

AGENDA ITEM

JULY 163

Legal Services Trust Fund:
Policy on “comparably
conservative” IOLTA Accounts –
Proposed Approval

DATE: June 17, 2008

TO: Members, Board Committee on Stakeholder Relations
Members, Board of Governors

FROM: Legal Services Trust Fund Commission
Stephanie Choy, Managing Director
Legal Services Trust Fund Program

SUBJECT: Policy to Govern Determination of When Money-Market Funds are “Comparably Conservative” to those that Invest Solely in U.S. Government Securities under Business and Professions Code Section 6211

EXECUTIVE SUMMARY

Business & Professions Code Section 6210 et seq. requires that attorneys hold their Interest on Lawyers’ Trust Accounts (IOLTA) at financial institutions that provide the same interest or dividends on those accounts as they provide on the highest-paying, non-IOLTA banking products for which accounts qualify. B&P Code Section 6213(j) specifies that accounts may be held in interest-bearing checking accounts, or “an investment sweep product that is a daily (overnight) financial institution repurchase agreement or an open-end money-market fund.” The statute further provides that “An open-end money-market fund shall be invested solely in United States Government Securities or repurchase agreements fully collateralized by United States Government Securities **or other comparably conservative debt securities.** . . .” (emphasis added)

The Legal Services Trust Fund Commission proposes that the Board of Governors adopt the attached policy to provide the Legal Services Trust Fund staff and commission with a uniform and consistently conservative basis for determining the eligibility of money-market funds that are not invested solely in United States Government Securities, but are invested in “comparably conservative” debt securities.

Questions regarding this agenda item should be directed to Stephanie Choy, Managing Director, Legal Services Trust Fund Program (415) 538-2249.

I. Background

Since the 1980's, Business and Professions Code Sections 6210 et seq. [Funds for Provision of Legal Services to Indigent Persons] has required that trust funds held in trust by California attorneys be held in interest bearing trust accounts; that the interest be paid by the financial institution holding the funds over to the State Bar; and that the State Bar distribute those funds to "qualified legal services" providers through a statutorily defined grant program. The State Bar's Legal Services Trust Fund Commission and Trust Fund Program staff administer this program for the State Bar and its Board of Governors.

Last year, the Legislature amended the statute regulating Interest on Lawyers' Trust Accounts (IOLTA) effective January 1, 2008. *B&P Code §§6091.2, 6211-6213, added Cal. Stats. 2007, Ch. 422.* (Attachment 1) The amended statute provides that an attorney's IOLTA account should earn no less than the interest rate or dividend generally available to non-IOLTA depositors at the same institution when the IOLTA account meets or exceeds the same minimum balance or other account eligibility requirements.

B&P Code Section 6213(j) specifies that accounts may be held in an interest-bearing checking account, or "investment sweep product that is a daily (overnight) financial institution repurchase agreement or an open-end money-market fund." The statute further provides that,

A daily financial institution repurchase agreement shall be fully collateralized by United States Government Securities or other comparably conservative debt securities, and may be established only with any eligible institution that is "well-capitalized" or "adequately capitalized" as those terms are defined by applicable federal statutes and regulations. **An open-end money-market fund shall be invested solely in United States Government Securities or repurchase agreements fully collateralized by United States Government Securities or other comparably conservative debt securities**, shall 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. Sec.80a-1 et seq.), and, at the time of the investment, shall have total assets of at least two hundred fifty million dollars (\$250,000,000). (emphasis added)

The Legal Services Trust Fund Program (LSTFP) is charged with administering the IOLTA program, assisting both attorneys and financial institutions with complying with the statute. In the months since the statute went into effect, the LSTFP has qualified almost 300 institutions that hold IOLTA, including approximately 15 banks that offer¹ rates comparable to sweep products that link to daily overnight financial institution repurchase agreements or open-end money-market funds (MMF).

IOLTA-eligible banks that offer investment sweep products offer a range of sweep products that include MMFs that are often identified and marketed as "U.S. Government Money-Market Funds," or "Treasury Funds," or something similar. These funds **usually** are invested **solely** in United States Government Securities or repurchase agreements fully collateralized by United States Government Securities."

¹ Institutions may establish qualifying IOLTA in sweep products but more often these institutions "emulate" or copy the rates and fees of the investment sweep products rather than actually moving the IOLTA funds from the interest-bearing checking account into those sweep products.

The *Code of Federal Regulations Sec. 270.35d-1* governing how these investments are identified and marketed to investors provides that when a fund that has a name that suggests to the investing public that the fund has a particular fund focus, the fund administrators must have “adopted a policy to invest, under normal circumstances, at least 80% of the value of its Assets in the particular type of investments, or in investments in the particular industry or industries, suggested by the Fund’s name.”

In accordance with this 80% rule, a MMF must include disclosures advising investors of the possibility that up to 20% of the securities held in the fund may be invested in securities that do not conform strictly to the investments identified in the fund’s name, but which are nevertheless consistent with the MMF’s investment goals of safety and liquidity.

