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In the Supreme Court of Florida

Case No. 89,552

THE FLORIDA BAR FOUNDATION,

RE AMENDMENT TO RULES

REGULATING THE FLORIDA BAR

5-1.2(e) IOTA RULE

REPLY BRIEF OF THE FLORIDA BAR FOUNDATION IN SUPPORT OF PETITION TO AMEND RULE 5-1.2(e)

On Petition to the Supreme Court

SUMMARY OF THE RESPONSE IN OPPOSITION TO PETITION

In objecting to the Foundation's Petition, the Respondent states that the IOTA Rule amendment proposed by the Foundation "unreasonably restricts" the investment vehicle into which IOTA account balances may be swept. *Response at 1.* The Respondent also asserts that the Foundation failed to disclose the "serious drawbacks" and "risky features" of daily bank repurchase agreements (REPOS). *Response at 2.* In view of the above, the Respondent requests that the Court delay any action on the Foundation's Petition and direct the Foundation "to more thoroughly investigate alternative investments that would better accomplish the purposes [of its] Petition."

SUMMARY OF THE REPLY ARGUMENT

In seeking approval for use of REPOS, the Foundation did not consider or reject other investment vehicles and makes no comment about the suitability of additional investments for IOTA Funds. The Foundation would not necessarily oppose additional plans to increase IOTA revenue which might be considered by the Court in the future, but urges the Court not to delay the Foundation's current Petition to approve the use of REPOS.

Contrary to the Respondent's broad and general assertions that REPOS are risky, the Foundation believes that REPOS do not,

in practical terms, represent significant risk to client trust funds. The true measure of REPO safety is the health of the issuing financial institution. If the Court felt it necessary and helpful, the Foundation would propose an additional amendment to the IOTA Rule limiting REPOS to those entered into with financial institutions which carry superior capitalization ratings by the Federal Deposit Insurance Corporation.

Without an increase in IOTA revenues, IOTA funding for legal aid, improvements in the administration of justice, and loans and scholarships for law students will be cut significantly as early as September, 1997. Accordingly, the Foundation opposes the Respondent's request that the Court delay action on the Foundation's Petition for use of REPOS in order to study additional investments.

REPLY ARGUMENT

I. THE ISSUE BEFORE THIS COURT IS WHETHER LAWYERS SHOULD HAVE THE OPTION OF INVESTING IOTA FUNDS IN REPOS

In its Petition, the Foundation is proposing that the IOTA Rule be amended to clarify whether lawyers have the option of investing nominal or short-term funds (IOTA Funds) in daily bank repurchase agreements which are not insured, but which are collateralized by U.S. Treasury Notes, Bonds or U.S. Agency debt. In a REPO transaction under the proposed amended IOTA Rule,[1] "The [financial institution] sells government securities to an investor on an overnight basis, with an agreement to buy back those securities the next [business] day at a slightly higher price. The increase in the price is the overnight interest."[2]

Under the Foundation's proposed Voluntary IOTA Sweep Account Program, the Foundation would recruit law firms with IOTA account balances of $30,000.00 or greater to enter into sweep agreements and REPO agreements at their financial institutions. A sweep agreement authorizes the financial institution, at the close of the bank's business day at 2:00 p.m., to electronically transfer

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[1]A REPO transaction is illustrated in Exhibit A.

[2]Bodie, Kane, Marcus, Investments, (Burr Ridge, IL: Irwin, 1989), pp.43-44.

the funds, above a preset target balance, out of the checking account into the REPO (or, unrelated to this Petition, into any other investment selected by the customer). When the bank opens on the next business day, the funds are electronically redeposited into the checking account and any unposted deposits, checks or charges are cleared against the account.

Financial institutions provide this overnight investment method as a service to checking account customers and to compete with money market checking accounts offered by government securities broker-dealers.[3]

A. The IOTA Rule Contemplates Products Other Than Checking Accounts

The IOTA Rule provides only that IOTA funds are held in **financial institutions** which are insured under federal or state laws. *5-1.2(e)(3) Rules Regulating The Florida Bar.* The IOTA Rule also provides that "Higher rates offered by the financial institution to customers whose deposits exceed certain time or quantity minimums may be obtained by a lawyer or law firm on some or all of the deposited funds so long as there is no impairment

