

# The Resource

*For Great Programs, Inc.*

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## MEMORANDUM

TO: The Yield Increase Committee of the State Bar of California's Legal Services Trust Fund Commission

FROM: Matthew D. Weber, Policy Analyst  
The Resource for Great Programs, Inc.

RE: A Policy to Define Money Market Mutual Funds That Are Comparably Conservative to Those That Invest Exclusively in U.S. Government Securities.

DATE: April 18, 2008

You asked us to draft a policy for your consideration, to govern the determination of whether a money market mutual fund ( MMMF ) that invests in something other than U.S. Government Securities ( or repurchase agreements collateralized by U.S. Government Securities ) satisfies the "comparably conservative" requirements of Business and Professions Code § 6213(j)(3). To determine policy considerations, we conducted research in three areas. First, we reviewed the structural features of MMMFs that make them conservative investments by nature. Second, we researched the rules and statutes of other IOLTA programs across the country for their treatment of MMMF investments. Third, we looked at the investment policies adopted by various California municipalities and institutions entrusted with public funds. We also drew on our extensive experience in assisting IOLTA programs across the country in implementing their comparability rules. Our goal was to build on this research to draft a policy that would be highly

protective of client funds, while also being practical to administer and offering clear-cut decision points for analysis.

We believe the attached draft policy achieves this goal. The policy would find that an MMMF satisfies the requirements of Business and Professions Code § 6213(j)(3) when:

- At least 90 percent of the fund is invested in U.S. Government Securities or repurchase agreements fully collateralized by U.S. Government Securities;
- No more than 3 percent of the fund is invested in the securities of any one issuer (excluding U.S. Government Securities and repurchase agreements collateralized by U.S. Government Securities);
- The fund invests only in the highest-quality (“First Tier”) securities; and
- The fund receives a top rating from at least one nationally recognized statistical rating organization (“NRSRO”) or the fund has retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of five hundred million dollars (\$500,000,000).

Following is a summary of our research, and a detailed explanation for each of the policy provisions we have proposed. To put our research in context, we begin with a brief review of California’s IOLTA interest rate comparability requirements.

## **I. Background – IOLTA Interest Rate Comparability Requirements**

As you know, recent statutory and rule changes in California require financial institutions that offer IOLTA accounts to provide the same rate of return on those accounts as they provide on the highest-paying, non-IOLTA banking products for which the accounts qualify (unless the institution chooses the established compliance rate approach). Often, a financial institution’s highest-paying banking product is a “sweep” account in which excess funds are transferred overnight into a MMMF, and returned the next morning, along with any dividends earned. IOLTA accounts that meet the sweep account’s minimum balance and other eligibility requirements, if any, are to receive the

sweep account's same high rate of return. However, this requirement applies only if the MMMF to which the sweep account is linked meets the requirements of Business and Professions Code § 6213(j).

Business and Professions Code § 6213(j) establishes three basic requirements for MMMFs linked to sweep accounts:

- (1) The fund must hold itself out as a “money-market fund” as that term is defined by federal statutes and regulations under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.).
- (2) The fund must have total assets, at the time of investment, of at least two hundred fifty million dollars (\$250,000,000).
- (3) The fund must be “invested solely in United States Government Securities or repurchase agreements fully collateralized by United States Government Securities or *other comparably conservative debt securities*.”

Both the statute and the State Bar Rules<sup>1</sup> contemplate that MMMFs may be invested in United States Government Securities and other comparably conservative debt securities. This Committee requested research to develop a policy with criteria for determining when MMMFs are in “comparably conservative” debt securities within the meaning of the statute.

What constitutes “comparably conservative” debt securities is subject to interpretation, and may indeed change over time with changes in market conditions, available investment vehicles, etc. The attached draft policy provides one framework for identifying MMMFs that satisfy the “comparably conservative” requirement of Business and Professions Code § 6213(j)(3). It is not intended to imply that a different framework would not also be adequate. Indeed, we recommend that the Committee review the

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<sup>1</sup> See Rules of the State Bar of California, Title 2, Division 5, Rule 2.100(c), which provides that the phrase “comparably conservative” includes “but is not limited to” securities issued by Government-Sponsored Enterprises.

policy it ultimately adopts on a regular basis in order to appropriate adjustments. Adopting a policy will ensure that the Commission has a uniform and consistently conservative basis for determining the eligibility of MMMFs. A policy will also ensure that appropriately safe MMMFs are not excluded from the IOLTA rate comparability analysis (causing a concomitant loss in revenues generated to fund civil legal services for indigent Californians). The following three sections review the research we have conducted, while the final section presents our proposed draft policy based on this research.

