A. INTRODUCTION TO POOLED INVESTMENTS

Pooled investment vehicles include common trust funds and employee benefit collective funds (both generically referred to as collective investment funds), proprietary mutual funds and other pooled investments. Because of their similarities, reference to collective investment funds (CIFs) within this manual will refer to both common trust funds and employee benefit collective funds, unless otherwise noted. Unlike CIFs, proprietary mutual funds are SEC registered securities that can be distributed to a wider variety of investors. Other pooled investments refer to less common or emerging account types such as master deposit accounts and private equity funds.

All pooled investment vehicles are designed to facilitate investment by combining fiduciary funds of various trust department accounts. Although the operation of CIFs runs counter to the accepted common law duty of the trustee not to commingle trust funds, legislation has been passed in every state authorizing banks to establish and administer CIFs.

The administration of pooled investment vehicles must follow principles of prudent management; comply with applicable laws, regulations, and regulatory opinions; and maintain proper documentation, recordkeeping, and accounting. For each type of pooled investment vehicle, proper management entails compliance with specific aspects of the laws and implementing regulations promulgated by Internal Revenue, Securities and Exchange Commission, Office of the Comptroller of the Currency (OCC), Department of Labor (DOL), and ERISA. Any apparent violations of applicable laws and regulations expose the institution to a substantial risk of loss, due to the cost of corrective action including possible regulatory sanctions and penalties. Inadequate management of pooled investment vehicles could also harm the trust clients and create potential liabilities to the trust department and the bank.

As with individual trust accounts, bank management and the trust committee are required by the Statement of Principles of Trust Department Management to provide adequate oversight of pooled investments. At a minimum, management and the trust committee should document the performance of an annual administrative and investment review - including assuring that the funds are administered in accordance with governing law.

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B. COMMON AND COLLECTIVE FUNDS (CIFS)

General Information on CIFs

A CIF is a trust fund maintained by a bank exclusively for the collective investment of assets from several trust accounts administered by a trust department. They are not available to the general investing public. CIFs are sometimes operated on a multiple-bank basis within a bank holding company. In such cases, the largest trust department in the holding company typically makes its CIFs available to fiduciary accounts in smaller, affiliated trust departments (where permitted by the trust instrument, terms of the account, and local law).

Before a particular account purchases a participation in a CIF, it must be determined that the account's governing agreement permits CIFs and that the particular CIF is a suitable investment for the account. The trust committee, or alternatively designated individual or committee, should direct the account's participation in a common trust fund.

Common Trust Fund and Employee Benefit Collective Fund

CIFs are divided into two general categories depending on the types of trust accounts qualified to invest in the CIF and the source of their federal tax exemption.

Common Trust Fund

A common trust fund is a fund that is typically held by personal trust accounts. As these funds obtain exemption from Federal tax under IRC Section 584, they are also referred to as "IRC 584 funds". Additionally, common trust funds are operated under OCC Regulation 9.18(a)(1). For this reason, these funds are many times also referred to as "(a)(1)" funds.

Employee benefit trust accounts are not permitted to be commingled with personal trust accounts in a common trust fund. However, a common trust fund may apply the tax-exemption afforded by IRC Section 584 to the collective investment of employee benefit trust accounts only. This is permissible only as long as all of the accounts invested in the common trust fund are employee benefit trust accounts. In this case, no employee benefit agency accounts or personal trust accounts may be invested in the common trust fund. Due to these restrictions, this application of IRC 584 is rare.

The collective investment of charitable trust accounts is discussed in Subsection H.1, Charitable Trust Usage of Collective Investment Funds.

Employee Benefit Collective Investment Fund

When not used generically, the term collective investment fund is normally applied to funds established for the collective investment of employee benefit trust and agency accounts, as permitted under OCC Regulation 9.18(a)(2). Consequently, employee benefit collective investment funds are sometimes referred to as "(a)(2) funds". These funds generally obtain exemption from Federal tax under IRS Revenue Ruling 81-100, and are also referred to as "RR 81-100 funds".

Under IRC Section 584, no agency accounts, including employee benefit agency accounts, are allowed. Therefore, RR 81-100 is the method employed by most banks operating employee benefit collective investment funds.

Note that operating a CIF for the purpose of managing employee benefit accounts is subject to ERISA “partying-interest" concerns - prohibited transactions. The Department of Labor (DOL) has issued two class exemptions to address this issue. Refer to for information.

Importance of Tax-Exempt Status

If the CIF is operated in conformance with applicable rules and regulations, the CIF qualifies for Federal income tax-exemption. CIFs draw their tax-exempt status from either Section 584 of the Internal Revenue Code or IRS Revenue Ruling (RR) 81-100. Each source of exemption imposes different requirements on the fund, and it is essential that examiners understand the requirements of each and their differences; and how they impact the operations of a given fund.

A bank may request a written opinion from the IRS on whether its CIF qualifies for tax-exempt treatment under the Internal Revenue Code. As in the case of employee benefit plans, there is no IRS requirement that banks apply for a determination of the tax-exempt status of CIFs. However, obtaining this opinion provides assurance that the CIF was drafted in compliance with Federal tax laws, and that it qualifies for tax-exempt treatment.

If a CIF was later found not to qualify for tax-exempt treatment, all CIF capital gains, and ordinary income might become subject to taxation. With respect to personal trust accounts, taxation might occur both at the CIF level and again at the participant level (double taxation). Employee benefit accounts would only experience taxation at the CIF level, since the participating employee benefit plans are themselves exempt from taxation. The loss of favorable tax treatment could cause the bank to incur a liability to the participants in a collective investment fund, whose proportional interests in the fund are directly impacted by any loss in value due to the loss of a fund's tax-exempt status.

IRC Section 584 and RR 81-100 are discussed in Subsection C - CIF Tax-Exempt Status - IRC Section 584 and IRS Revenue Ruling 81-100.

Importance of Securities Law Exemptions

CIFs are exempt from securities registration and regulation as a security and as a mutual fund only when operated in compliance with specific exemptions under Federal securities laws. Funds operated without the benefit of these exemptions must register under the Securities Act of 1933, and operate as mutual funds, under the Investment Company Act of 1940. With the repeal of Section 20 of the Banking Act of 1933, banks now have more flexibility in underwriting and operating mutual funds. The increased flexibility comes from the Gramm-Leach-Bliley Act of 1999, which is explained in Subsection K Proprietary Mutual Funds. To understand the nuances of the exemption one must ensure that the concept of "bona fide fiduciary" as interpreted by the SEC is followed. Subsection D - Registration under Securities Acts provides more information.

"Bona Fide Fiduciary" Rule

CIFs are established by banks to facilitate the administration of accounts held under "bona fide fiduciary" appointments (as defined under Federal securities laws). CIFs operating rules strictly limit fund participation to "bona fide fiduciary" appointments, and employee benefit trust and agency accounts. A bank's CIF investment expertise cannot be offered either to personal agency accounts or to non-trust department customers.

"Bona fide fiduciary" appointments have been interpreted by the SEC under Federal securities laws to be limited to the traditional "personal trust" appointments of trustee, executor, administrator, guardian, and Custodian under a Uniform Gift to Minors Act. The SEC holds that the exercise of trust powers must involve duties beyond those that are merely incidental to money management. Examples of accounts involving such incidental money management include investment agency relationships, IRA accounts , and mini-trusts. The absence of a genuine underlying fiduciary purpose has consistently been interpreted, by the SEC, as falling outside the confines of a trust relationship. Further, the staff of the SEC has repeatedly ruled that so called mini-trusts established under standardized, revocable, or minimum asset level contracts, constitute little more than investment management agency accounts (refer to the SEC interpretive letter in Appendix G). Therefore, these types of accounts are not permitted to participate in a bank collective investment fund.

The sole exception to the "bona fide fiduciary" rule applies to CIFs operated for employee benefit accounts. In these situations (discussed later in this section) banks are permitted to invest funds held as trustee or agent in CIFs.

OCC Regulation 9.18 Requirements

OCC Regulation Section 9.18 provides the regulatory requirements for the operation of common and collective investment funds. Refer to Subsection E - OCC Regulation 9.18 and Appendix G for further information. Although not an FDIC regulation, state nonmember banks operating CIFs granted tax-exempt status pursuant to IRC Section 584, must comply with Regulation 9.18, because Section 584 requires compliance with this regulation. Compliance with Regulation 9.18 is not required for funds operated by FDIC regulated state nonmember banks which do not rely on IRC 584 for tax exemption (typically employee benefit collective investment funds receiving tax-exemption under RR 81-100). However, State Law and general standards of practice make OCC Regulation 9.18 or other similar guidelines applicable to RR 81-100 funds as well. Many states have promulgated laws regarding CIFs. Due primarily to the need to comply with Federal securities and tax laws, State laws are generally similar to Regulation 9.18.

OCC Regulation 9.18 covers the written plan, fund management including use of outside adviser, fund valuation, admission and withdrawal, audit and financial reports, and self-dealing/conflicts of interest among other things.