[3]Banks make use of a customer's funds in a REPO most often by investing them in repurchase agreements entered into with other banks or government securities broker-dealers. This investment activity takes place, generally in the west coast markets, between the 2:00 p.m. bank closing and the bank's federal reserve deadline at 6:00 p.m. eastern standard time.

of the right to immediately withdraw or transfer principal." 5-12.(e)(4) *Rules Regulating The Florida Bar.*

Based on this "higher rates" language in the IOTA Rule, in January, 1996, the Foundation asked the Professional Ethics Committee of The Florida Bar for an opinion whether IOTA funds could be invested in REPOS under the current IOTA Rule.[4] The Bar's Professional Ethics Committee declined to issue an opinion and, instead, recommended that the Foundation resolve the question by seeking an IOTA Rule amendment from this Court, which is the purpose of this Petition.

B. Lawyers Presently Invest Non-IOTA Funds Without Benefit of Deposit Insurance in Compliance with the Rules Regulating The Florida Bar

The Rules Regulating The Florida Bar permit lawyers to invest large or long-term client trust funds (non-IOTA funds) in uninsured investments for the benefit of clients. *4-1.15(a) Rules Regulating The Florida Bar.* To do so, however, the lawyer must receive advance, written permission from the client. *Ibid.* In the case of IOTA Funds, such client permission is prohibited

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[4]Certificates of deposit and money market checking accounts, both of which are government insured, were rejected by the Foundation as unworkable as a means of increasing interest rates on IOTA Funds. CD's, as term deposits, allow for no transactions during the term. Money market checking accounts carry a transaction limit of three, third-party transactions (checks) per month.

by the Internal Revenue Service.[5]

C. Client Trust Deposits Held in Financial Institution Checking Accounts Are Not Necessarily Fully Insured

Financial institution deposits are insured up to $100,000.00 per depositor.[6] In the case of large loan closings or settlements, individual trust deposits often exceed $100,000.00, resulting in the funds in excess of $100,000.00 being uninsured. Even trust deposits of less than $100,000.00 are not fully insured if the depositor (client) has additional funds on deposit in the same financial institution, and the client's aggregate funds exceed $100,000.00.

II. THE FOUNDATION INTENTIONALLY LIMITED ITS STUDY TO REPOS

The Foundation made a conscious decision to pursue methods for increasing IOTA revenue within the traditional banking

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[5]Internal Revenue Service Ruling 81-209, under which Florida and other states' IOTA programs operate, prohibits clients from vetoing placement or non-placement of their nominal or short-term funds in an IOTA Account. Because clients do not participate in this placement decision, IOTA account interest is taxable to the Foundation and not to the client. For a further discussion of Revenue Ruling 81-209 and the *Assignment of Income Doctrine*, see Donald M. Middlebrooks, "Interest on Trust Accounts Program, Mechanics of its Operation," The Florida Bar Journal (February, 1982), p. 117.

[6]Under 12 U.S.C. § 1821(a)(1)(C) in the case of a lawyer's or law firm's trust account, the insured depositor is the client or third-party owner(s) of the funds and not the lawyer or law firm.

environment. Presently, the Foundation is negotiating with financial institutions: 1) to reduce or eliminate the special handling fee charged IOTA and receive more timely payment of IOTA account interest through improved automation; 2) to eliminate service charges on IOTA accounts in excess of the gross interest earned; and 3) to increase the interest rate on IOTA [checking] accounts. In order to further the chance for success of these negotiations, the Foundation has proposed investing IOTA Funds in the existing bank product of REPOS to increase IOTA revenue, rather than in any non-bank investment products. That decision also was based on several additional factors: 1) the current requirement that lawyers may establish IOTA accounts only at insured financial institutions; 2) the familiarity of the legal community with REPOS; 3) the administrative ease of establishing a REPO at the lawyer's or law firm's own bank; and 4) the Foundation's assumption that REPOS represent less intrusion into the business relationship between the law firm and the bank.

A. The Foundation Makes No Comment on Additional Investment Products

Because the Foundation decided, for the reasons stated above, to seek approval only of REPOS, it did not consider other investment vehicles. Accordingly, the Foundation makes no comment on the suitability of additional investment products for IOTA Funds as proposed by the Respondent.