In this way, the MMF reserves for itself the right to invest up to 20% of fund assets in investments that are not fully collateralized by the United States Government while continuing to advise investors that the fund is a U.S. Government Security or Treasury fund. In actual practice, based on the Trust Fund Commission’s research, these funds do not generally utilize this 20% option and in fact do invest completely in U.S.-backed securities. Occasionally, a small percentage of these funds – between 1.7% and 7% -- appear to be invested in other securities, but not to the full 20% that is allowed under the governing regulations.

Due to the fact that the federal regulations governing funds identifying themselves as being invested in U.S. Securities allow 20% of the fund to be invested otherwise, and the fact that the recently adopted IOLTA regulations allow IOLTA to be invested in “**other comparably conservative debt securities,**” the LSTFC consulted with the Resource for Great Programs (“the Resource”) for their assistance in crafting a policy to provide the Legal Services Trust Fund staff and Commission with a uniform and consistently conservative basis for determining the eligibility of Money-Market Funds that are not invested solely in United States Government Securities.

Attached is a memorandum from the Resource discussing the issues (Attachment 2), and outlining a framework for policy recommendations. The Legal Services Trust Fund Yield Increase Committee has been working with the Resource, and based on their recommendations proposes adoption of the policy which is attached as Attachment 3.

The Legal Services Trust Fund Commission through its Yield Increase Committee will consider this policy at the Commission’s June 27, 2008 meeting. Assuming it is approved by the Commission, the policy will be before the Board Committee on Stakeholder Relations and the Board for approval at the July meetings.

II. Bases for Resource for Great Program’s Policy Recommendation

The Resource first reviewed the structural features of MMFs that make them conservative investments by nature. In doing so, they looked at industry standards for defining what is “comparably conservative” to U.S. government securities. They researched the rules and statutes of other IOLTA programs across the country. They also looked to the policies of government entities, which have an interest to protect public funds similar to the State Bar’s interest to protect client funds. Below is a brief summary of the Resource’s findings. Cites to sources can be found in the Resource Memorandum (Attachment 2).

1. MMFs are structured to be inherently safe

Money-market funds are, by design, conservative investments. Any fund that holds itself out as a MMF must meet the stringent requirements of the United State Securities and Exchange Commission's Rule 2a-7 under the Investment Company Act of 1940. The rule requires MMFs to be managed with the goal of maintaining a stable net asset value and preserving shareholders' investment principal, while allowing for modest dividend income. SEC requirements underpin the safety of MMFs' and their stable net asset value, including through: credit quality (only First Tier or Second Tier investments), diversification (generally no more than 5% of assets in the securities of any one issuer), and maturity requirements (all securities are "short-term").

2. The Investment Company Institute considers MMFs that invest exclusively in First Tier securities to be equivalent in quality and security to MMFs that invest exclusively in U.S. Government Securities

The Investment Company Institute (ICI), a national association of the U.S. investment company industry (with over 9,446 member companies, and with mutual fund member assets of approximately \$10.917 trillion) considers MMFs that invest exclusively in First Tier securities to be equivalent in quality and security to MMFs that invest exclusively in U.S. Government Securities. In comments on amendments to financial responsibility rules for broker-dealers addressed to the U.S. Securities and Exchange Commission in June 2007, the ICI stated:

The Institute recommends that the Commission expand the proposal to include money market funds beyond those that invest solely in U.S. Treasury securities. . . .

Specifically, we recommend expanding the proposal to include money market funds that invest exclusively in "first tier" securities as defined under Rule 2a-7. Under rule 2a-7, a "first tier" security includes a security that has received the highest short-term rating from a nationally recognized statistical rating organization ("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 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." (emphasis added)

While the ICI opines that a MMF exclusively of first tier securities is of the same safety as a MMF invested exclusively in U.S. Treasuries, the policy here proposed does not seek to reach the entire fund portfolio, but only that small portion (less than 20%) of the MMF portfolio that may under the MMF prospectus terms potentially be held in something other than the named investments.

3. Comparison to other state IOLTA programs, and to statutes and policies governing short-term investment of public funds

Most of the early IOLTA comparability rule adopters modeled their rules after Florida, which only provides for funds to be swept into products that are invested in United States government securities. Maine and Arkansas have governing rules that provide that funds may be invested outside of government securities: Maine provides that “substantially all” funds are to be invested in U.S. Government Securities, and Arkansas provides that the fund invest “primarily” in U.S. Treasury Securities. The Ohio rule does not contain any requirement of investments in U.S. government securities, and negotiates on a bank-by-bank basis. None of those States have adopted policies for qualifying products under their rules.