Basic Terms and Accounting Concepts

- Plan - The governing instrument of a fund. This is in effect a trust agreement and is often entitled a declaration of trust or a group trust.
- Units - Units represent investments in a CIF and, like shares of a mutual fund, units represent a proportional ownership interest in all the investments held by the fund.
- Participants - Individual accounts investing in the fund are called participants.
- Valuation Date - The CIF valuation date is set by the Plan. It can vary from daily to quarterly, but it cannot be less frequently than quarterly (for CIFs maintained for personal trust accounts). Participants may only gain admission to (purchase units) and withdrawal (sell units) from a CIF on or before a CIFs valuation date.
- Principal value of a unit - This is the amount a participant pays or receives when investing in or selling a unit of a CIF. The principal value of a unit is determined by dividing the total number of CIF units into the CIFs total market value on a valuation date.
- Income value of a unit - This is the amount of income accrued by each unit during a valuation period. Methods used for calculating both the principal value and income value of each unit must be outlined in each CIFs plan.
- Fund and Participant Accounting Systems - Trust departments operating CIFs must operate two parallel accounting systems for each CIF. First, each CIF portfolio must have an adequate "fund accounting system" operated on an accrual method of accounting, reflecting the CIFs securities transactions and income earned. Secondly, all participants in each CIF must have a "participant accounting system" to reflect each participant's holdings in the CIF, (including: the number of units bought

and sold, original cost per unit, all capital gains and losses per unit, balance of units held, income earned and distributed per unit, etc.).

Benefits and Limitations of CIFs to Fund Participants and to the Bank

Benefits of CIFs to participants and bank include:

- CIFs offer the advantage of investment diversification, which is often difficult to achieve when investing small amounts of fiduciary funds individually.
- Smaller accounts benefit because they are able to regularly invest in CIF units that typically do not require large outlays of cash. This improves the diversification of their account and reduces uninvested cash balances.
- Given the size of the transactions, it is more efficient for the trustee to make and supervise investments for CIFs.
- CIFs allow management to concentrate investment decision-making and research efforts by permitting it to manage fewer, but larger, portfolios.
- CIF securities transaction costs and brokerage commissions are reduced, since larger purchases and sales can be effected more economically. Also, to the extent a participant invests in a CIF, securities commissions are eliminated, because no fees or charges may be assessed on the purchase or sale of CIF units under OCC Regulation 9.18.

Limitations of CIFs for the participants include:

- Adverse tax consequences can arise when unrealized capital gains are allowed to accumulate in the fund. New participants become subject to the taxable treatment of unrealized gains when they enter the fund. All capital gains are passed through for tax purposes to the participants in a fund during the taxable period in which the gains are realized. The passthrough applies to new participants, whether or not they experience any appreciation in their units.
- Participating accounts are faced with reduced liquidity. Since participants may only withdraw from a fund as of a valuation date, this could be as infrequent as monthly or quarterly, participants may experience liquidity problems arising from the inability to sell CIF units.
- The inability to divest of CIF units except at valuation dates may inadvertently "lock in" all participants during a period of falling prices. The longer the interval between valuation dates, the greater the potential impact on all participants.

Limitations of CIFs for the bank include:

- Most of the costs involved in establishing a common trust fund must be borne by the bank, including legal fees for drafting the original agreement and any subsequent modifications, and any reorganization expenses.
- Banks also experience greater pressure on fund performance, as the CIFs performance results are easily compared with performance attained by various industry benchmarks or outside mutual funds with similar investment objectives.

Typical Fund Categories

CIFs must be maintained by the type of qualifying accounts (personal trust accounts vs. employee benefit trust and agency accounts), as well as for the fund objective, such as fixed income or equity. The following are the more common types of CIFs which may be found in a trust department:

- Equity Fund - These funds usually consist primarily, or wholly, of common stocks. They are designed to achieve market appreciation while producing some current income.
- Diversified or Balanced Fund - Typically, such funds have a balance of equity and fixed income securities providing asset diversification by asset type. Such funds seek capital appreciation with a regular stream of income.
- Fixed Income Fund - Portfolios of these funds are composed predominately, or wholly, of bonds, preferred stocks, mortgages, and other assets from which the income return is fixed.
- Municipal Bond or Tax-Exempt Bond Fund - These CIFs are comprised of state and municipal obligations which provide income exempt from both Federal and State taxes for residents of the state issuing the securities.
- Real Estate Investment Fund - Portfolios of these funds are invested primarily in real estate.
- Mortgage Fund - These funds consist predominately of mortgages.

- Short Term Investment Fund (STIF) - These funds are CIF equivalents to a money market mutual fund. They are established for the temporary investment of trust cash. Their primary objective is to provide high liquidity and a continuous stream of income at current rates of return. OCC Regulation 9.18(b)(4), "Valuation" in subsection E.7, contains specific requirements for proper STIF administration.
- Covered Call Option Fund - These funds permit the writing of covered call options. Refer to subsection F.2. Specialty CIFs for information on OCC guidance.
- Foreign Securities Investment Fund - These CIFs are primarily composed of foreign securities. They may consist predominately of equities or fixed income investments or may be structured as balanced funds. Subsection F.2. Specialty CIFs contains information on OCC regulatory requirements, including interpretations regarding the use of Foreign Securities Investment Funds by ERISA accounts.
- Index Fund - These funds are invested in securities tied to a particular securities index, such as Standard & Poor's, the New York Stock Exchange Index, or the Dow Jones Industrials. Refer to subsection F.2. Specialty CIFs for investment related information in operating this type of fund.
- Guaranteed Investment Contract ("GIC") Fund - These CIFs are primarily, or fully, invested in GICs, which are usually issued by insurance companies. Refer to subsection F.2.e. for investment information and GIC valuation requirements.

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C. CIF TAX-EXEMPT STATUS - IRC SECTION 584 AND IRS REVENUE RULING 81-100

Each CIF is considered a separate tax entity, having its own tax identification number and administrative requirements. To maintain its tax-exempt status, CIFs must be operated in conformity with IRS regulations. The primary IRS regulations granting CIFs tax-exempt status are Internal Revenue Code Section 584 and IRS Revenue Ruling 81-100, described separately below. Each imposes different requirements that significantly affect both the CIFs operation, and which accounts are allowed to invest in the CIF. Nondeposit trust companies are permitted to operate common trust funds under IRC Section 581. Additional information on IRC Section 581 is located in Appendix G.

Internal Revenue Code Section 584

IRC Section 584 primarily pertains to the operation of common trust funds for personal accounts (personal trusts, estates, guardianships, and accounts created under a Uniform Gifts to Minor Act). There are four key points to consider when reviewing a fund granted tax-exempt status under Section 584:

- IRC Section 584 provides that any common trust fund that obtains its tax-exempt status from this section of the Code must comply with OCC Regulation 9.18.
- Therefore, FDIC-supervised banks operating common trust funds drawing tax-exemption from Section 584 must comply with OCC Regulation 9.18.
- There are no state or local laws exempting state banks from compliance with this provision, as compliance is mandatory to achieve CIF tax-exemption under Section 584.
- Personal agency accounts and IRAs may not participate in ANY common trust fund, due to restrictions contained in Federal securities laws.

Failure to comply with IRC Section 584 requirements jeopardizes the tax-exempt treatment afforded common trust funds. Therefore, any loss of the fund's tax favored treatment could expose the bank to liability. Tax liability could occur at the fund level and the participant level. The latter would occur due to regulatory sanctions and penalties and/or pending participant actions, such as lawsuits. The fund participants' proportional interest in the fund are directly impacted by any loss in the fund's value. The bank may be responsible for absorbing the tax consequences incurred by participants.

There are forms that must be filed annually with the IRS. U.S. Treasury Regulation Section 1.6032.1 and IRC Section 6032 require banks operating common trust funds to file annual informational returns with the IRS for each fund established under IRC Section 584. The IRS has not developed a specific form for this purpose. However, Schedule K-1 of Form 1065 (Partner's Share of Income, Credits, Deductions) is typically used to satisfy the reporting requirement. The return must include, for each fund participant: the name; the address; and the proportional share of taxable income or losses, and capital gains or losses. This informational return is required, regardless of the taxable income earned during the reporting period. The aforementioned

Treasury regulation requires banks to file a full copy of the common trust fund's declaration of trust at least once with the return. If the plan is amended, the bank must resubmit the plan and its amendments with the informational return.

As noted in the earlier discussion of common trust funds, banks may in some instances rely on the tax-exempt treatment afforded by IRC Section 584 when establishing funds exclusively for employee benefit trusts and certain other tax-exempt fiduciary accounts administered in the capacity of trustee. If an IRC 584 fund is established for employee benefit trusts, the fund would be required to comply with OCC Regulation 9.18, and employee benefit trusts could not be commingled with personal trust accounts in common trust fund. Reasons for this distinction relate to SEC decisions regarding securities registration.

IRC Section 584 appears in its entirety in Appendix G. Also, Subsection P.3 - Federal Tax Laws contains additional information on IRC Section 584.