B. The Foundation does not Oppose Additional Investment Products to Increase IOTA Revenue which might be Approved by the Court

Although the Foundation makes no comment about investments other than REPOS, it is not necessarily opposed to other plans to increase IOTA revenue which might be considered or approved by the Court. However, the Foundation would need guidance from the Court concerning the appropriate role of the Foundation in recruiting law firms to participate in any non-bank investments. In addition, the Foundation would require clarification of it administrative authority for any such additional investments, especially with respect to approval of fees and other charges deducted from earnings on IOTA funds.

C. The Foundation Opposes Delay in Action by the Court on the Use of REPOS for IOTA Funds in order to Study Additional Investment Products

Because of the critical need to increase IOTA revenue and in order to avoid or reduce impending cuts in IOTA funding for legal aid and other IOTA grant programs, the Foundation opposes the Respondent's request that the Court delay action on this Petition. Further, and consistent with its decision to pursue methods for increasing IOTA revenue within the traditional

banking environment, the Foundation does not believe it would be appropriate, at this time, for it to study or propose non-bank, additional investment products for IOTA Funds.

III. REPOS ARE NOT RISKY INVESTMENTS

REPOS are one of the most common forms of overnight investment for financial institution checking account customers.

A. REPOS are Structured to be a Purchase and Sale of Securities

A transaction under a REPO is structured to be a purchase (by the customer) and sale (by the bank) of securities.[7] In the unlikely event of financial institution failure, if the REPO transaction is deemed to be a purchase and sale as the parties intended, then the REPO Agreement would be transferred to the assuming financial institution which would repurchase the securities on the next business day.[8] Or, the buyer would take possession and sell the purchased securities. *12 USC §*

[7]Exhibit B is a representative Master Repurchase Agreement from SunTrust Banks, promulgated by the Public Securities Association and currently in use by the other banks in Florida (Barnett Bank, First Union Bank, NationsBank, Northern Trust, and United National Bank). Exhibit B also includes SunTrust Bank's "investment selection form," incorporated into SunTrust Bank's Master Repurchase Agreement.

[8]"These contracts are exempt from various receivership powers and the collateral for the transactions may be liquidated upon appointment of a receiver absent an immediate and complete transfer to another [financial] institution." *FDIC Statement of Policy, 5113, December 12, 1989.*

1821(e)(8)(A)(i) at their market value.[9]

It is clear that FDIC policy is "intended to provide a 'safe harbor' for bona fide [REPO] transactions conducted by depository institutions" through their treatment as "qualified financial contracts." *FDIC Statement of Policy 5113, December 12, 1989.* However, if a financial institution fails, there is some possibility that the REPO transaction could be deemed a loan. Although REPO agreements pledge the purchased securities to the customer as collateral in the event the REPO transaction is deemed a loan, the theoretical risk is if the security interest is deemed not to have been perfected. If not perfected, then the REPO customer's funds would be an unsecured loan to the financial institution.

However, when the New Hampshire Supreme Court approved its voluntary IOLTA sweep account program in 1995, it relied on state law, which is the same in Florida, that a security interest in an uncertificated security is automatically perfected for 21 days. *See, Fla. Stat. §678.321(2).* Thus, the security interest is perfected for the duration of each daily repurchase

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[9]Master Repurchase Agreements contain a margin maintenance feature providing for the market value of the purchased securities to equal or exceed the cash invested plus interest (repurchase price).

transaction.[10]

B. Respondent's Proposed Safeguards are not Common to Daily Bank REPOS

The safeguards proposed by the Respondent may be common for longer-term or even overnight repurchase agreements individually negotiated between major institutional investors and government securities broker-dealers, and to a lesser degree, with financial institutions. *Response at 4.* However, such safeguards are not common for REPOS. Moreover, the statutory and regulatory safeguards which exist for daily bank REPOS currently provide the same protection as the Respondent's proposed safeguards.[11]

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[10]Even if the state law provision for automatic perfection of a security interest were held not to control, the funds in a REPO transaction are at no greater risk than the uninsured portion of a trust checking account deposit. Both would be deemed unsecured obligations of the failed financial institution and would be treated the same under the Depositor Preference Act. *12 USC §1821(d)(11)(A)*(iii).

