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OCC's Adoption of Floating NAV for STIFs Highlights Recent Developments Affecting Collective Investment Funds

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I. Short-Term Investment Funds: OCC Adopts "Floating Rate" Requirement under Stress Situations

Effective July 1, 2013, bank-maintained short-term investment funds for fiduciary accounts ("STIFs") that are subject to Regulation 9 of the Office of the Comptroller of the Currency ("OCC") are required to implement "floating NAV" unit pricing procedures in certain stress situations. Given the recent announcement that the Securities and Exchange Commission ("SEC") "will not act to issue a money market fund reform proposal," potentially including a floating per share net asset value ("NAV"),¹ the OCC's action creates a clear distinction – and potentially "uneven playing field" – between bank-maintained STIFs and money market mutual funds ("MMMFs"), which continue, at least for the time being, not to be subject to a floating NAV requirement.

The floating NAV requirement for bank STIFs is part of major changes to the rules governing STIFs (the "STIF Rules") the OCC adopted on September 26th and published in the Federal Register on October 9.² This Alert summarizes the highlights of the new STIF Rules. As described below, the new STIF Rules are substantially similar to the changes the OCC proposed earlier this year.³

Background

According to the OCC, the new STIF Rules "enhance protections provided to STIF participants and reduce risks to banks that administer STIFs." The OCC also repeated its position that the changes "are informed by the SEC's [2010] revisions to Rule 2a-7," but also noted "important differences" between STIFs and MMMFs, the main one being that STIFs are available only to authorized fiduciary accounts, while MMMFs are open to retail investors generally. The OCC's decision to adopt the floating NAV requirement generally as proposed surprised some in the industry, who had expected the OCC to drop (or at least delay implementing) this condition after the SEC failed to promulgate the floating NAV idea (and other major MMMF reforms) this past August. However, in adopting the new STIF Rules, the OCC noted that bank-maintained STIFs make up only a small fraction of the money market fund universe.⁴ In any case, the OCC indicated that it would "continue to evaluate the requirements of [Regulation 9] in light of future policy assessments and initiatives concerning stable NAV funds, and will take such additional actions as are appropriate."

¹ Statement of SEC Chairman Mary L. Shapiro on Money Market Fund Reform, Rel. 2012-166 (Aug. 22, 2012).

² 77 Fed. Reg. 61229 (Oct. 9, 2012).

³ Please see our client alert at <http://www.klgates.com/occ-proposes-major-changes-to-stif-rules-05-01-2012/> for a discussion of the OCC's original proposal.

⁴ The OCC indicated that total assets of STIFs maintained by national banks amount to approximately \$118 billion, while assets of MMMFs (as of July 2012) totaled approximately \$2.5 trillion.

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Impact

The new STIF Rules require significant enhancements to STIF operations and procedures (including, *e.g.*, procedures addressing “break the buck” scenarios) and impose an array of new disclosure requirements on sponsoring banks. Not surprisingly, the OCC reiterated that banks are required to revise governing documents of their STIFs to comply with the new STIF Rules.

Although the STIF Rules technically apply only to national banks and federal savings associations, certain state banking laws and other federal and state banking regulators look to Regulation 9 as the primary benchmark for regulating fiduciary activities of state-chartered institutions. In addition, any federal or state institution maintaining a STIF in the form of a common trust fund described in Section 584 of the Internal Revenue Code is required by Section 584 to operate that fund in compliance with Regulation 9. Although the OCC acknowledged that the STIF Rules could place national banks at a competitive disadvantage with respect to state chartered banks that are not required to comply with the STIF Rules, it concluded that the benefits of enhancing participant protections and reducing risks outweigh any potential competitive disadvantage.