## **II. Structural Features of Money Market Mutual Funds Make Them Conservative Investments**

Money market mutual funds are, by design, conservative investments. Any fund that holds itself out as a MMMF must meet the stringent requirements of the United States Securities and Exchange Commission's Rule 2a-7 under the Investment Company Act of 1940.<sup>2</sup> The rule requires MMMFs to be managed with the goal of maintaining a stable net asset value, which is usually fixed at \$1 per share.<sup>3</sup> Thus, while the return generated by MMMFs may fluctuate, the share price is expected to remain stable. This preserves shareholders' investment principal, while allowing for modest dividend income.

Other SEC requirements reinforce MMMFs' stable net asset value, and therefore the conservative nature of these investments. These include requirements concerning credit quality, diversification, and maturity.

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<sup>2</sup> See 17 CFR 270.2a-7.

<sup>3</sup> 17 CFR 270.2a-7(c)(1).

*Credit Quality.* MMMFs may only invest in short-term securities that present minimal credit risk. Under the SEC rules, these are “First Tier” or “Second Tier” securities. A security’s “tier” depends in large measure on the rating it receives from nationally recognized statistical rating organizations (“NRSROs”). These ratings reflect the rating organization’s judgment, as of a specific date, of the creditworthiness of a particular company, security, or obligation. The SEC currently recognizes seven NRSROs, the largest and most prominent of which are Fitch Investors, Inc. (“Fitch”), Moody’s Investors Service, Inc. (“Moody’s”) and Standard & Poor’s (“S&P”).<sup>4</sup>

Notably, the Investment Company Institute – the trade organization for the mutual fund industry – considers MMMFs that invest exclusively in First Tier securities to be equivalent in quality and security to MMMFs that invest exclusively in U.S. Government Securities. ICI recently submitted comments to that effect to the Securities and Exchange Commission. The comments were addressed to a SEC proposal to allow broker-dealers to meet their customer reserve deposit requirements by placing funds in MMMFs that invest exclusively in U.S. Treasury Securities. The ICI supports the SEC’s proposal, but advocates expanding it to include MMMFs that invest exclusively in First Tier securities as defined under SEC Rule 2a-7 under the Investment Company Act of 1940. ICI wrote:

Under Rule 2a-7, a “first tier” security includes a security that has received the highest short-term rating from a national recognized statistical rating organizations (“NRSRO”), an unrated security that is of comparable quality to a security that has received the highest short-term rating from an NRSRO as determined by a fund’s board of directors, a security issued by a money market fund, or a “government security” as defined in the Investment Company Act. Such an expansion would afford investor protections that are even higher than the current strict standards of Rule 2a-7 and that are similar to the safety of U.S. Treasury-only money market funds. By expanding the proposal to include money market funds

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<sup>4</sup> The remaining NRSROs include A.M. Best Company, Inc., DBRS Ltd., Japan Credit Rating Agency, Ltd., and Rating and Investment Information, Inc.

beyond those that only invest in U.S. Treasury securities, there also would be a significant increase in the availability of funds, and, in turn, an increase in liquidity for broker-dealers to satisfy their special reserve account requirements.<sup>5</sup>

Accordingly, while SEC rules ensure that the securities in which all MMMFs invest have a “strong” to “superior” ability to repay debt according to the ICI, those MMMFs that invest exclusively in First Tier securities achieve a level of safety on par with MMMFs that invest exclusively in U.S. Government Securities.

*Diversification.* SEC rules enhance the safety of MMMFs by imposing a diversification requirement. Generally, MMMFs may not invest more than 5 percent of assets in the securities of any single issuer, and not more than one percent of assets in the Second Tier securities of any issuer.<sup>6</sup> This requirement limits a fund's economic exposure to any single issuer.

However, “government securities” (which includes both securities issued by the U.S. Treasury, as well as those issued by a government sponsored enterprise) are excluded from this diversification requirement.<sup>7</sup> . Accordingly, MMMFs may invest heavily – or even exclusively – in government securities. Notably, a MMMF can hold itself out as a “Government” fund if it invests at least 80 percent of its assets in such securities.<sup>8</sup>

*Maturity.* MMMFs must invest in securities that are considered “short-term.”<sup>9</sup> Indeed, the fund’s “weighted average maturity” – an average of the maturities of all securities held in the portfolio, weighted by each security's percentage of net assets –

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<sup>5</sup> See Letter to Nancy M. Morris, U.S. Securities and Exchange Commission, from Jane G. Heinrichs, Investment Company Institute, dated June 18, 2007 (emphasis added). The letter is available at [www.ici.org/statements/cmltr/07\\_sec\\_bdrespon.com.html](http://www.ici.org/statements/cmltr/07_sec_bdrespon.com.html).

<sup>6</sup> See generally, 17 CFR 270.2a-7(c)4.