IRS Revenue Ruling 81-100

IRS Revenue Ruling 81-100 applies to the collective investment of employee benefit trust and agency accounts. The qualifying accounts are from employee benefit plans which obtain their tax-exempt status from Section 401 of the Internal Revenue Code. RR 81-100 also technically permits IRA accounts which obtain their tax-exempt status from Section 408 of the Internal Revenue Code.

Under Federal securities laws, bank CIFs must qualify for exemption from securities registration and exemption from investment company registration (i.e., registration as a mutual fund). Therefore, **IRA accounts should not be allowed to participate in any CIF**. Examiners should note the differences in purpose between IRC and SEC regulations and opinions. Federal tax laws do permit IRAs to be invested in collective investment funds, see IRC Sections 408(a)(5) and 408(e)(6). Due to the SEC's restrictive interpretation of: (1) an “exempted security" under Section 3(a)(2) of the Securities Act of 1933, and (2) "investment company" (mutual fund) exemptions under Sections 3(c)(1), (3), and (11) of the Investment Company Act of 1940, IRAs are effectively barred from CIFs and, for all practical purposes, may only be collectively invested in mutual funds operated under the Investment Company Act of 1940. Therefore, examiners should review collective investment funds that allow the investment of funds held by IRA accounts, determine if the bank is complying with securities law, and cite apparent violations where applicable. Refer to Subsection D - Registration Under Securities Acts and the December 6, 1994, SEC ORDER on The Commercial Bank of Salem, Oregon in Appendix G for additional details.

Some banks have used exemptions afforded under Regulation D of the Securities Act of 1933 to collectively invest otherwise non-permissible accounts, such as IRAs, without registration. Regulation D places restrictions on the number and sophistication of investors. Refer to Subsection N.5. Regulation D Exempted Securities Offerings for details.

For all practical purposes, only employee benefit accounts whose tax exemptions derive from IRC Section 401 may invest in RR 81-100 funds. These funds are typically established in a form identical to that outlined by OCC Regulation 9.18(a)(2), even though compliance with OCC regulations is not mandatory. Therefore, no violation should be cited unless local law requires state nonmember banks to comply with 9.18(a)(2). OCC Regulation 9.18, however, generally addresses items considered as standard industry practice and, therefore, serves as a guide to the prudent operation of employee benefit CIFs. The operation of such funds under OCC guidelines, or guidelines substantially similar, should be recommended. Refer to Subsection E - Regulation 9.18 for more information.

RR 81-100 requires that:

- Participating employee benefit plans adopt the “group trust" as a part of the plan ("group trust" refers to the collective investment fund declaration of trust discussed in Subsection P.3 - Federal Tax Laws);
- "Group trusts" prohibit collective investment fund assets from being diverted to any purpose other than the exclusive benefit of participating plan beneficiaries;
- "Group trusts" prohibit the assignment of any collective investment fund assets by any of the participating plans; and
- "Group trusts" must be established and maintained as domestic U.S. trusts.

Failure to comply with RR 81-100 jeopardizes a collective investment fund's tax-exempt status. The loss of favorable tax treatment could cause the bank to incur a liability to the participants in a collective investment fund, whose proportional interests in the fund are directly impacted by any loss in value due to the loss of a fund's tax-exempt status.

No informational returns are required for employee benefit collective investment funds operated in accordance with RR 81-100, and that derive their tax-exemption under IRC Section 501(a). However, Department of Labor regulations define collective investment funds used for the collective investment and reinvestment of funds contributed to an employee benefit plan as Direct Filing Entities (DFE). DFE's are required to file reports with the Department of Labor. Refer to Section 5.J.1 of this manual for more information concerning Department of Labor reporting requirements.

Revenue Ruling 81-100 is reprinted in its entirety in Appendix G. Also, Subsection P.3 - Federal Tax Laws contains additional information on RR 81-100.

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D. REGISTRATION UNDER SECURITIES ACTS

CIFs maintained by banks are generally exempt from the requirements of the Securities Act of 1933 (1933 Act) and the Investment Company Act of 1940 (1940 Act). However, if a bank does not strictly meet the exemption requirements, the bank would be required to register the CIF as a security under the 1933 Act and as an investment company (mutual fund) under the 1940 Act. Banks generally seek to avoid registration of their CIFs, due to the additional regulatory requirements imposed with registration.

The following items explain the exemption rules and how banks may violate the acts depending on which types of participant accounts are allowed or if different account types are commingled.

Securities Act of 1933 (1933 Act)

The 1933 Act provides for the registration of securities sold in interstate commerce to the investing public and requires issuers of such securities to make full and fair disclosure in connection with the offering of such securities.

Exemptions under the 1933 Act:

Section 3(a)(2) of the 1933 Act exempts from the registration requirements and other provisions of the act:

- Any interest or participation in any common trust fund or other similar fund that is excluded from the definition of the term "investment company" under Section 3(c)(3) of the Investment Company Act of 1940. This generally exempts any CIF maintained by a bank for the collective investment and reinvestment of assets contributed by the bank in its capacity as trustee, executor, administrator, or guardian.
- Any interest or participation in a single or collective trust fund maintained by a bank for stock bonus, pension, or profit sharing plans which meet the requirements for qualification under Section 401 of the Internal Revenue Code of 1954.
- Any interest or participation in a single or collective trust fund maintained by a bank for a governmental plan as defined in section 414(d) of the Internal Revenue Code of 1954 within certain described parameters.

Implications of Admitting Certain Participants Into a CIF - 1933 Act:

- *IRAs*: Funds permitting participation by IRAs would not be exempt under Section 3(a)(2), because IRAs qualify under Section 408 of the Internal Revenue Code. The participation of IRAs in a CIF would therefore trigger securities registration requirements under the 1933 Act. If the CIF was not registered, the participation of IRA accounts would constitute an apparent violation of the 1933 Act. See further discussion of IRAs below under Investment Company Act of 1940 subheading.
- *Keogh Plans*: The exemption provisions of 3(a)(2) do not cover CIFs that allow participation by some or all employees who are categorized under 401(c)(1) of the Internal Revenue Code pertaining to Keogh plans (HR-10 Plans). Keogh plans may not normally be invested in CIFs without the CIF having to register under Federal securities laws. However, a small number of specialized Keogh accounts may qualify for a limited exemption and therefore be able to invest in a bank CIF. To qualify, the plan accounts and plan sponsor must comply with a narrowly defined intrastate exemption or SEC Rule 180 "Sophisticated Investor Rule". Refer to Section H.2. Keogh Account Usage of Collective Investment Funds for details.
- *Government Plans*: Various governmental organizations' plans receive their tax-exempt status from different Internal Revenue Code sections (such as IRC 401, 403, 457, and other sources). Plan participation in employee benefit CIFs is generally permissible without causing the bank's CIF to have to register under the 1933 Act. However, there are instances where examiners should inquire further about the respective plan's qualifications. This includes state and local government

entities which may obtain their plan's tax-exempt status from other sources and may not meet other 1933 Act standards. Refer to information in Section H.3 Government Plan Usage of Collective Investment Funds to ensure that CIF registration under the 1933 Act is not required.

- *Traditional Agency Accounts*: Banks may never collectively invest a traditional investment management agency account in a CIF. See Subsection B.2 Common Trust Fund and Subsection E.3. Regulation 9.18(a) (1) for further explanation. However, agency accounts are permitted to invest in mutual funds that are registered under the 1933 Act.
- *Employee Benefit Agency Accounts*: Employee benefit agency accounts are permitted in Regulation 9.18(a)(2), "RR 81-100" CIFs. See Subsection B.2. Employee Benefit Collective Investment Fund for additional information.
- *Regulation D Exemption*: Although difficult to apply, some banks have used exemptions afforded under Regulation D to collectively invest in otherwise non-permissible accounts, such as IRAs, without registration. Regulation D places restrictions on the number and sophistication of investors. Refer to Subsection N.5. Regulation D Exempted Securities Offerings for details.

Investment Company Act of 1940 (1940 Act)

The Investment Company Act of 1940 (1940 Act) provides for the registration and regulation of investment companies. Under the 1940 Act, an investment company is an issuer, which holds itself out as being primarily engaged in the business of investing, reinvesting, or trading in securities. In assessing the extent to which the provisions of the 1940 Act may have applicability to the trust activities of banks, reference should be made to the following exemptions contained in the 1940 Act.

Exemptions under the 1940 Act:

- Section 3(c)(3) of the 1940 Act does not apply to "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."
- Section 3(c)(11) of the 1940 Act exempts from the definition of an investment company: "employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1986 or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts or governmental plans".