STIF Rules

Similar to SEC rules governing MMMFs, Regulation 9 currently permits a bank maintaining a STIF to value beneficial interests (typically taking the form of “units”) at amortized cost rather than market value if certain conditions are met. Those conditions require the sponsoring bank to (i) maintain a dollar-weighted average portfolio maturity of 90 days or less, (ii) accrue on a straight-line basis the difference between cost and anticipated principal receipt on maturity of each instrument, and (iii) hold the STIF’s assets until maturity under usual circumstances. The new STIF Rules retain the existing STIF Rule’s amortization and hold-to-maturity requirements. However, the portfolio maturity requirement is revised and several new requirements are added, all as described below in order of appearance in Regulation 9, as amended.

Stable Net Asset Value (NAV) Objective. The OCC noted that STIFs “typically maintain stable NAVs in order to meet expectations of the fund’s bank managers and participating fiduciary accounts.” The new STIF Rules require that a STIF’s governing document state affirmatively that a STIF’s “primary fund objective” is to “operate with a stable net asset value of \$1.00 per participating interest.”

Portfolio Maturity. The new STIF Rules require two separate portfolio maturity calculations, both to be determined in the same manner as is required pursuant to Rule 2a-7 for MMMFs.

First, the new STIF Rules reduce the maximum dollar-weighted average maturity of the STIF portfolio from 90 days to 60 days. The OCC’s objective here is to reduce certain risks, including maturity date, interest rate and liquidity risks. This mirrors the SEC’s 2010 amendments to Rule 2a-7.

Second, the new STIF Rules seek to decrease volatility by adding a new measurement, also included in amended Rule 2a-7 – “dollar-weighted average portfolio life maturity” – which must be 120 days or less. Importantly, when calculating average portfolio life maturity, the bank is required to use the stated maturity date of the instrument, rather than the next interest reset date, as is used under current STIF Rules for certain adjustable or variable rate holdings.

Although commenters on the proposed STIF Rules urged the OCC to “grandfather” STIF assets held prior to the publication of the new STIF Rules for purposes of the new maturity calculations so as to avoid possible adverse consequences resulting from unplanned sales, the OCC declined to provide for any “grandfathering” of STIF assets. Consequently, if a STIF holds investments that do not meet the

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new maturity requirements, those investments must be sold by or before July 1, 2013 to comply with the new STIF Rules.

Qualitative Standards, Concentration Restrictions. Banks will be required to “identify, monitor, and manage” issuer and lower quality investment concentrations. The OCC expects banks to implement due diligence procedures as part of the bank’s risk management policies and procedures for each STIF, taking into consideration “market events and deterioration of an issuer’s financial condition.”

Liquidity. To address concerns that a STIF might be unable to satisfy withdrawal requests promptly if it holds illiquid securities, the new STIF Rules require banks to adopt liquidity standards that address “contingency funding needs.” The OCC indicated that this does not require the STIF to obtain a letter of credit or similar arrangement. The OCC stated, however, that liquidity standards should delineate policies to manage various stress environments, establish lines of responsibility and implementation and escalation procedures, and identify alternative potential funding sources. In addition, these procedures should be tested and updated regularly. (See also the “event notice” requirement for certain events affecting a STIF, including financial support provided to a STIF, described below.)

Shadow Pricing. The new STIF Rules require “shadow pricing” procedures to track the difference, if any, between the \$1.00 NAV (calculated using amortized cost) and the actual market value of the STIF’s holdings. Shadow pricing must be based on market quotations or, when market prices are unavailable, “an appropriate substitute that reflects current market conditions.” Shadow pricing is required on “at least” a weekly basis or more frequently as determined by the bank when market conditions warrant. As a practical matter, however, the bank will need to perform shadow pricing on a daily basis, if for no other reason than to comply with the “event notice” requirements described below.

If shadow pricing indicates a difference between the amortized cost NAV and market price NAV exceeding one-half cent (\$0.005) per unit, the bank is required to “take action” to protect STIF participants from unfair dilution. The new STIF Rules do not specify exactly what action the bank is expected to take, but such action presumably could include suspending fiduciary account withdrawals and possibly moving to a floating NAV. The OCC stated that, in any event, whatever actions the bank may take must not impair the safety and soundness of the bank.