<sup>7</sup> 17 CFR 270.2a-7(c)(4)(i).

<sup>8</sup> 17 CFR 270.35d-1.

<sup>9</sup> 17 CFR 270.2a-7(c)(2)

must not exceed 90 days. Moreover, a MMMF may not acquire a security with a remaining maturity of greater than 397 days. These requirements make the performance of securities in MMMFs more predictable, and, therefore, more secure.

Accordingly, MMMFs incorporate many features that enhance the security of funds invested in them. These include a requirement that the fund be managed to maintain a stable net asset value, that it invest only in high quality debt securities, that its investments be diversified to limit exposure to risks associated with any particular issuer, and that its investments be short-term to limit exposure to changes in market conditions. As explained below, the policy we have drafted for the Commission’s consideration builds on two of these features – credit quality and diversification – by raising the bar even higher for MMMFs that invest in something other than U.S. Government securities.

### **III. Other States’ IOLTA Regulations Provide Little Guidance in How California Might Interpret “Comparably Conservative.”**

Our research into other states’ IOLTA rules and statutes provided little insight into how California might define MMMFs that invest in “comparably conservative debt securities.” Early adopters of IOLTA comparability requirements modeled them on Florida’s Comparability Rule 5-1.1(e) which restricts IOLTA funds to repurchase agreement collateralized by United States Government Securities and MMMFs that “consist solely of . . . United States Government Securities.”<sup>10</sup> There is no provision to allow for investments in other kinds of securities.

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<sup>10</sup> Rule 5-1.1(e)(1)(E) of the Rules Regulating the Florida Bar. For examples of similar rules in other states, *see* Rule 1.15 of the Alabama Rules of Professional Conduct; Rule 1.15(a)(3) of the Connecticut Rules of Professional Conduct; Rule 1.15(d)(3) of the Illinois Rules of Professional Conduct; Rule 1.15 of the Indiana Rules of Professional Conduct; Rule 1.15 (g) (1) of the Massachusetts Rules of Professional Conduct; Michigan State Bar Foundation Attorney IOLTA Guidelines; Rule 1.15(o) of the Minnesota Rules of Professional Conduct; Rule 4-1.15(a)(6)(C) of the Missouri Supreme Court Rules; Rule 1.15 of the Mississippi Rules of Professional Conduct; Administrative Determination of the New Jersey Supreme

Ohio, by contrast, has a very permissive rule.<sup>11</sup> It allows investment in a wide range of products, without expressly limiting MMMFs to investment in United States Government Securities. Ohio leverages this flexibility to negotiate with financial institutions to achieve higher rates for IOLTA accounts. Accordingly, in practice, Ohio functions like a “safe harbor” state, with the rate to be paid on IOLTA accounts negotiated individually with each financial institution based on the rates that institution pays on its non-IOLTA accounts.

The only IOLTA comparability rules that, like California’s, tread a middle ground, are Maine’s and Arkansas’.<sup>12</sup> Maine’s rule defines a “qualified money market fund” to be one in which “substantially all” of its funds are invested in U.S. Government Securities.<sup>13</sup> Similarly, Arkansas provides that “an open-end money-market fund must invest primarily in U.S. Treasury Securities or repurchase agreements fully collateralized by U.S. Treasury Securities.” Accordingly, like California, Maine and Arkansas do not restrict IOLTA funds to MMMFs that invest exclusively in U.S. Treasury and GSE Securities. Significantly, the rules in Maine and Arkansas differ from California’s in that those rules focus only on the quantity of non-U.S. Government Securities in a fund. California’s rule, by contrast, focuses on the relative safety of those securities. As our review of SEC money market regulations indicates, security is a function of many factors, include the credit quality, maturity and the concentration (or diversification) of

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Court dated November 15, 2005; 21 NYCRR 7000.9(a)(3); Rule 1.15 of the Pennsylvania Rules of Professional Conduct; Rule 4 of the Rules Governing the Operation of the Texas Access to Justice Foundation.

<sup>11</sup> Rule 120.51-1-03, Ohio Legal Assistance Foundation Rules.

<sup>12</sup> The IOLTA comparability rule currently being considered by Hawaii’s Supreme Court borrows California’s “comparably conservative” language.

<sup>13</sup> Rule 6(A)(3) of the Maine Bar Rules. Maine’s rule also defines “U.S. Government Securities” to include “securities of Government Sponsored Entities, including but not limited to Federal National Mortgage Association Securities, Government National Mortgage Association Securities, and Federal Home Loan Mortgage Corporation Securities.”

the securities in a fund. Thus, in defining MMMFs that invest in “comparably conservative debt securities,” it is appropriate for California to address both the quality and the quantity of the non-U.S. Government Securities in the fund.

