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MEMORANDUM

To: Members of the Investment Subcommittee
Cc: Liza Druck Davis, Deputy State Treasurer; Jason Staib, Deputy Attorney General
From: Colleen Davis, State Treasurer
Sent: July 30, 2020
Subject: Investment Guidelines – Potential Changes

BACKGROUND

The Office of the State Treasurer ("OST"), with the assistance of the assigned Deputy Attorney General and NEPC, has conducted an annual review of the Cash Management Policy Board's Investment Guidelines. OST is recommending several changes, a few of which would appear to qualify as "substantive" within the meaning of the Delaware Administrative Procedures Act, 29 Del. C. §§ 10101-10161 (the "APA"). Under the APA, substantive changes to official APA regulations must be adopted pursuant to a formal process that includes a public notice and comment period. If our recommended changes are approved by the full Board, OST will take the steps necessary to ensure that the changes are promulgated in accordance with the APA.

RECOMMENDED CHANGES TO THE INVESTMENT GUIDELINES

1. *Define the term "Merchant Banks."* In 2019, OST, on behalf of the Board, revised the Investment Guidelines to encompass the State's "Settlement Accounts," defined as the demand deposit accounts used to collect State funds resulting from the electronic processing of debit and credit card transaction. The primary purpose of this change was to require "Merchant Banks" to collateralize Settlement Accounts. Due to an oversight, the capitalized term "Merchant Banks" was used but not specifically defined. OST proposes to define this term in § 2.1.6 as "a qualified financial institution approved by the Board to maintain a Settlement Account."

2. *Extend reserve account maturity restrictions by one month*. Under the Investment Guidelines, § 7.2, the maximum maturity for any investment in a reserve account is 10 years. OST proposes to extend that maturity restriction to 10 years and one month to permit reserve account managers to invest in certain longer-dated securities that would otherwise be disqualified because of a technical timing issue.

3. *Clarify that the lowest NRSRO rating controls*. In several instances, the Investment Guidelines require that certain institutions (*e.g.*, banks issuing certificates of deposit) and securities (*e.g.*, corporate debt instruments) be rated by at least two Nationally Recognized

Statistical Rating Organizations ("NRSRO"). OST proposes to clarify that, where two or more NRSRO ratings are required by the Investment Guidelines, the lowest such rating shall control.

4. *Clarify the deadline to remove purchases in violation of the Investment Guidelines and after a downgrade*. The Investment Guidelines presently require managers to remove from their portfolios "as soon as possible" those securities that (a) were purchased in violation of the Investment Guidelines, or (b) cease to qualify as permissible investments as the result of a downgrade. The Investment Guidelines further require managers to report "immediately" any such violation or downgrade and the remedial action taken. This language recently was at issue after the downgrade of certain securities in the Lazard account. OST proposes that the Investment Guidelines, §§ 11.2, 11.3, be changed to require that ineligible securities be sold and OST notified "by the close of the business day following" the date on which the manager learns of the violation or downgrade.

5. *Limit the mutual fund exception to the Investment Guidelines.* The Investment Guidelines, § 11.5, acknowledge that (a) mutual funds can provide lower costs and better diversification than can be obtained with a separately managed fund pursuing the same investment objectives, and (b) such funds normally cannot customize their investment policies to conform to the Investment Guidelines. The Investment Guidelines state that each mutual fund's own investment policy supersedes the Investment Guidelines. The result is that managers - in particular, endowment managers - may purchase and hold mutual fund shares even if the mutual fund (a) owns impermissible investments (*e.g.*, a hedge fund stake), or (b) holds particular categories of permissible investments (*e.g.*, domestic and international equities) in violation of the maximum and maximum percentages set forth in the Investment Guidelines. OST is proposing to include a limit on this exemption that would require an endowment or other manager utilizing a mutual fund to adhere to those specific provisions of the Investment Guidelines that OST, after consultation with the Board's consultant, determines should apply to and govern the account.

A redlined version of the Investment Guidelines incorporating the foregoing proposed changes is attached.