Stress Testing. Similar to the 2010 Rule 2a-7 amendments, the new STIF Rules require a bank to adopt procedures for periodic “stress testing” of the STIF’s ability to maintain a stable \$1.00 NAV. The testing must be performed at least monthly and at such other intervals as determined by “an independent risk manager or a committee responsible for the STIF’s oversight.” The “committee” should consist of members independent of the group responsible for the STIF’s investment management, but need not be a third party. Presumably, therefore, employees or officers of the bank who do not perform investment management functions for the STIF are sufficiently “independent” for this purpose.

Stress tests are to be based on hypothetical events, including changes in short-term interest rates, the level of participant redemptions, security downgrades or defaults, and changes in spreads between yields of an appropriate overnight rate benchmark and those of the STIF’s holdings. The bank must provide stress test reports to the independent risk manager or committee. The reports must include: (i) the date on which the test was performed; (ii) the magnitude of each hypothetical event that would cause the stable value NAV and current market value to differ by more than \$0.005; and (iii) an assessment of the STIF’s ability to withstand the events (including concurrent events) reasonably

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likely to occur within the next year. The bank also must report “adverse” stress testing results to the bank’s senior management personnel who are independent of the STIF’s investment management.

Portfolio Holdings Disclosure. The bank must disclose to the OCC and STIF participants, within five business days after each calendar month-end (i) the amount of the STIF’s net assets, (ii) the STIF’s amortized cost NAV and market value NAV (both with and without capital support agreements),⁵ (iii) the dollar-weighted average portfolio maturity, (iv) the dollar-weighted average portfolio life maturity as of the last day of the calendar month, and (v) various details about each security held in the STIF, including, among other things, identification of issuers, maturity dates, coupon or yield, and amortized cost value. The new STIF Rules do not contain a required form of disclosure, leaving this to the bank’s discretion; however, such disclosures may be made to STIF participants electronically, provided the disclosures are reasonably accessible to such participants. The OCC stated that it will provide guidance to banks on making electronic portfolio holdings disclosures to the OCC at least 90 days before the STIF Rules become effective.

Event Notices. A bank must adopt procedures for notifying the OCC prior to, or within one business day following, the occurrence of any of the following events:

- The difference between amortized cost NAV and market price NAV exceeds \$0.0025 (effectively requiring the bank to perform “shadow pricing,” as described above, on a daily basis);
- The STIF reprices its NAV to an amount below \$0.995 per unit;
- Any withdrawal in-kind by, or segregation of assets of, STIF participants;
- Any delay or suspension of withdrawals;⁶
- A decision to formally approve the STIF’s liquidation or segregation of assets or portfolios or some other liquidation of the STIF; and
- The bank, an affiliate, or a third party provides any financial support to the STIF, such as a cash infusion, credit extension, purchase of defaulted or illiquid asset, or other support designed to maintain a stable NAV per unit.⁷

Like the portfolio holdings disclosures, the OCC has indicated that these disclosures may be made electronically.

Floating Rate NAV. As mentioned above, to decrease the likelihood of a “run on the bank” and to protect a STIF’s remaining participants, the new STIF Rules require the bank to effect admissions to and withdrawals from a STIF at market value NAV in the event STIF units are repriced below \$0.995 per unit. The bank is not, however, required to begin liquidation of the STIF under these circumstances.

As noted above, this new requirement is similar to one of the options the SEC was considering for MMMFs before it failed to effectuate reforms this past August. However, it is markedly different from the current requirements of Rule 2a-7, which, under the same circumstances, require only that

⁵ This requirement differs slightly – but importantly – from the requirements under Rule 2a-7. Similar to the new STIF Rules, Rule 2a-7 requires disclosure to the SEC on, among other things, a fund’s shadow price within five days of month-end on Form N-MFP. However, Rule 30b1-7(b) under the 1940 Act states that such information will be made publicly available 60 days after the month-end to which the information pertains. The new STIF Rules, on the other hand, make this information available to investors almost immediately.