**IV. Statutes and Policies Governing the Short-Term Investment of Public Funds Point to Important Provisions the Commission May Consider to Safeguard Those Funds.**

For insight into policies the Commission might adopt to give further definition to the “comparably conservative” standard in the review of money market funds, we considered the investment policies adopted by a variety of public sector entities in California, and the statutes that govern those policies. Specifically, we looked at the policies of Los Angeles County, Sonoma County, the County of Santa Cruz, the City of Riverside, and the University of California System. We focused in particular on policies governing the short-term investment of idle funds. These policies apply in situations similar to those found in the IOLTA context – funds are temporarily available for investment, but they may need to be withdrawn at any moment. Moreover, the “generally accepted objectives” in investing these funds are, in order of priority:

- (1) Safety
- (2) Liquidity
- (3) Yield<sup>14</sup>

As the California Institute for Local Government explains, “These objectives mean it should *never* be an investment manager’s goal to earn *maximum* returns on the city’s portfolio: this would expose the city to an unacceptable level of risk. Instead, a more prudent goal would be to earn a reasonable rate of return on the city’s investments, while preserving capital in the overall portfolio.”<sup>15</sup>

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<sup>14</sup> See California Institute for Local Government Financial Management Checklist at 6.

<sup>15</sup> Id.

This investment philosophy is consistent with the IOLTA program. While the program seeks to generate revenue to fund critical legal services for low income Californians, it uses client funds to achieve this goal. In doing so, it bears a particular responsibility to ensure the security of those funds. Accordingly, in crafting a policy on the kinds of MMMFs into which client funds may be placed, the protection of those funds is, and must be, paramount.

While the investment policies of other public sector entities are relevant, we note that they do not present an “apples to apples” comparison. IOLTA funds may be swept into either of two kinds of investments: repurchase agreements or money market mutual funds. By contrast, public sector entities have a wide variety of categories of investments from which to choose. For example, state law governing local agencies’ short-term investments allows investments in 16 categories of investment vehicles.<sup>16</sup> Accordingly, investment policies for local governments and other public sector entities must address a wider range of investments than are allowed under IOLTA rules. For purposes of this memorandum, our review of these policies focused on two areas: (1) quality and diversification requirements specifically addressed to investments in money market mutual funds, and (2) quality and diversification requirements on other kinds of debt securities into which MMMFs typically invest.

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<sup>16</sup> These include: U.S. Treasury Obligations, U.S. Agency / GSE Obligations, State of California Obligations, California Local Agency Obligations, Bankers’ Acceptances, Commercial Paper, First Tier Securities, Negotiable Certificates of Deposit, CD Placement Service, Repurchase Agreements, Reverse Repurchase Agreements and Securities, Debt securities issued by corporation or depository institution, Mutual funds and money market mutual funds, Contracts issued by insurance companies, Mortgage and collateral-backed securities, SEC Rule 2a-7 Allowable Investments. *See* Local Agency Investment Guidelines, California Debt & Investment Advisory Commission, at 18 (2008). The Guidelines are available at: [www.treasurer.ca.gov/cdiac/laig/guideline.pdf](http://www.treasurer.ca.gov/cdiac/laig/guideline.pdf).

A. *Restrictions on Investments in Money Market Mutual Funds.*

Government Code Section 53601 establishes some baseline restrictions on local governments' investments in money market funds. With regard to quality, the code requires that the fund meet either of the following criteria:

- The fund has received the highest rating from at least two NRSROs; or<sup>17</sup>
- The fund has retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of five hundred million dollars (\$500,000,000).<sup>18</sup>

The Government Code also imposes a diversification requirement by prohibiting local governments from investing more than 10 percent of their portfolio in any single mutual fund.<sup>19</sup>

Our review of the short-term investment policies from several local governments found that the policies were moderately more demanding than state law required. Only the City of Sunnyvale added additional quality restrictions. The City requires that MMMFs meet both the NRSRO ratings requirement and the experienced management requirement of state law. Sunnyvale also limits itself to MMMFs that invest only in US Treasury and federal agency securities and in repurchase agreements backed by US Treasury and federal agency securities. But Sunnyvale limits investment in MMMFs to

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<sup>17</sup> Note that the scale that rating organizations use to rate MMMFs differs from the scale they use to rate short-term securities. The highest rating categories for the three largest NRSROs are as follows: Moody's – Aaa (“best quality” and “similar to Aaa-rated fixed income obligations”); Fitch – AAA (“highest credit quality” and “lowest expectation of credit risk”) or V-1+ (“Funds rated 'V-1+' are considered to have the lowest market risk. The rating is assigned only to money market funds or local government investment pools that should not experience loss of principal value to shareholders or participants even in severely adverse interest rate environments”); and S&P – AAAM (“A fund rated 'AAAM' has extremely strong capacity to maintain principal stability and to limit exposure to principal losses due to credit, market and/or liquidity risks”)

<sup>18</sup> Government Code § 53601.7(e)(10).