Implications of Admitting Certain Participants Into a CIF - 1940 Act:

- *IRAs:* The bank CIF exclusion under the 1940 Act does not include IRAs, which fall under Section 408 of the Internal Revenue Code. Due to the SEC's restrictive interpretation of an exempted security under Section 3(a)(2) of the Securities Act of 1933, and investment company exemptions under Sections 3(c)(1), (3), and (11) of the 1940 Act; IRAs are effectively barred from CIFs and, for all practical purposes, may only be collectively invested in registered mutual funds operated under the 1940 Act. Therefore, examiners should question any CIF that allows the investment of funds held by IRA accounts and must determine if the bank is violating both the 1933 Act and 1940 Act. Refer to the December 6, 1994, SEC ORDER on The Commercial Bank of Salem, Oregon in Appendix G for additional particulars.
- *Commingling of employee benefit and personal accounts*: The SEC has interpreted the phrase "common trust fund" as applying only to those accounts administered by banks in their traditional capacity as trustee, executor, administrator or guardian for individuals. Therefore, the commingling of both employee benefit and personal accounts fails to qualify under the 3(c)(3) exemption because employee benefit plans are by definition not personal trust accounts. Furthermore, the commingling of both employee benefit and personal trust accounts fails to qualify under the 3(c)(11) exemption because personal trust accounts are not covered by Section 401 of the Internal Revenue Code.

  Examiners should ensure that employee benefit and personal accounts are not invested in the same CIF, due to the registration requirements that would result. Failure to qualify under the above exemptions due to the commingling of personal and employee benefit accounts in a CIF subjects the CIF to registration and regulation as a mutual fund (investment company) under the 1940 Act.

  The SEC has taken the position that employee benefit accounts administered in the capacity of trustee may not be commingled in common trust funds established for personal trust accounts. The SEC has consistently made a distinction between personal trusts and employee benefit trusts under securities laws. Consequently, it is irrelevant that both OCC Regulation 9.18 and IRC Section 584 appear to permit accounts administered in the capacity of trustee to be commingled without reference to the type of accounts being invested (personal vs. employee benefit plan). These accounts are not permitted to be commingled in a CIF.

In the November 1, 1991, No-Action Letter to Santa Barbara Bank and Trust found in Appendix G, the SEC replied to an inquiry concerning Federal securities law restrictions against commingling assets of employee benefit plans, IRAs, and personal trust accounts. The SEC stated that this would require registration of a CIF as a mutual fund under the 1940 Act, and that interests in the CIF would then have to be registered as securities under the Securities Act of 1933.

Appendix D provides additional information on the Applicability of Federal Securities Law to Banks and Bank Sponsored Securities Activities, including three separate sections on collective trust funds.

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E. OCC REGULATION 9.18

The complete text of OCC Regulation 9 - Section 9.18, regarding the operation of collective investment funds, can be found in Appendix G. The following is a synopsis of significant parts of Section 9.18.

Section 9.18 Applicability to State Nonmember Banks

State nonmember banks need to comply with Section 9.18 for funds granted tax-exempt status pursuant to IRC Section 584. Funds granted tax-exempt status pursuant to Revenue Ruling 81-100, such as employee benefit CIFs, are generally not subject to Section 9.18 requirements. However, state law often requires that all CIFs comply with Section 9.18 or comply with a similarly written state provisions. Even where not required by law, the standards set forth in Section 9.18 should be followed by state nonmember banks as industry best practices for all funds.

1997 Revision of Section 9.18

The OCC revised its national bank fiduciary regulations in 1997. At the time, several OCC fiduciary precedents and trust interpretive letters had been issued under the prior version of the regulation. The OCC opined that the precedents and interpretations in these interpretation letters have become industry practice or simply articulate sound fiduciary principals.

At the same time, the OCC opined that whether a CIF plan needs to be amended to accommodate the changes in the revised regulation, depends upon the language in the existing plan. If the language specifically states the requirements of the old regulation, management should continue to operate the plan in compliance with the original plan - unless the plan is amended. If the plan's language merely makes general reference to 12 CFR 9.18, an amendment may not be necessary. However, banks operating short-term investment funds should amend their plans to reflect the new valuation provision in the revised regulation. Any amendment should be approved by the bank's board or its designee. Expenses incurred in amending a plan are considered the cost of establishing or organizing a CIF, and, therefore, may not be charged to the fund (Section 9.18(b)(10)). Refer to Appendix G for OCC Bulletin 97-22 (Excerpts) for further information regarding the implementation of the revised Section 9.18 to pre-existing CIFs.

Section 9.18(a)(1)

Section 9.18(a)(1) provides that banks may operate a fund maintained exclusively for the collective investment of monies contributed by the bank in its capacity as trustee. Section 9.18(a)(1) funds are commonly referred to as common trust funds and are defined in Subsection B.2. Common Trust Fund. In the administration of funds created pursuant to Section 9.18(a)(1), bank procedures should provide that no units of participation may be held by an agency account.

The 1997 revision to Section 9.18(a)(1) eliminated the 10% limit on a participant's interest in a common trust fund, and the 10% limit on investment of a common trust fund in the obligations of one issuer. The revised regulation also eliminated the requirement that a bank maintain, in cash and readily marketable assets, a percentage of common trust fund assets as necessary to provide for the liquidity needs of the common trust funds.

Section 9.18(a)(2)

Section 9.18(a)(2) states the general permissibility of banks to operate a fund consisting solely of assets of retirement, profit sharing, stock bonus, or other trusts that are exempt from Federal income tax. Section 9.18(a)(2) funds are often referred to as Collective Investment Funds (as previously described in Subsection B.2.). In the administration of funds created pursuant to Section 9.18(a)(2), bank procedures should not allow participation by any trust accounts which are subject to Federal income tax.

Section 9.18(b)(1) The Written Plan

A CIF must be established and maintained in accordance with a written plan. The plan may cover multiple funds. The plan must be approved by resolution of the bank's board of directors or a committee authorized by the board. (Although not required by 9.18, it is recommended that legal counsel examine the plan.) A copy of the plan must be made available to any person for inspection at the main office of the bank during banking hours.

Section 9.18(b)(1) sets forth the required minimum content of the written plan establishing a CIF:

- Investment powers and policies with respect to the fund,
- Allocation of income, profits, and losses,
- Fees and expenses that will be charged to the fund and to participating accounts,
- Terms and conditions governing the admission and withdrawal of participating accounts,
- Audits of participating accounts,
- Basis and method of valuing assets in the fund,
- Expected frequency for income distribution to participating accounts,
- Minimum frequency for valuation of fund assets,
- Amount of time following a valuation date during which the valuation must be made,
- Bases upon which the bank may terminate the fund, and
- Any other matters necessary to define clearly the rights of participating accounts.

Items (iii) and (vii) are 1997 additions to Section 9.18. Plans that were approved and in operation prior to the 1997 revisions (unless the plan is amended) are not required to maintain such provisions.

Section 9.18(b)(2) Fund Management

Under Section 9.18(b)(2), a bank administering a CIF shall have exclusive management thereof, except as a prudent person might delegate responsibilities to others. The ability of management to delegate certain responsibilities to others under the prudent person standard was added in 1997. Management, however, is responsible for conducting a due diligence review prior to delegation, having board or designee approval of the delegation, ensuring a written agreement sets forth duties and responsibilities, and closely monitoring the activities and performance of the third party. In OCC Bulletin 97-22, the OCC recommended that a bank review, with their attorney, the securities laws and tax implications prior to any delegation of investment responsibility. Delegating investment advise is discussed in Subsection F.1 - Use of Outside Investment Advisers.

Section 9.18(b)(4) Valuation

Section 9.18(b)(4) requires that the fund be valued at least once every three months. Funds must be valued at market value or, if such valuation is not readily ascertainable, at a fair value determined by the trustee.

The current regulation grants a valuation frequency exception for 9.18(a)(2) funds (retirement, pension, profit sharing, stock bonus, or other trusts exempt from Federal taxation) that invest primarily in real estate or other assets that are not readily marketable. For these types of funds, the bank is only required to determine the value of the fund's assets at least once each year.

Note: Section 9.18(b)(4), "Valuation", is currently being revised to provide increased flexibility when valuing assets that are illiquid, difficult to value, or not readily marketable. The anticipated change will allow these assets to be valued once per year within all funds (without the existing restrictions on fund type). The valuation of the fund's readily marketable assets will still be required to be valued at least once every three months. Refer to www.occ.gov for most current regulatory information on this issue.

There are specific valuation guidelines for Short-term Investment Funds (STIFs). The assets of a STIF may be valued at cost (as opposed to fair market value), if the STIF maintains a dollar weighted average portfolio maturity of 90 days or less, the bank uses straight line accrual between the cost and anticipated principal receipt on maturity, and the bank holds fund's assets until maturity under usual circumstances [Section 9.18(b)(4)(ii)(B)]. Revisions to Section 9.18 made substantial changes with respect to the operation of STIFs. One significant change is the elimination of the requirement that a STIF invest at least 80% of the STIFs assets in instruments payable on demand or that have a maturity date not exceeding 91 days from date of purchase. The revised regulation also eliminated the requirement that at least 20% of the fund's assets must be cash, demand obligations, and assets that will mature at the fund's next business day.

Section 9.18(b)(5) Admission and Withdrawal

Under Section 9.18(b)(5), participants should be admitted to or withdrawn from a fund only on the basis of the valuation described in Section 9.18(b)(4), and on such valuation date. The admission or withdrawal must be under prior request or notice on or before the valuation date. The bank may require notice of up to one year for withdrawals from funds with assets that are not readily marketable. No admission or withdrawal request or notice can be canceled or countermanded after the valuation date. Distributions to withdrawing participants may be made in cash, ratably in kind, a combination of cash and ratably in kind, or in any other manner consistent with the applicable state law.