⁶ The new STIF Rules do not define “delay” or elaborate on what withdrawal “suspensions” would trigger the notice requirement. The subject is addressed further under “Suspension and Liquidation” below.

⁷ See also OCC Bulletin 2004-2, Interagency Policy on Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates (Jan. 5, 2004).

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the fund's board to "promptly consider what action, if any, should be initiated by the Board of Directors."

Suspension and Liquidation. A bank, in "extraordinary circumstances when there is significant risk of extraordinary withdrawal activity," will be permitted to suspend redemptions if (and only if): (i) the bank determines that the difference between market value NAV and amortized cost NAV may result in material dilution⁸ of participating interests or other unfair results to STIF participants; (ii) the bank formally has approved the liquidation of the STIF; and (iii) the bank facilitates the fair and orderly liquidation of the STIF for the benefit of all STIF participants.

II. New Annual CFTC Filing Requirements for Exclusion from Registration as a Commodity Pool Operator.

Banks and trust companies typically are excluded from registration with the Commodity Futures Trading Commission ("CFTC") as a commodity pool operator ("CPO") in connection with operation of their collective investment funds and other commingled fiduciary accounts.⁹ A condition of this exclusion had been the filing of a one time notice with the National Futures Association ("NFA") with regard to each collective investment fund and other commingled account for which the bank or trust company had claimed the exclusion. However, to maintain this exclusion, banks and trust companies will now have to annually file an additional electronic notice with the NFA affirming their excluded status with regard to these accounts. The first of these annual filings must be made within 60 days after December 31, 2012 and subsequent filings must be made within 60 days after the applicable calendar year end.

Background

The Commodity Exchange Act ("CEA") and rules adopted thereunder by the CFTC generally require that any operator of a pooled investment vehicle that trades commodity interests register as a CPO. Commodity interests include futures contracts (including security futures), options on futures contracts and on physical commodities, leverage contracts, retail forex transactions and swaps other than security-based swaps.¹⁰ However, CFTC Rule 4.5 has for many years provided an exclusion from the definition of CPO for banks and trust companies operating trust, custodial or other separate units of investment for which the bank or trust company is acting as a fiduciary and for which it is vested with investment authority. A condition of this exclusion had been that the institution make a one time filing, currently through the NFA electronic filing system, claiming the exclusion with regard to **each** applicable fund or account. The notice is required to be amended within 15 business days if information in the notice becomes incorrect (such as, for example, if the bank or trust company's name changes or the account's name changes). This filing requires a representation that the operator will notify in writing any participant in the fund or account of its excluded status.

The CFTC amended Rule 4.5 earlier this year to add a number of substantive requirements for registered investment company operators wishing to be excluded from CPO status. While the specific exclusion with regard to banks and trust companies was not altered, all persons claiming any exclusion under Rule 4.5 must now, in addition to their initial exclusion notice with regard to each

⁸ The new STIF Rules do not provide guidance as to what would constitute "material dilution" for this purpose.

⁹ Note that, under Section 1(a)(12)(B)(i) of the Commodity Exchange Act, banks and trust companies and any person acting as an employee thereof are exempt from registration as commodity trading advisors.

¹⁰ <http://www.klgates.com/swap-definitions-rules-finalized-by-the-sec-and-the-cftc-under-dodd-frank/>

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applicable fund and account, annually affirm their excluded status within 60 days of each calendar year end through a new electronic filing with the NFA.

Impact

Banks and trust companies managing collective investment funds and other commingled fiduciary accounts should initially determine which of these funds or accounts might trigger CPO registration by virtue of their trading in commodity interests and the nature of the account. Second, if the Rule 4.5 exclusion is to be relied on for particular funds and/or accounts, the institution should verify that the initial filing has been made with regard to each relevant fund or account and is reflected in the current NFA electronic filing system. This can be determined by using the NFA's BASIC system on the NFA's website (www.nfa.futures.org).³ Our experience suggests that the NFA system may not accurately reflect all previous Rule 4.5 filings that were filed in paper before the electronic system was initiated. You may wish to consult with counsel on how best to correct the NFA record in the event that it does not show all necessary Rule 4.5 filings. Finally, steps will need to be taken to assure that the required new filings affirming excluded status are made during the first 60 days of 2013 and annually thereafter within 60 days of the calendar year end.