<sup>19</sup> Government Code § 53601.7(c)(3).

10% of total funds, so that at least 90% of its funds will be placed in other kinds of investments, including commercial paper, corporate notes, asset-backed securities, etc.

Most of the local government investment policies we reviewed included diversification requirements that went beyond those mandated by state law. Besides limiting the share of funds that could be invested in any single MMMF, some also limited the share of funds that could be invested in all MMMFs collectively.

The University of California System, which is not subject to the restrictions of Government Code Section 53601, takes a much different approach to quality and diversification with regard to MMMFs in its Short-Term Investment Pool. The University does not require that MMMFs be rated by NRSROs or be managed by someone with a particular experience level in order to be eligible for investment. Indeed, it does not directly address MMMF quality at all. With regard to diversification, the University adopts a broad principle that “the Program’s investments will be appropriately diversified to control overall risk.” Accordingly, at least in theory, all of the University’s assets could be placed in a single MMMF, provided the fund’s investments were sufficiently diversified to meet this principle and the investments met the other restrictions in the University’s Short-Term Investment Pool policy.

In sum, the investment policies we reviewed generally were not concerned with the quality of the investments found in MMMFs, provided that the fund was highly rated or run by experienced management. Some imposed diversification requirements that opted for use of a variety of investment vehicles over exclusive use of MMMFs. Others did not. The table below summarizes our findings with regard to investment policy restrictions on MMMFs.

<b>Investment Policy Restrictions on MMMFs</b>					
	Los Angeles County	Sonoma County	County of Santa Cruz	City of Sunnyvale	Univ. of Calif.
<b>Quality Restrictions</b>					
Fund received the highest possible rating by 2 NRSROs. <sup>20</sup>	✓	✓	✓	✓	
Fund is managed by a SEC Registered Advisor with at least 5 years of experience and with assets under management in excess of \$500 million. <sup>24</sup>	✓	✓	✓	✓	
Fund invests only in US Treasury and federal agency securities, and in repurchase agreements backed by US Treasury and federal agency securities				✓	
<b>Diversification Requirements</b>					
Maximum percent of portfolio that may be invested in any single MMMF	10%	10%	10%	10%	Must be “appropriately diversified”
Maximum percent of portfolio that may be invested in all MMMFs collectively.	15%	No Limit	20%	10%	Must be “appropriately diversified”

B. *Restrictions on other kinds of debt securities into which MMMFs typically invest.*

As indicated, the county, city and university investment policies we reviewed regulate a wide range of investments, well beyond investments in MMMFs. These include direct investments in such things as commercial paper, corporate notes, and asset-backed securities. Although IOLTA funds cannot be placed in such investments directly,

<sup>20</sup> Note: Los Angeles, Sonoma and Santa Cruz Counties provide that an MMMF must satisfy either the NRSRO rating requirement or the experienced fund manager requirement. The City of Sunnyvale requires that both be satisfied.

we nonetheless reviewed the restrictions that policies impose on such investments for insight into the rating and diversification requirements.

The table below summarizes our findings with regard to ratings requirements. Two points stand out from this table. First, while the investment policies generally steer funds into high quality investments, they may not be of as high quality as ordinarily found in MMMFs. For example, commercial paper need only receive the highest rating from one NRSRO under the policies we reviewed to be deemed an eligible investment. It would remain eligible even if another NRSRO gave that same commercial paper its third-highest rating. However, under SEC regulations, that commercial paper would lose its status as a First Tier or Second Tier security due to the NRSRO's third-highest rating, making it ineligible for investment by a MMMF.

Second, many of the policies drop the convention of using the generic term "NRSRO," and refer instead to the top three rating agencies by name. This makes administration of the policy easier, as an analyst need only consult three of the seven NRSROs. However, for IOLTA purposes, such a limitation may exclude otherwise eligible MMMFs that have not been rated by Moody's, Fitch or S&P, but have been rated by one of the other NRSROs. Accordingly, we recommend retaining the more generic reference to "NRSRO," rather than following the lead of these other policies.

