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## OCC Proposes Major Changes to STIF Rules

*By Mark J. Duggan, Donald W. Smith, William P. Wade*

On April 9<sup>th</sup>, the Office of the Comptroller of the Currency (the OCC) proposed major changes to rules governing bank-maintained short-term investment funds for fiduciary accounts (STIFs).<sup>1</sup> According to the OCC, the proposed changes (the Proposal) in the rules (STIF Rules) are designed to safeguard against the risk of loss to a STIF, offer greater transparency to participants and regulators concerning STIF holdings and pricing, and protect STIF participants from undue dilution in the case where the market value of a STIF's assets drops significantly.

The proposed changes are in response to suggestions in the 2010 report of the President's Working Group on Financial Markets – which reviewed causes and effects of the 2007-09 financial market turmoil – that bank regulators “consider additional restrictions to mitigate systemic risk for bank common and collective funds . . . that seek a stable NAV but that are exempt from registration” under the securities laws. While acknowledging differences between STIFs and registered money market funds, particularly with respect to the nature of their investors, the OCC also noted the proposed changes “are informed by . . . but differ in certain respects from” changes to Rule 2a-7 under the Investment Company Act of 1940 (the 1940 Act) adopted by the Securities and Exchange Commission (the SEC) in 2010.

The OCC requested comments and posed 13 specific questions about various aspects of the Proposal. Comments and responses are due by June 8, 2012.

### Impact

The Proposal affects a relatively small number of federal and state-chartered banks that use STIFs for fiduciary account cash management purposes or investment of securities lending cash collateral.<sup>2</sup> 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 that statute to operate that fund in compliance with Regulation 9.

The Proposal would require significant enhancements to STIF operations and procedures, including, for example, procedures addressing “breaking the buck” scenarios, and would impose an array of new disclosure requirements on sponsoring banks. In somewhat of an understatement, the OCC noted that, if the Proposal is adopted, banks would need to revise governing documents of their STIFs to comply with the revised rules.

<sup>1</sup> 77 Fed. Reg. 21057 (April 9, 2012).

<sup>2</sup> The OCC indicated that, as of December 31, 2011, 15 national banks (and no federal savings associations) reported maintaining STIFs.

## Current STIF Rules

Similar to SEC rules governing money market mutual funds, 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 STIF Rules were last amended in 1997 “to make them more consistent with Rule 2a-7.” The Proposal likewise seeks to maintain general consistency with Rule 2a-7, as amended.

## The Proposal

The Proposal retains the existing STIF Rule’s amortization and hold-to-maturity requirements. However, as summarized below, it would revise the portfolio maturity requirement and add several new requirements.

**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 Proposal would require that the STIF 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 Proposal would require two separate portfolio maturity calculations, both to be performed in accordance with Rule 2a-7.

First, the Proposal reduces 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 Proposal “provides an extra layer of protection” against volatility in the credit markets by adding a new measurement, also included in amended Rule 2a-7 – “weighted average portfolio life maturity” – which must be 120 days or less. Importantly, when calculating average portfolio life maturity, the bank would be required to use the stated maturity date of the instrument, rather than the next interest reset date, as is used currently for certain adjustable or variable rate holdings.

**Qualitative Standards, Concentration Restrictions.** Banks would be required to “identify, monitor, and manage” issuer and lower quality investment concentrations. Banks also would need 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 Proposal requires banks to adopt liquidity standards that address “contingency funding needs.” (See also the “event notice” requirement for certain events affecting a STIF, including financial support provided to a STIF, described below.)

**Shadow Pricing.** The Proposal would 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 would be based on market quotations or, when market prices are unavailable, “an appropriate substitute that reflects current market conditions.” Shadow pricing would be required on “at least” a weekly basis or more frequently as determined by the bank when market

conditions warrant. As a practical matter, the bank likely would 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 \$0.005 per unit, the bank would be required to take action to protect STIF participants from unfair dilution, which could include suspending fiduciary account withdrawals and, presumably, although not stated specifically by the OCC, moving to a floating NAV.

**Stress Testing.** Similar to the recent Rule 2a-7 amendments, the Proposal would require a bank to adopt procedures for periodic stress testing of the STIF’s ability to maintain a stable NAV. The frequency of such tests would be determined by “an independent risk manager or a committee responsible for the STIF’s oversight.” The “committee” would consist of members independent from the group responsible for the STIF’s investment management. The stress test would 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 OCC did not elaborate on the concept of the committee’s “independence” for this purpose. Presumably, however, employees or officers of the bank who do not perform investment management functions for the STIF would be sufficiently independent.

The bank also would be required to provide stress test reports to the independent risk manager or committee. Each report would 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 likely to occur within the next year.

**Portfolio Holdings Disclosure.** Banks would be required to disclose to the OCC and STIF participants,<sup>3</sup> within 5 business days of each month-end, (i) the amount of the STIF’s net assets, (ii) the STIF’s stable value NAV and market price NAV (with and without capital support agreements),<sup>4</sup> (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.

**Event Notices.** A bank would be required to 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 the stable value NAV and the 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;

<sup>3</sup> The Proposal does not contain a required form of disclosure; rather, the OCC has requested industry input on an appropriate disclosure format.

<sup>4</sup> This requirement differs slightly – but importantly – from the requirements under Rule 2a-7. Similar to the Proposal, Rule 2a-7 requires disclosure to the SEC of, among other things, a fund’s shadow price within 5 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 Proposal, on the other hand, would make this information available to investors almost immediately.

- Any delay or suspension of withdrawals;<sup>5</sup>
- A decision to formally approve the STIF’s liquidation or segregation of assets or portfolios or some other liquidation of the STIF; and
- If 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.<sup>6</sup>

**Floating Rate NAV.** To decrease the likelihood of a “run on the bank” in the event STIF units are repriced below \$0.995 per unit, and to protect remaining STIF participants, the Proposal would require the bank to effect transactions at the market NAV. This is similar to one of the options the SEC currently is considering for money market mutual funds.<sup>7</sup> However, this is markedly different from the current requirements of Rule 2a-7, which, under the same circumstances, merely require a board to “promptly consider what action, if any, should be initiated by the Board of Directors,” rather than requiring a floating NAV.

**Liquidation.** A bank, in “extraordinary circumstances,” would be permitted to suspend redemptions only if (i) the bank determines that the difference between the market NAV and the stable value NAV may result in material dilution<sup>8</sup> of participating interests or other unfair results to STIF participants, (ii) the bank has formally 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.

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<sup>5</sup> The Proposal does not define “delay” or elaborate on what withdrawal “suspensions” would trigger the notice requirement. However, the fact that suspensions are mentioned in a manner that implies they are permissible (which generally is assumed) is important, given that Regulation 9 itself does not mention suspensions expressly.

<sup>6</sup> 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).

<sup>7</sup> See, e.g., Chairman Mary L. Schapiro, Remarks at 2011 Annual Meeting of the Securities Industry and Financial Markets Association (Nov. 7, 2011); Commissioner Elise B. Walter, Remarks at 2012 Mutual Funds and Investment Management Conference (Mar. 19, 2012).

<sup>8</sup> The Proposal does not provide any guidance as to what would constitute “material dilution” for this purpose.

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