In OCC Interpretive Letters #920 and #936, the OCC stated that while Section 9.18(b)(4) addresses the frequency of valuing a CIF, that requirement does not mandate a similar frequency for admissions and withdrawals. The confusion, the OCC writes, results from the fact that the regulation provides that admissions and withdrawals may only be on the basis of the valuation. The Interpretive Letters are located in Appendix G.

Section 9.18(b)(6)(i) Annual Audit

Section 9.18(b)(6)(i) requires that each CIF be audited at least once during each 12-month period by auditors responsible only to the bank's board of directors. [If permitted by state law, Section 9.18(b)(10) permits the plan to pay reasonable expenses incurred to operate the fund. The regulation does not define reasonable or specify which expenses may be paid. The OCC had interpreted the prior regulation to permit the recapture of the audit costs associated with independent outside auditors, but not internal audit costs.]

There are no regulatory requirements as to the scope of the audit. Therefore, as long as the audit appears reasonably complete, examiners should express no objection. As mentioned previously, CIFs that obtain tax-exempt status under RR 81-100 are not necessarily subject to Section 9.18 requirements except if required to do so under state law or regulation. Nonetheless, audits are strongly recommended by the Corporation, and examiners should criticize any CIF that is not audited annually. When OCC Regulation 9.18 sets specific requirements, a reasonable equivalent should be in place for a CIF subject to RR 81-100.

Both internal and external audits are acceptable, if the audit scope is adequate. Items typically addressed in a CIF audit:

- Sufficient tests to permit the auditor to provide an opinion on financial data required by OCC Regulation 9.18(b)(6)(ii).
- Confirmation or verification of the fund's assets, together with a reconciliation of pending transactions.
- Reconciliation of any cash positions in deposit or money-market funds.
- General compliance with OCC Regulation 9.18, especially as to: advertising restrictions [Section 9.18(b)(7)] and prohibited transactions regarding self-dealing and conflicts of interest [Section 9.18(b)(8) and Section 9.12(b)].
- General compliance with any applicable state laws or regulations.
- Conformance with the plan document, particularly as to: limitations on the types of eligible participants and limitations on permissible investments.
- Review of any transactions with bank insiders or investments in their related interests.
- Review of any fees paid by the CIF to the bank, its insiders, and their related interests.
- A test to ensure that income receivable from investments is posted to the CIF, and that proper accruals are used in distributing net income.

Section 9.18(b)(6)(ii) Financial Report

Section 9.18(b)(6)(ii) requires each CIF to issue an annual report that is intended both for the bank and the beneficiaries of participating accounts. At least once during each 12-month period, a financial report of the fund based on the audit (Section 9.18(b) (6)(i) above) must either be furnished, or made available, at no charge to each person who would receive an accounting from each participating trust account. It may also be provided to prospective customers.

The financial report must contain a list of investments at both cost and current market value, a summary of investment changes for the period reflecting purchases (with costs) and sales (with profit or loss), income and disbursements since the last report, and notation of any investments in default. The report may not contain predictions of future fund performance, but may include historical performance data.

Additionally, Part 344 of the FDIC Rules and Regulations - Recordkeeping and Confirmation Requirements For Securities Transactions requires an annual financial report for all CIFs (even RR 81-100 Employee Benefit CIFs). Part 344.6(e) states that for collective investment fund accounts: "The bank shall at least annually give or send to the customer a copy of a financial report of the fund, or provide notice that a copy of such report is available and will be furnished upon request to each person to whom a regular periodic accounting would ordinarily be rendered with respect to each participating account. This report shall be based upon an audit made by independent public accountants or internal auditors responsible only to the board of directors of the bank."

Section 9.18(b)(7) Advertising of Collective Investment Funds

Advertising of common trust funds established for personal trust accounts (9.18(a)(1) funds) is prohibited under OCC Section 9.18(b)(7), except in connection with the advertisement of general fiduciary services. The advertising restrictions of this section do not apply to employee benefit collective investment funds (9.18(a)(2) funds) typically organized under RR 81-100. Be advised that advertising of any collective investment fund may jeopardize its exemption from securities laws, thereby requiring registration.

Section 9.18(b)(8) Self-Dealing and Conflicts of Interest

Section 9.18(b)(8) requires banks administering CIFs to comply with Self-Dealing and Conflicts of Interest requirements. The following is a summary of CIF self-dealing and conflict of interest rules (with links to the specific Regulation 9 sections):

- The bank may not have an interest in the CIF, except in its fiduciary capacity. (This includes a prohibition on any creditor relationship between the bank and the fund or its participants. This section has been interpreted to extend to overdrafts.) [9.18(b)(8)(i)]
- The bank may not make a loan on the security of the participant's interest in the fund. [9.18(b)(8)(ii)]
- The bank may not lend, sell, or otherwise transfer assets of a fiduciary account to the bank, insiders, or affiliates. [9.12(b) as referenced by Section 9.18(b)(8)]
- Defaulted investment exception: A bank may purchase a defaulted fixed income investment from a fund for its own account. If it does so, the purchase price must be at the greater of: market value, or cost plus accrued unpaid interest. [9.18(b)(8)(iii)]
- No fund assets may be invested in the bank's stock or obligations. [Section 9.12(a) as referenced by Section 9.18(b)(8)]

See entire text of Section 9.18(b)(8) and Section 9.12 in Appendix G for further information.

Own-Bank Deposits in a Short-Term Investment Fund (STIF): OCC Interpretive Letter #969 states that a bank may use own-bank deposits for fiduciary assets awaiting investment or distribution collectively in a STIF administered by the bank. However, the activities must comply with conditions set forth in the letter and Section 9.10 and Section 9.12 of the regulation. The activity must be "lawfully authorized by the instrument creating the relationship, or by court order or by local law". Refer to Interpretive Letter #969 in Appendix G for further information.

Underperforming CIFs: In addition to the specific conflicts of interest principles addressed in Section 9.18, banks confront other conflicts of interest in the administration of CIFs. One of the most difficult is management's continued use of a CIF that consistently underperforms general market indices. The costs of establishing and maintaining CIFs, together with marketing or public relations, and potential litigation considerations, may influence management's decision to continue to invest customer assets in CIFs. Sound fiduciary investment practice, on the other hand, might require that account assets invested in an underperforming CIF be sold and investments made in more productive investment vehicles. CIF performance must be evaluated in the same manner as other investments. CIF performance should be compared with mutual fund performance indices and overall market indices (S&P 500, Dow Jones Industrials, etc.). Examiners should not recommend either the continuation or termination of a particular fund. However, management's failure to routinely evaluate and document fund performance should be criticized. Funds that have underperformed general market indices should receive management's (including the board of directors) close scrutiny, and be covered by a strategic plan to improve performance.

Section 9.18(b)(9) Management Fees

Section 9.18(b)(9) permits a bank administering a CIF to charge a reasonable fund management fee only if the fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the bank maintains the fund. The amount of the fee must be commensurate with value of legitimate services of tangible benefit.

Through various interpretive letters, the OCC has provided some clarification to Section 9.18(b)(9) regarding what constitutes reasonable fees commensurate with the value of services provided. OCC Interpretive Letter #829, responds to a bank inquiry regarding applying different management fees to common participants commensurate with the amount and type of participant services provided. Interpretive Letter #829 addressed charging different fees to various 401(k) employee benefit plans participating in the bank's CIFs based on the complexity of the 401(k) plans' administrative characteristics.

Section 9.18(b)(10) Expenses

Section 9.18(b)(10) permits a bank administering a CIF to charge reasonable expenses incurred in operating the CIF, to the extent not prohibited by applicable state law. The section specifies that the bank shall absorb the expenses of establishing or reorganizing a CIF.

OCC Interpretive Letter #919, located in Appendix G, provides guidance for permissible expense recovery from participants in model-driven funds and index funds. Model-driven funds are collective investment funds that seek to outperform a specified index or benchmark based on a pre-determined investment strategy. The Interpretive Letter indicated that model-driven funds may charge participants the cost of entering or exiting a fund just as index funds do, provided the fund's governing document authorizes such changes.

Section 9.18(b)(11) and (12) Prohibition Against Certificates / Good Faith Mistakes

Sections of 9.18(b)(11) and 9.18(b)(12) prohibit issuing certificates or documents representing an interest in the CIF and provide an opportunity for bank's to promptly correct good faith mistakes, respectively.

Section 9.18(c) Other Collective Investments

Section 9.18(c) prescribes other permissible instances when banks may collectively invest assets that it holds as fiduciary. Under certain circumstances, 9.18(c) address commingling single loans or obligations, variable amount notes (vans), Mini funds, trust funds of corporations and closely-related settlors, and other, special exemption funds subject to OCC approval.