<b>Rating Requirements in Investment Policies</b>					
	<b>Los Angeles County</b>	<b>Sonoma County</b>	<b>County of Santa Cruz</b>	<b>City of Sunnyvale</b>	<b>Univ. of Calif.</b>
<b>U.S. Government Securities</b>					
Treasury & Agency Securities	None	None	None	None	None
Government Sponsored Enterprise Securities	None	Not Addr'd	None	Not Addr'd	Not Addr'd
<b>Repurchase Agreements</b>					
Repurchase Agreements	None	None	None	None	None
<b>Commercial Paper</b>					
The paper is of "prime" quality of the highest ranking or of the highest letter and number rating as provided for by a NRSRO.	✓			✓	
Commercial paper issuer must maintain an "A-1" rating by S&P, a "P-1" rating by Moody's, or a "F-1" rating by Fitch.		✓	✓		✓
<b>Corporate Notes</b>					
Rating of Issuer	A-1 by S&P or P-1 by Moody's	None	None	None	None
Rating of Notes	At least A by S&P and Moody's	At least A by S&P and Moody's	At least AA by S&P and Moody's	At least AA by S&P and Moody's	Average A
<b>Asset-Backed Securities / Collateralized Mortgage Obligations</b>					
Rating of Issuer	At least A	None	N/A <sup>21</sup>	None	None
Rating of Securities	At least AA	At least AA	N/A	At least AA	Average A

In addition to ratings, we also looked at diversification requirements. The table below summarizes our findings. Again, two points stand out. First, most policies allow for a greater concentration of funds in the hands of a single issuer than is allowed under SEC regulations applicable to MMMFs. Except for U.S. Government Securities, MMMFs are generally limited to investing 5 percent of total assets in the securities of a

<sup>21</sup> Sonoma County does not invest in these securities.

single issuer, and 1 percent of assets in the Second Tier securities of a single issuer. By contrast, many of the investment policies we reviewed allow 10 percent of assets to be invested in the securities of a single issuer. The University of California stands out for generally limiting investments to 3 percent of assets in the securities of a single issuer.

<b>Investment Concentration Restrictions in Investment Policies</b>					
	<b>Los Angeles County</b>	<b>Sonoma County</b>	<b>County of Santa Cruz</b>	<b>City of Sunnyvale</b>	<b>Univ. of Calif.</b>
<b>U.S. Government Securities</b>					
Limit Per Issuer	None	None	None	None	None
Limit of Total Invested Funds	None	None	None	None	None <sup>22</sup>
<b>Repurchase Agreements</b>					
Limit Per Dealer	\$500 Million	None	None	None	3%
Limit of Total Invested Funds	\$1 Billion	None	None	10%	None
<b>Commercial Paper</b>					
Limit Per Issuer	10%	10%	10%	5%	5%
Limit of Total Invested Funds	40%	None	40%	15%	None
<b>Corporate Notes</b>					
Limit Per Issuer	Varies <sup>23</sup>	None	10%	5%	3%
Limit of Total Invested Funds	30%	30%	30%	30%	None
<b>Asset-Backed Securities / Collateralized Mortgage Obligations</b>					
Limit Per Issuer	Varies	10%	Not Allowed	5%	3%
Limit of Total Invested Funds	20%	20%	Not Allowed	20%	None

Second, investment policies include categorical diversification requirements not typically found in MMMFs. SEC rules do not tell fund managers, for example, the percent of commercial paper that may be included in a fund. Rather, the SEC relies on fund managers' judgment and experience, and the regulatory mandate to maintain a

<sup>22</sup> The University of California policy does not set a fixed limit on the percent of total funds that may be invested in a particular kind of investment. The policy declares that its portfolio should be "appropriately diversified to control overall risk."

<sup>23</sup> Los Angeles places a dollar value limit on the amount that may be invested in corporate notes and asset-backed securities which varies based on how the notes / securities are rated.

stable net asset value, to determine an appropriate allocation of assets across investment policies.

## V. Policy Recommendations

We drew on the policies and investment frameworks outlined above to draft a policy for the Commission’s consideration. Following is a point-by-point explanation of the provisions included in the proposed policy. At the end of this memo you will find a complete, “clean” copy of the proposed policy.

<b>Proposed Policy Provision</b>	<b>Rationale</b>
<p>A sweep account at an eligible institution will be deemed to satisfy the requirements of Business &amp; Professions Code § 6213(j) if it sweeps funds to an open-end money-money market fund that, on the date of review, satisfies all of the criteria from either Group A or Group B below</p>	<p><i>If either set of criteria is satisfied, then the sweep product can be considered in the IOLTA rate comparability analysis.</i></p>
<p><u>Group A</u></p> <ol style="list-style-type: none"> <li>(1) The fund holds itself out as a “money-market fund” as that term is defined by federal statutes and regulations under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.); and</li> <li>(2) The fund has total assets of at least two hundred fifty million dollars (\$250,000,000).</li> <li>(3) The fund is invested solely in any or all of the following:               <ol style="list-style-type: none"> <li>a. United States Government Securities;</li> <li>b. Securities of any Government Sponsored Enterprise;</li> <li>c. Repurchase agreements that are fully collateralized by United States Government Securities or securities of any Government Sponsored Enterprise.</li> </ol> </li> </ol>	<p><i>These requirements are drawn directly from Business and Professions Code § 6213(j) and incorporate the definition of “comparably conservative” in Title 2, Division 5, Rule 2.100(c) of the Rules of the State Bar of California to include GSE securities.</i></p>