III. IRS Issues Group Trust Application Form 5316

The IRS has announced that Form 5316 – *Application for Group or Pooled Trust Ruling* – is now to be used to request a group trust determination letter (see Rev. Proc. 2012-6). Most bank-sponsored collective trust funds for employee benefit plans take the form of group trusts, which are trusts consisting of assets of tax-qualified corporate employee benefit plans, governmental employee plans, and (subject to conformance with the federal securities laws) individual retirement accounts. A trust that meets the requirements of Revenue Ruling 81-100, as clarified and modified by Rev. Rul. 2004-67 and Rev. Rul. 2011-1 (“Rev. Rul. 81-100”), is exempt from federal income taxation under Internal Revenue Code Section 501 (except to the extent the group trust receives “unrelated business taxable income” described in Code Section 512).

Historically, a group trust sponsor has applied for an IRS determination letter by submitting an application in the form of a letter, together with the governing declaration of trust, ancillary forms, and a user fee payment. The application letter described how the trust satisfied the requirements of Rev. Rul. 81-100. Form 5316, consisting of three pages (plus instructions), continues to require basic identifying information about the group trust sponsor and includes a “checklist” of procedural requirements (required documents, user fee, and other ancillary forms), largely unchanged from the current process. However, Form 5316 replaces the narrative description of how the group trust conforms to Rev. Rul. 81-100, formerly contained in the application letter, which typically included cross references to pertinent provisions of the governing declaration of trust, with eight “Yes or No” questions covering the basic substantive requirements of Rev. Rul. 81-100. IRS reviewers presumably will review the group trust documents themselves to confirm the required language is included.

The Instructions to Form 5316 are relatively straightforward, although there are some items that require clarification. For example, the Specific Instructions state that “the trust sponsor/employer must have an EIN,” which is to be entered on the Form. Although the Instructions do not define “trust sponsor/employer,” it presumably includes both an employer maintaining a “master” group trust for multiple plans of the employer and/or its affiliates, and a bank or investment advisory institution maintaining a group trust for otherwise unrelated client plans.

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The Instructions go on to provide that the sponsor/employer's EIN, “**must** be used in all subsequent filings of the trust determination letter requests” (emphasis in original). The IRS generally takes this approach to track employers and individual qualified employee benefit plans they sponsor, and it makes sense for “master” group trusts. However, using the EIN of a bank or adviser for multiple group trusts that institution may maintain for client plans potentially may lead to unnecessary confusion. Until now, banks/advisers typically have obtained separate ID numbers for each of their group trusts (or discrete families of group trusts). This practice not only recognizes the separate identities of the group trusts and the sponsoring institution, but also facilitates identification of each group trust as distinct from other group trusts sponsored by the same institution. It remains to be seen whether this practical approach can continue under Form 5316.

IV. Collective Investment Funds: OCC Proposal on Retail Forex Transactions

The OCC has proposed amendments to its rule governing bank involvement in retail foreign exchange transactions (“Forex Transactions”). The proposed rule would allow national banks and federal thrifts to enter into Forex Transactions with bank-maintained common and collective trust funds (“CIFs”) on the same terms that apply to Forex Transactions for other regulated entities (*e.g.*, other banks, investment companies, broker-dealers). However, the national bank or federal thrift would be prohibited from acting as the counterparty in a Forex Transaction with a CIF over which the national bank, federal thrift, or an affiliate has discretionary authority (*i.e.*, to cause the institution's own CIFs to enter into Forex Transactions). The OCC proposal also establishes a safe harbor for national banks and federal thrifts that follow adequate policies and procedures and rely on certain written representations made by counterparties in Forex Transactions.

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