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F. INVESTMENT MANAGEMENT ISSUES

Use of Outside Investment Advisors

OCC Regulation 9.18(b)(2) requires that the bank hold exclusive management over collective investment funds, except as a prudent person might delegate responsibilities to others. However, if management delegates investment responsibility, as allowed under the 1997 revised OCC regulation, the CIF may lose its exemption from Federal securities law (Section 3(a)(2) of the 1933 Act) and exemption from Federal taxation (IRC 584, for common trust funds).

The OCC has stated that management may delegate investment responsibility so long as it is done prudently. Per the OCC, this includes conducting a due diligence review of the investment advisor prior to delegation and closely monitoring the investment advisor's performance after delegation. The Board or its designee should approve the delegation and ensure that an agreement outlining each party's duties and responsibilities is in place. Management should review the securities law and tax law implications of the delegation with legal counsel prior to the delegation of investment management responsibilities.

CIFs Tax-Exempt Under IRC 584 (Subject to OCC Regulation 9.18)

In the past, the OCC has permitted the use of outside investment advisors if:

- such delegation is proper under governing law or if the surrender of control and management results in strict liability of the trustee for the acts of its delegate,
- the arrangement is governed by a written agreement,
- the adviser can perform only the functions the bank could perform,
- the CIF is subject to the jurisdiction of the OCC (no definition of OCC jurisdiction over state nonmember bank CIFs has been rendered),
- the trustee bank establishes specific investment guidelines to be followed by the investment advisor,
- the trustee bank frequently reviews the investment advisor's activities, and
- the trustee bank can terminate the contractual relationship at will.

CIF Tax-Exempt by Revenue Ruling 81-100

There is no explicit coverage of outside investment advisors for CIFs that are tax-exempt subject to RR 81-100. Examiners should look first to ERISA, as these funds are restricted to tax-qualified employee benefit plans, and then to OCC precedents. State law or regulations may also contain applicable guidance.

ERISA concepts:

- In general, ERISA would appear to permit the use of a **non-affiliated** investment advisor, so long as the fees were reasonable.
- ERISA Section 406(b)(3), however, appears to **prohibit** the use of an **affiliated** investment advisor for a fee in connection with a transaction involving the assets of the plan. If the affiliated investment advisor charged **no fee, no violation would occur**.
- Prohibited Transaction Class Exemptions (PTE's) 80-51 & 91-38 (located in Appendix E) do not address the use of investment advisors for RR 81100 funds.

OCC precedent:

- In the past, the OCC has issued approval for the use of an outside investment advisor for an employee benefit CIF consisting primarily of a diversified portfolio of guaranteed investment contracts (GICs). The approval was conditioned upon a number of items.
- Each participating account, either in its governing instrument or in a separate authorization agreement, specifically authorized the investment in the fund, the employment of the advisor (outside investment advisor) by the trustee of the unrelated fund, and the amount of fees to be paid to the advisor for the GIC Fund.
- Approval of this arrangement also required that any investment advisor fee charged to the fund be listed as a separate line item on participating account statements, and in the annual financial statement of the fund.

Specialty CIFs

The following subsections provide information for several types of special investment funds. (This is not meant to be an all-inclusive list).

Short-Term Investment Fund (STIF)

STIFs are the CIF equivalents to a money market mutual fund, typically used for the temporary investment of trust cash. Their primary objective is to provide high liquidity and a continuous stream of income at current rates of return. Refer to OCC Regulation 9.18(b)(4) discussion in Subsection E.7 for STIF valuation and management rules.

Covered Call Option Fund

The OCC requires that each participating account provide specific investment authority regarding use of the bank's covered call option fund. However if the fund was established under Revenue Ruling 81-100, the incorporation may be by reference. The fund should also provide a specific method for valuing options.

Foreign Securities Investment Fund

The OCC requires that each participating account contain specific authority to invest in the bank's Foreign Security Investment Funds, unless the funds are established under Revenue Ruling 81-100, which requires incorporation by reference. In prior statements, the OCC also indicated that where custody of the securities is maintained outside the jurisdiction of the District Court of the United States, the requirements of Section 404(b)(l) of ERISA must be met (i.e., no fiduciary may maintain the "indicia of ownership" of any assets of the plan outside of the jurisdiction of District Courts of the United States). If the securities are not held in foreign branches of U.S. chartered banks, the bonding requirements of ERISA 412 must also be met.

Index Collective Investment Fund

The assets of such funds are structured to replicate the performance of a recognized financial index, e.g., the S&P 500. The OCC indicates that the index funds may not include own-bank securities or securities of an affiliated holding company, even though the securities of such companies may be included in the financial index.

Guaranteed Investment Contract (GIC) Fund

GIC funds are comprised primarily of guaranteed investment contracts issued by insurance companies, as well as equivalent bank products (refer to the Glossary Section of this manual). Since GICs are perceived to be guaranteed, they are extremely popular with 401(k) plans and their participants, as they appear to provide a no-risk investment. The only guaranteed portion of a GIC, however, is its interest rate and other contractual provisions. Repayment of the principal is dependent on the financial condition of the GIC's issuer. The failure of several large insurance companies (which issued GICs), made it clear that there is credit risk in GICs. In addition, the value of any fixed-rate investment product is affected by changes in prevailing interest rates.

OCC Regulation 9.18(b)(4) requires that CIF investments be valued at a reasonable fair market value. If a market value is not readily ascertainable, the investments should be valued at fair value determined in good faith by the trustee. Determining a fair value for GICs is difficult because these investments are not actively traded on a secondary market or exchange, and do not have quoted market values. The OCC, however, has stated that the unsupported use of the contract price or book value does not meet the requirements of Regulation 9.18. In the December 21, 1995, letter to the law firm of Mayer, Brown & Platt, the OCC gave permission to value GICs at contract/face value **if** (1) only defined contribution plan assets are in the CIF, **and** (2) the CIFs assets consist solely of: "benefit responsive" GICs, short-term government securities, and money market instruments. This position follows an approach taken by AICPA Statement of Position ("SOP") #94-4. Examiners should closely review the valuation methodology employed for any GIC or similar investment vehicles used in CIFs.

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G. ERISA IMPLICATIONS ON CIF OPERATIONS

ERISA Section 406 prohibited transaction rules are applicable when employee benefit plan assets are invested in CIFs. In addition, DOL advisory opinion states that investment of plan assets in a CIF maintained by a bank trustee causes the assets of the CIF to be treated as assets of the plan. ERISA 408(b)(8) and PTE 91-38 (discussed below) provide exemptions for certain ordinary activities and transactions.

ERISA 408(b)(8) Exemption

ERISA Section 408(b)(8) provides an exemption from the prohibitions outlined in ERISA Section 406 for any transaction between an employee benefit plan or its participating accounts and the bank CIF if:

- the transaction is a sale or purchase of an interest in the fund,
- the bank or trust company receives not more than reasonable compensation, and
- the transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company or affiliate thereof) who has authority to control and manage the assets of the plan.

DOL PTE 91-38 Exemption

Transactions between a bank CIF that holds plan assets and plan related parties (such as the bank or an affiliate) are subject to ERISA Section 406 prohibitions and Internal Revenue Code 4975; but Department of Labor (DOL) PTE 91-38 provides an exemption under certain conditions.

In PTE 91-38, the DOL grants a class exemption for bank-maintained CIFs, in which employee benefit plans have an interest, to engage in certain transactions with plan-related parties provided specified conditions are met. For example, to qualify for the exemption under PTE 91-38, the plan must hold less than a 5 to 10% interest in the total assets of the CIF.

The proper application of PTE 91-38 precludes a violation of ERISA 406(a), transactions between plan and party in interest. However, if the CIF enters into a transaction with the bank or affiliate insider, there would be a violation of ERISA 406(b)(1), transactions between plan and fiduciary (and thereby triggering a violation of IRC 4975 tax on prohibited transactions). There is no exemption from this section of ERISA. For example, if the CIF purchased loans from the bank, the CIF would be in violation of 406(b) and could possibly be in violation of 406(a) if the conditions for relying on PTE 91-38 were not met.

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H. OTHER PARTICIPANT ACCOUNT LIMITATIONS

Charitable Trusts usage of Collective Investment Funds

Banks are appointed to manage charitable trusts established by associations which qualify as tax-exempt charitable organizations under IRC Section 501(a), and Charitable Remainder Trusts created by individuals under IRC Section 664. This is slightly different from bank managed "pooled income funds" organized by outside organizations (discussed separately under section N.4).