Proposed Policy Provision	Rationale
<p><u>Group B</u></p> <p>(1) The fund holds itself out as a “money-market fund” as that term is defined by federal statutes and regulations under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.); and</p> <p>(2) The fund has total assets of at least two hundred fifty million dollars (\$250,000,000).</p>	<p><i>These first two provisions are the same as the first two provisions from Group A, above.</i></p>
<p>(3) At least 90 percent of the total assets of the fund are invested solely in any or all of the following:</p> <ul style="list-style-type: none"> <li>a. United States Government Securities;</li> <li>b. Securities of any Government Sponsored Enterprise;</li> <li>c. Repurchase agreements that are fully collateralized by United States Government Securities or securities of any Government Sponsored Enterprise.</li> </ul>	<p><i>This provision ensures that substantially all of the assets of a MMMF will be in U.S. Government Securities or GSE Securities. This requirement helps ensure that the MMMF that satisfies these “Group B” requirements is as protective of client funds as the MMMF that satisfies the “Group A” requirements. Even at 90%, the standard far exceeds any requirement found in the investment policies we reviewed. None of the policies required any investment in U.S. Government Securities. Even the City of Sunnyvale, which limits investments in MMMFs to those that invest exclusively in U.S. Treasury Securities, nonetheless caps investment in MMMFs to 10% of all invested funds. Accordingly, at least 90% of its funds will be invested otherwise. Moreover, as there is not requirement that Sunnyvale invest in MMMFs at all, 100% of its investments could be in something other than U.S. Government Securities.</i></p>
<p>(4) Any assets that are not invested as provided in Group B, Criterion 3 are invested as follows:</p> <ul style="list-style-type: none"> <li>a. The assets are invested in “First Tier” securities as defined in Securities and Exchange Commission Rule 2a-7 under the Investment Company Act of 1940, 17 CFR sec. 270.2a-7.</li> </ul>	<p><i>This provision builds on the safeguards ordinarily incorporated into MMMFs, and makes them stronger. By restricting IOLTA funds to MMMFs that invest only in First Tier securities, the policy achieves a level of security that is “similar to the safety of U.S. Treasury-only money market funds,” according to the Investment Company Institute.</i></p>

Proposed Policy Provision	Rationale
<p>b. No more than 3 percent of the fund's assets are invested in the securities of any single issuer.</p>	<p><i>This provision ensures some additional diversity in the portion of the MMMF that is not invested in U.S. Government Securities. MMMFs generally cannot place more than 5% of assets in the securities of a single issuer (excluding government securities). At 3%, therefore, the policy is even more demanding than what the SEC requires of MMMFs, and in line with the restriction imposed under the University of California Policy. This should enhance the security of funds placed in the MMMF, but may also have the consequence of eliminating some "safe" funds from consideration. The Committee may wish to discuss whether this requirement is necessary, or if other criteria in the policy adequately address it.</i></p>
<p>(5) The fund has received a rating in the highest rating category from at least one nationally recognized statistical rating organization or the fund has retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of five hundred million dollars (\$500,000,000).</p>	<p><i>Top ratings by these NRSROs, or satisfaction of the alternative criteria (which are drawn from Government Code Section 53601) are intended to ensure that the fund is under strong management.</i></p>

**VI. Conclusion**

We hope this memorandum and the attached draft policy are useful to the Committee as it discusses the proper interpretation of the “comparably conservative” language in Business and Professions Code § 6213(j)(3). We look forward to discussing this matter further with the Committee.