[11]The Respondent suggests REPO collateral be held by a third-party custodian. However, in its Statement of Policy on "Overnight Hold-in-Custody Repurchase Transactions" of August 9, 1996, the FDIC acknowledged that "...the operational requirements for a daily sweep repo program currently require institutional control of the underlying securities." The Statement goes on to affirm that financial institutions and government securities broker-dealers, pursuant to 17 CFR §403.5(d), must issue daily confirmations for each REPO transaction. Cited in this affirmance was a 1992 government study which, "...affirmed Treasury's long-standing policy that daily confirmations provide fundamental customer protection in identifying the specific securities transactions that are the subject of the repurchase transactions." Such daily confirmations provide documentation under the automatic 21-day perfection of security interest under Fla. Stat. §678.321(2).

The Respondent also suggests that assurances be granted

C. Eligibility to Enter Into REPOS for IOTA Funds Could be Limited

If the Court felt it necessary and helpful, the Foundation would propose an additional amendment to the IOTA Rule limiting the REPOS into which IOTA funds could be invested to those of financial institutions with the highest collateralization levels as determined by the Federal Deposit Insurance Corporation. We did not propose such a limitation in our original Petition as that action might have been misconstrued as the Foundation's attempt to limit a lawyer or law firm's choice to do business among otherwise eligible financial institutions under the IOTA Rule.

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against cross-collateralization of REPO collateral. Banks already are required to segregate REPO collateral from the bank's assets and must keep the collateral "free from any lien, charge or claim of any third party..." *17 CFR §450.4(a)(1)*.

Finally, the Respondent suggests that in the event the customer is purchasing securities from a client of the bank, that the customer should be prepared to evaluate the credit worthiness of that client. In a typical REPO transaction, the customer either is purchasing securities of the bank or of a government securities broker-dealer for whom the bank is acting as an agent or with whom the bank entered into a REPO. While there is a theoretical risk that the broker-dealer could default, broker-dealers are highly regulated in REPO transactions by the Government Securities Act of 1986. Further, even if a broker-dealer defaulted on the specific REPO transaction, the risk to the REPO customer is not the default, but the overall financial health of the bank and its ability to absorb any such default.

CONCLUSION

The Foundation believes that its proposal for investment of IOTA Funds in REPOS poses no significant risk to the immediate availability of client funds as required under the IOTA Rule. To the extent a risk exists -- a risk predicated on bank failure -- the risk in a REPO is no greater and may be less than the risk to IOTA funds held in trust checking accounts which are routinely in excess of the deposit insurance limit.

The Rules Regulating The Florida Bar currently permit lawyers to invest trust funds for the benefit of clients in uninsured investments with clients' written, advance permission.

If requested by the Court, the Foundation would propose an additional amendment to the IOTA Rule to limit the availability of REPOS to those of financial institutions with superior capitalization as determined by the FDIC.

The Courts of other IOLTA states have approved similar Sweep Account Programs.[12]

The Foundation's proposal for use of REPOS for IOTA Funds is voluntary for lawyers and law firms. As a voluntary plan, the ultimate decision whether or not to invest IOTA funds in REPOS

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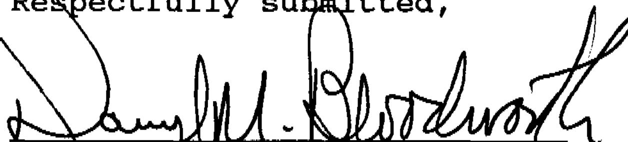
[12]See Exhibit C.

would rest in the sound judgement of the lawyer or law firm acting in a fiduciary capacity.

There is a critical need to increase IOTA revenue in order to avoid or reduce impending cuts in IOTA grants for legal aid, improvements in the administration of justice, and loans and scholarships to law students. In view of this need, the Foundation respectfully urges the Court to approve the proposed IOTA Rule Amendment, and that the Court not delay action on the Foundation's petition solely to study additional investment products for IOTA funds.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing has been furnished by U.S. Mail this 24th day of February, 1997, to the following:

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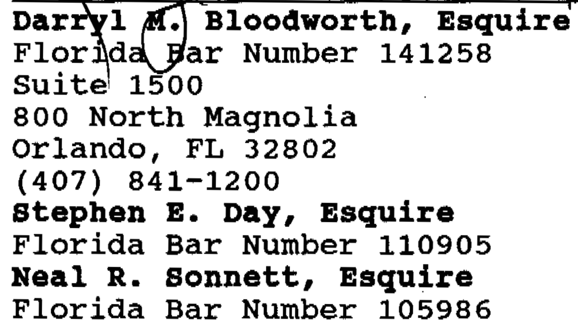

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