Issues to be considered when contemplating the collective investment of charitable accounts:

- Collective investment of charitable trusts must be confined to CIFs whose tax-exempt status is derived from IRC Section 584. IRC Section 584 permits the collective investment of funds held by a bank in the capacity of trustee for an individual, and in the capacity of *trustee* for employee benefit accounts. Charitable trusts fall outside the scope of RR 81-100 which are limited to participation in CIFs for employee benefit plans administered by banks in the capacities of both trust or agency.
- Charitable accounts for which a bank acts as "*agent*" may not be invested in collective funds of any type. Remember it is impermissible under Federal securities laws to collectively invest personal *agency* accounts.
- Collective investment of charitable trusts must comply with OCC Regulation 9.18. The Internal Revenue Code, by virtue of IRC Section 584, requires CIFs obtaining tax-exempt status under that section of the Code to comply with OCC Regulation 9.18.
- In the past, the OCC opined that charitable trusts may be collectively invested with other fiduciary accounts in CIFs operated in accordance with either Section 9.18(a)(1) or Section 9.18(a)(2). The CIF operated for the collective investment of charitable trusts must conform to IRC Section 584 requirements. This includes Section 9.18(a)(2) CIFs, which are normally operated in accordance with RR 81-100. As a practical matter, Section 9.18(a)(2) CIFs are confined to employee benefit plans and operated in accordance RR 81-100. It would therefore be unusual for charitable trusts to be invested in a Section 9.18(a)(2) CIF.

- The OCC also ruled, pursuant to Section 9.18(c)(5), that it was permissible to collectively invest funds in a CIF consisting solely of charitable trusts without the need to comply with all of the requirements contained in Section 9.18(b). This interpretation would not extend, however, to CIFs whose participation included charitable trusts along with personal trusts, executorships, guardianships, etc., because the collective investment of these personal trusts would have to comply with OCC Regulation 9.18 in its entirety.

Under the revised OCC Regulation 9.18, banks establishing CIFs for charitable trusts and relying on Section 9.18 (c)(5) for exemption from the provisions of 9.18(b) must submit a written plan to the OCC. The content of the written plan is enumerated in the text of Regulation 9.18(c) (5). The OCC has opined that state nonmember banks operating charitable collective funds are also required to submit the fund's plan to the OCC to qualify for special exemption under 9.18(c)(5).

Keogh Accounts Usage of Collective Investment Funds

Keogh plans, also referred to as HR-10 plans, are self-employed retirement plans that are qualified under IRC Section 401(c)(1). As with IRA accounts, owing to a narrow interpretation of the Securities Act of 1933 (Act) by the SEC, Keogh plans may not normally be invested in CIFs without the CIF having to register under Federal securities laws.

It is possible, nevertheless, through the careful application of either: (1) Section 3(a)(11) of the Securities Act of 1933 Intrastate Exemption, or (2) SEC Rule 180-Sophisticated Investor Exemption, to invest Keogh plans in CIFs without registering either the Keogh plans, or the CIFs, as securities under Section 5 of the Act.

Intrastate Exemption for Keogh Accounts

CIFs seeking Section 3(a)(2)(C)(ii) exemption from registration, must also comply with the requirements of Section 3(a)(11) ("intrastate exemption" requiring all fund participants to reside in the same state as the fund's issuer).

- Section 3(a)(11) of the Act provides an intrastate exemption from registration for any security which is offered and sold only to residents within a single state, and where the securities issuer is also a resident, and doing business, within the same state.
- For the intrastate exemption to be available: (a) all commingled fund participants (including all beneficiaries of the Keogh plans) and (b) the bank operating the CIF, must be intrastate.

While the foregoing suggests that Keoghs may be commingled with other employee benefit plan accounts, this is not the case. The commingling of intrastate Keogh plans with interstate employee benefit plans precludes the Section 3(a)(11) registration exemption for the Keogh plans. On January 15, 1981, the SEC's Division of Corporation Finance opined that intrastate Keogh plans may be commingled with other types of interstate employee benefit plans (pension, profit sharing, etc.) without the interests of the non-Keogh plans having to be registered under the Act. However, the Keogh plans themselves would have to be registered unless specifically exempted by statute, or by Commission rule, or order. (SEC Release No. 33-6281, 17 C.F.R. 231.6281).

Examples of SEC interpretations of the exemptions afforded by Sections 3(a)(2) and 3(a)(11) of the Act include:

- In National Bank of Fairfax, the bank wanted to invest Keogh accounts of both resident and nonresident employers. The National Bank of Fairfax Self-Employed Retirement Plan and Trust would only have been available to self-employed individuals and their employees. The Plan provided two methods for investing Keogh accounts under its single "umbrella" plan:

    - If an employer was a resident of Virginia, its plan would be collectively invested in the CIF. This method would comport with the exemption requirements of Section 3(a)(11).
    - If an employer was not a resident of Virginia, the CIF required funds relating to the nonresident plan to be segregated into a separate trust account. The separate trust account would be operated under the same terms and conditions as the accounts maintained for Virginia residents. In doing so, the bank sought to apply the registration exemption afforded by Section 3(a)(2).

    In response to the bank's inquiry, the SEC denied the issuance of a No-Action Letter, stating that it was not the intent of Section 3(a)(2) to provide specific exemptions for Keogh plans and, therefore, the Section 3(a)(2) exemption would not be available for the creation of separate trust accounts for nonresident accounts. The National Bank of Fairfax's December 29, 1976, request for No-Action letter and the SEC's response appears in Appendix G.

- The Citizens and Southern National Bank of Georgia also requested a No-Action letter_from the SEC to permit application of Section 3(a)(2) and 3(a)(11) registration exemptions for the commingling of two employee benefit collective investment funds maintained by the bank.

  - The C&S Pooled Profit-sharing and Pension Trust held only employee benefit accounts, exclusive of Keogh accounts. These accounts were sponsored by both Georgia and non-Georgia employers.
  - The Commingled Retirement Trust Fund held funds of Keogh plans of Georgia residents.

  The bank sought the SEC's approval to commingle these two funds without registration based on SEC Release 33-6281.

  The SEC replied that Release 33-6281 was intended to permit commingling without the corporate plans losing their registration exemption under SEC Section 3(a)(2). However, the exemption granted the Keogh accounts under Section 3(a)(11) would be lost if the two funds were combined, requiring the interests of the Keogh plans to be registered. The Citizens and Southern National Bank of Georgia, September 25, 1981, request for a No-Action letter and the SEC's response are included in Appendix G.

"Sophisticated Investor Rule" Exemption for Keogh accounts

SEC Rule 180 (17 C.F.R Section 230.180) provides what is often termed the "sophisticated investor rule" exemption. Details on this exemption are discussed in the overview of securities laws Section P.1.b. SEC Rule 180 (Sophisticated Investor Rule) and in Appendix G, 17 C.F.R. Section 230.180 "Sophisticated Investor Rule".

Government Plan Usage of Collective Investment Funds

Government employee benefit plans as defined in the Internal Revenue Code include plans of the government of the United States, the government of any state or political subdivision, or plans of any agency or instrumentality thereof. Many of these plans qualify for tax-exemption under IRC Sections 401, 403, or 457. However, not all government plans are qualified under these sections of the Code. Due to the fact that some state and local plans cannot meet all the qualifications for tax-exemption, particularly vesting requirements as embodied in Section 401, the Code was amended to provide special tax treatment for such plans by adding Section 414(d). Further, under some local law restrictions, it is not permissible for some government plans to be established under formal trust arrangements.

Securities registration and investment company exemptions for bank CIFs used to collectively invest government plans are contained in: Section 3(a)(2)(C)_of the Securities Act of 1933, Section 3(a)(12)(C)(iii) of the Securities and Exchange Act of 1934, and Sections 3(c)(11)(A) and (B) of the Investment Company Act of 1940. Therefore, ample securities law exemptions exist for the collective investment of government plans. SEC No Action Letters, including those covering government plan participation in CIFs, are located in Appendix G.

Regardless of the form of tax qualification used, and regardless of the presence or absence of a formalized trust agreement, government plans may be collectively invested by banks consistent with the requirements of OCC Regulation 9.18(a)(2) and Revenue Ruling 81-100. Government plans may be invested in CIFs together with corporate-sponsored employee benefit plans, or in CIFs confined to government plans. Those plans not established under trusts must, however, be held: (a) under some form of fiduciary arrangement and (b) in the custody of the organization authorized under local law.

It should be noted that some governmental plans do not obtain an exemption from Federal income taxation. Instead, they rely on an "exclusion" from taxation allowed through the concept of "intergovernmental constitutional immunity". If a governmental plan has not obtained tax-exempt status by meeting the requirements of the Internal Revenue Code, evidence must exist that the plan is appropriately relying on the exclusion from taxes allowed though "intergovernmental constitutional immunity."

The following SEC No-Action Letters permit the inclusion of government plans (including IRC Section 457 qualified plans of state and local government employees) with corporate employee benefit plans without triggering registration under: the Securities

Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940: The Provident Bank (1991), The Idaho First National Bank (1988), and Fidelity Management Trust Company (1989), all located in Appendix G.

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I. INVESTING IN CIFS OF OTHER INSTITUTIONS

Affiliated Institutions

When permitted in the governing instrument and allowed by state law, banks may invest funds of fiduciary accounts in affiliate bank CIFs. The OCC has permitted such investments in the past. The SEC has also addressed this issue in a 1989 No-Action Letter to Old Kent Financial Corporation (located in Appendix G). In that No-Action Letter, the SEC permitted banks under the holding company of Old Kent Financial Corporation to use the common and collective funds of other affiliated banks under the holding company.