**Appendix 1**

<b>Top 2 Rating Categories by Largest NRSROs</b>			
<b>NRSRO</b>	<b>Fitch<sup>24</sup></b>	<b>Moody's<sup>25</sup></b>	<b>S&amp;P<sup>26</sup></b>
<b>Highest Category</b>	<ul style="list-style-type: none"> <li>• <b>F1+ or F1</b> – “Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments; may have an added “+” to denote any exceptionally strong credit feature.”</li> </ul>	<ul style="list-style-type: none"> <li>• <b>P-1</b> – “Issuers (or supporting institutions) rated Prime-1 have a superior ability to repay short-term debt obligations.”</li> <li>• <b>MIG-1</b> – “This designation denotes superior credit quality. Excellent protection is afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.”</li> </ul>	<ul style="list-style-type: none"> <li>• <b>A-1+, A-1</b> – “A short-term obligation rated 'A-1' is rated in the highest category by Standard &amp; Poor's. The obligor's capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligations are designated with a plus sign (+). This indicates that the obligor's capacity to meet its financial commitment on these obligations is extremely strong.”</li> <li>• <b>SP-1+ or SP-1</b> – “Strong capacity to pay principal and interest. An issue determined to possess a very strong capacity to pay debt service is given a plus (+) designation.”</li> </ul>
<b>2<sup>nd</sup> Highest Category</b>	<p><b>F2</b> – “Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings”</p>	<ul style="list-style-type: none"> <li>• <b>P-2</b> – “Issuers (or supporting institutions) rated Prime-2 have a strong ability to repay short-term debt obligations.”</li> <li>• <b>MIG-2</b> – “This designation denotes strong credit quality. Margins of protection are ample, although not as large as in the preceding group.”</li> </ul>	<ul style="list-style-type: none"> <li>• <b>A-2</b> – “A short-term obligation rated 'A-2' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rating categories. However, the obligor's capacity to meet its financial commitment on the obligation is satisfactory.”</li> <li>• <b>SP-2</b> – “Satisfactory capacity to pay principal and interest, with some vulnerability to adverse financial and economic changes over the term of the notes.”</li> </ul>

<sup>24</sup> Fitch’s ratings definitions are available at: <http://www.fitchratings.com>

<sup>25</sup> Moody’s ratings definitions are available at: <http://www.moodys.com>

<sup>26</sup> S&P’s ratings definitions are available at: <http://www.standardandpoors.com>

**State Bar of California**  
**Legal Services Trust Fund Program**  
**Money Market Mutual Fund Review Policy**  
DRAFT APRIL 18, 2008

**I. Scope**

This policy governs the Legal Services Trust Fund Commission's review of certain sweep accounts at **eligible institutions** for purposes of IOLTA interest rate comparability analysis. Specifically, it applies to the determination of whether a sweep account that sweeps funds into a money market mutual fund satisfies the requirements of Business & Professions Code § 6213(j).

**II. Authority**

The Legal Services Trust Fund Commission administers provisions of law governing lawyers' interest-bearing trust fund accounts pursuant to authority conferred by Rule 4 of the State Bar of California Board of Governors Rules Regulating Interest-Bearing Trust Fund Accounts for the Provision of Legal Services, as amended January 12, 2008. The provisions of law that the Commission administers include, without limitation, Business & Professions Code Sections 6091.2, 6210, 6211, 6212 and 6213, Rule of Professional Conduct 4-100, the Rules of the State Bar of California, Title 2, Division 5, and the State Bar of California Board of Governors Rules Regulating Interest-Bearing Trust Fund Accounts for the Provision of Legal Services. This policy is adopted to facilitate the Commission's duties under these provisions.

**III. Suitable and Authorized Investments**

A sweep account at an eligible institution will be deemed to satisfy the requirements of Business & Professions Code § 6213(j) if it sweeps funds to an open-end money-market fund that, on the date of review, satisfies all of the criteria from either Group A or Group B below:

Group A

- (1) The fund holds itself out as a "money-market fund" as that term is defined by federal statutes and regulations under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.); and
- (2) The fund has total assets of at least two hundred fifty million dollars (\$250,000,000).
- (3) The fund is invested solely in any or all of the following:
  - d. United States Government Securities;
  - e. Securities of any Government Sponsored Enterprise;
  - f. Repurchase agreements that are fully collateralized by United States Government Securities or securities of any Government Sponsored Enterprise.

Group B

- (1) The fund holds itself out as a “money-market fund” as that term is defined by federal statutes and regulations under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.); and
- (2) The fund has total assets of at least two hundred fifty million dollars (\$250,000,000).
- (3) At least 90 percent of the total assets of the fund are invested solely in any or all of the following:
  - a. United States Government Securities;
  - b. Securities of any Government Sponsored Enterprise;
  - c. Repurchase agreements that are fully collateralized by United States Government Securities or securities of any Government Sponsored Enterprise.
- (4) Any assets that are not invested as provided in Group B, Criterion 3 are invested as follows:
  - d. The assets are invested in “First Tier” securities as defined in Securities and Exchange Commission Rule 2a-7 under the Investment Company Act of 1940, 17 CFR sec. 270.2a-7.
  - e. No more than 3 percent of the fund’s assets are invested in the securities of any single issuer.
- (5) The fund has received a rating in the highest rating category from at least one nationally recognized statistical rating organization, or the fund has retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of five hundred million dollars (\$500,000,000).

This policy will be reviewed regularly and revised as necessary based on changes in the market or recommended standards.