Beyond other IOLTA programs, the Resource looked into the statutes and policies governing local government agencies. Notwithstanding that public sector entities have a paramount goal to maintain fund safety, state law permits those agencies to make short-term investments through a variety of vehicles, such as California obligations, first tier securities, negotiable certificates of deposit, debt securities, etc. – all outside of the relatively safe confines of a MMF.

The Resource’s review of sample local government policies showed a range of possible investments, provided that the investments met diversity requirements and quality standards, as determined in part by nationally recognized statistical rating organizations. The Resource used this information as a framework from which to recommend a policy for the LSTFP – recommending that we strengthen our own quality standard by requiring that the MMF receive the highest category of rating from a nationally recognized statistical rating organization.

III. Recommended Policy

In brief, the Commission recommends approval of a policy (Attachment 3) that adds the following conditions to the statutory requirements set forth in B&P Code Section 6213(j):

- At least 90 percent of the fund is invested in U.S. Government Securities or repurchase agreements fully collateralized by U.S. Government Securities at the time of review;
 - With respect to any funds invested in securities other than U.S. Government Securities or repurchase agreements fully collateralized by U.S. Government Securities:
 - The fund invests only in the highest-quality (“First Tier”) securities; and
 - The MMF has the highest rating category from at least one nationally recognized statistical rating organization (“NRSRO”).

These additional policy requirements build on the safeguards inherent in both the nature of overnight sweeps and in the quality of MMFs, and make the safeguards even stronger. The requirement that the fund be 90% invested in U.S. Government securities is more conservative than regulations that provide that MMF must have adopted a policy to invest, under normal circumstances, at least 80% of the value of its Assets in the particular type of investments suggested by the Fund’s name. By restricting IOLTA funds to MMFs that invest only in First Tier securities, the “up to 10% investments” are held to a level of security that is “similar to the safety of U.S. Treasury-only money market funds,” according to the Investment Company Institute. A top rating by a recognized NRSRO ascertains that the MMF meets industry standards for strong management and low risk.

Note the Commission has revised the Resource's proposed policy for clarity, e.g., deleting the two-pronged Group "A" and "B" approach to qualifying as comparably conservative – Group A is merely a restatement of the B&P Code 6213(j) statutory requirements. Additionally, the Commission recommends diverging from the draft policy attached to the Resource's memorandum, as follows:

- 1) The Resource's draft policy includes a provision that "no more than 3 percent of the fund's assets are invested in the securities of any single issuer." In fact, while the Resource put this additional criteria in its draft policy, it questioned the merits of this additional criteria in its Memorandum, stating "The Committee may wish to discuss whether this requirement is necessary, or if other criteria in the policy adequately address it." (page 17, under "Rationale") The *Investment Company Act of 1940*, 17 CFR Sec. 270.2a-7, with some minor and well-defined exceptions, already prohibits MMF from investing more than 5% of their total assets in any one issuer's securities. Therefore, the Committee feels that adding a stricter 3% criteria in lieu of the existing 5% regulatory limit, is insignificant, particularly weighed against the barriers to monitoring issuer diversity.
- 2) The Resource's draft policy allows as an alternative to the MMF having received the highest rating from one of the nationally recognized statistical rating organizations (NRSRO), that the MMF's manager meet certain minimum requirements. This option tracks Government Code Section 53601 regulating public entities, and would provide the LSTFP with an alternative method of qualifying a fund that is not nationally rated. However, the Commission believes that monitoring the experience level of the investment advisor is too complex to administer and that omitting this option does not reduce and in fact enhances the integrity of the policy.

IV. Conclusion

What constitutes "comparably conservative" debt securities is subject to interpretation, and may indeed change over time depending on available investment vehicles and prevailing industry standards. By adopting the attached policy, the Stakeholders Committee and the Board of Governors will provide uniform and consistent guidelines to the Trust Fund Program to interpret the "comparably conservative" language of the statute.

FISCAL/STAFF IMPACT

This recommendation does not require additional personnel or increased expenses.

BOARD BOOK/ADMINISTRATIVE MANUAL IMPACT

None.

PROPOSED BOARD COMMITTEE RESOLUTION

Should the Board Committee on Stakeholder Relations agree with the above recommendation, the following resolution would be in order:

RESOLVED, that the Board Committee on Stakeholder Relations recommends that the Board of Governors approve adoption of the Legal Services Trust Fund Program Money Market Mutual Fund Review Policy in the form attached.

PROPOSED BOARD RESOLUTION

Should the Board of Governors concur with the recommendation of the Committee on Stakeholder Relations, the following resolution would be in order:

RESOLVED, that, upon recommendation of the Board Committee on Stakeholder Relations, the Board of Governors hereby approves adoption of the Legal Services Trust Fund Program Money Market Mutual Fund Review Policy, in the form attached.

ATTACHMENTS

- Attachment 1: Business & Professions Code Section 6210 et seq.
- Attachment 2: The Resource Memorandum re. Policy to Define Comparably Conservative Money Market Funds
- Attachment 3: Money-Market Fund Review Policy (proposed)