rule 17a-9 conditionally exempts from the 1940

5. *See* 12 CFR 9.18(b)(4)(iii).

6. *See, e.g.,* Important Announcement Regarding Commonfund Short Term Fund (September 30, 2008) (PDF).

7. Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, p 35 (Oct. 2010) (PDF). The Adopting Release specifically cited this recommendation in adopting the amendments to the STIF Rule. *See* Adopting Release, *supra* note 1, at 61230.

Act's prohibitions against principal transactions purchases of portfolio securities from a money fund by an affiliated person, promoter, or principal underwriter of the fund, or an affiliated person of one of those persons.

13. *See* Item 77N of Form N-SAR.

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