When banks invest fiduciary funds in affiliate institution CIFs, examiners should ensure that:

- the CIF plan of operation or governing document authorizes use of the CIF by accounts of affiliated banks,
- the board of the affiliated bank has authorized the use of the originating bank's plan,
- the affiliated bank maintains documentation for all admission and withdrawal decisions for each fiduciary account invested in the originating bank's fund,
- the originating bank is notified on or before the fund valuation date, and the appropriate committee of the originating bank approves all affiliate bank admissions and withdrawals in compliance with 12 C.F.R. 9.18(b)(5), and
- the originating bank furnishes the annual financial report, or notice of its availability, to each fiduciary account invested in its CIFs).

Non-Affiliated Institutions

Examiners may also encounter situations where banks wish to invest fiduciary funds in CIFs of non-affiliated banks. In the past, the OCC permitted employee benefit CIFs (Section 9.18(a)(2) funds) maintained by a trustee in accordance with RR 81-100 to be invested in a CIF maintained by an unrelated trustee. However, the OCC staff indicated that personal trust CIFs (Section 9.18(a)(1) funds) deriving tax exemptions pursuant to IRC 584 cannot accept participations from non-affiliated institutions.

Although the OCC has permitted the investment of fiduciary funds in nonaffiliated institution CIFs, the SEC declined to issue a No-Action Letter to Northern Trust Corporation on this same issue. Northern Trust Corporation had been seeking permission for non-affiliated CIFs to invest in CIFs operated by Northern Trust Company (a subsidiary bank). Northern Trust Corporation had previously applied for and obtained OCC approval to conduct this activity. However, the SEC did not concur that the activity would be permissible without registering the Northern Trust CIFs as securities. The 1989 SEC No-Action letters to Northern Trust Corporation (Northern Trust I and Northern Trust II) are located in Appendix G.

Consequently, even where permissible under local law and the governing document, banks should not invest customer funds in non-affiliated bank CIFs or accept investments from non-affiliated bank CIFs. Banks wishing to do so should be advised to first seek an SEC No-Action ruling on the proposed activity. Failure to obtain such a ruling could result in an SEC enforcement action, fines, and losses to the participating accounts, which would inevitably be borne by the bank.

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J. CIFS INVESTING IN CIFS WITHIN THE SAME DEPARTMENT

The OCC has permitted CIFs to be invested in other CIFs operated by the same department. Investing equity or fixed income fund cash awaiting permanent investment in a short-term investment fund (STIF) would be a practical use of this provision. This is not the only application, and there is no limitation on which funds can take advantage of the provision.

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K. PROPRIETARY MUTUAL FUNDS

Considerations When Engaging in Mutual Fund Activity

There are numerous regulatory and costly administrative burdens associated with the operation of a proprietary mutual fund. The operation of a mutual fund requires knowledge of SEC and IRC rules and regulations. Furthermore, banks have the added burden of complying with applicable banking laws. Strong management oversight is required. Since a large volume of activity is required to effectively operate a fund and there is the potential for the receipt of lucrative fees, banks operating proprietary mutual funds must address a number of potentially abusive conflicts of interest.

Examples of the general considerations involved in operating a mutual fund:

- Mutual funds must be registered with the SEC, as both a security under the Securities Act of 1933, and as a mutual fund (mutual funds are investment companies under Federal securities laws) under the Investment Company Act of 1940.
- To operate on a tax-exempt basis and pass all income and capital gains through to investors, mutual funds must also comply with various tax laws, including Subchapter M of the Internal Revenue Code.
- The mutual fund would be organized under a trust and the bank (or related organization) would be trustee.
- State law would govern the establishment of trust.
- To be economically viable, a mutual fund must obtain a critical mass of assets to realize the necessary economies of scale.
- To profitably offer such products, the mutual fund sponsors must be compensated through a sufficient volume of business (generally portfolio size rather than number of investors).

Banks may act in a number of capacities for any mutual fund, including: custodian, transfer agent, and, investment adviser or investment manager. Each of these activities has its own unique risks and may expose the bank to different conflicts of interest. Also, the Gramm-Leach-Bliley Act (GLBA) of 1999 permits banks to engage in previously prohibited securities related activities, such as underwriting. A greater range of potential activities also increases the potential for conflicts of interest.

Refer to Appendix D discussion of Applicability of Federal Securities Laws to Banks and Bank Sponsored Securities Activities for specific requirements that would be applicable to proprietary mutual fund activities. Specific subsections include Bank as Investment Advisor, Bank as Investment Company , and Collective Trust Funds. Non-bank subsidiaries must, however, register with the SEC, if they engage in any of these activities.

State law may require registration as a custodian, investment advisor, or any other securities activities. FDIC regulated banks acting as mutual fund transfer agents must register and comply with Part 341 of the FDIC's Rules and Regulations.

Structure of Bank Financial Activities Under the Gramm-Leach-Bliley Act of 1999 (GLBA)

Effective March 12, 2000, the GLBA repealed Section 20 of the Banking Act of 1933. Banks may now underwrite and distribute proprietary and third-party mutual funds. This activity must be done through one of the following entities:

- Financial Holding Company (FHC). A FHC may engage in any activity and may acquire and retain shares of any company engaged in any activity that is determined by the Federal Reserve Board to be "financial in nature" or "incidental" to such financial activity. Or, a FHC may engage in an activity that is complementary to a financial activity and does not pose a substantial risk to the soundness of the financial institution. Activities that are financial in nature include providing financial, investment and economic advisory services, including advising an investment company. It also includes underwriting, dealing in, or making a market in securities (Section4(k)(4) of the Bank Holding Company Act of 1956).

    - A FHC that acquires any company or commences any of the above activities shall provide to the Federal Reserve Board written notice describing the activity conducted by the FHC. Notice must be provided not later than 30 calendar days after commencing the activity.
    - A "bank holding company" is also allowed to engage in the "expanded financial activities" of a FHC. However, there are minimum capital, management, and community reinvestment standards that must be met. Also, this requires pre-

notification to the Federal Reserve Board. Specific details are found in Section 4(l) of the Bank Holding Company Act. The entire Bank Holding Company Act text is located in the FDIC's Laws, Regulations and Related Acts.

- Financial Subsidiary. The activities that may be conducted by a subsidiary of a national bank have also been revised. A national bank may control a "financial subsidiary", or hold an interest in one, only if the subsidiary engages in activities that are financial in nature or incidental to a financial activity. Activities that are financial in nature include those described in the FHC subheading, above.

The GLBA added Section 46 to the Federal Deposit Insurance Act (FDI Act) to govern financial subsidiaries of state banks. Under the final rule, the FDIC adopted a streamlined certification process for insured state nonmember banks to follow before they may conduct activities as principal through a financial subsidiary. State nonmember banks self-certify that they meet the requirements for carrying out these activities. The self-certification process allows banks to conduct the new activities immediately. There is no delay for administrative approval or review, although the FDIC continues to evaluate these activities as part of the normal supervisory process.

To commence financial subsidiary activities under Section 46(a), the insured state nonmember bank must certify that it is well-managed; that it and all of its insured depository institution affiliates are well-capitalized; and that the insured state nonmember bank is in compliance with the capital deduction requirement. In addition, an insured state nonmember bank may not commence any new activity under Section 46(a), or directly or indirectly acquire control of a company engaged in any such activity, if the bank or any of its insured depository institution affiliates received a rating of less than satisfactory in its most recent CRA examination. Any insured state nonmember bank controlling or holding an interest in a financial subsidiary also must comply with Sections 23A and 23B of the Federal Reserve Act, as amended by the GLBA and meet the financial and operational safeguards required by Section 5136A(d) of the Revised Statutes of the United States (12 U.S.C. 24a(d)), unless otherwise determined by the FDIC.

If the financial subsidiary of the insured state nonmember bank engages in the public sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities activity of a type permissible for a national bank solely through a financial subsidiary, the state nonmember bank and the financial subsidiary must comply with certain provisions requiring the separation of the financial subsidiary from the bank. These provisions require that the financial subsidiary be physically separate and distinct in its operations from the operations of the bank; that the financial subsidiary conduct its securities business pursuant to independent policies and procedures designed to inform customers and prospective customers of the financial subsidiary that the financial subsidiary is a separate organization from the insured state nonmember bank and that the insured state nonmember bank is not responsible for and does not guarantee the obligations of the financial subsidiary. In addition, the bank must adopt policies and procedures, including appropriate limits on exposure, to govern its participation in financing transactions underwritten by its financial subsidiary. Further, the bank may not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by its financial subsidiary, unless the bank notifies the customer that the entity underwriting, making a market, distributing or dealing in the securities is a financial subsidiary of the bank.

The mutual fund, as a registered investment company under the Investment Company Act of 1940, would be under the supervision of the SEC. The SEC is required to share its supervisory findings with Federal banking agencies, upon request, and does not limit the FDIC's examining authority of affiliates as outline in Section 10(b)(4) of the Federal Deposit Insurance Act.

Investment Company Act of 1940

The Investment Company Act of 1940 (1940 Act) governs the activities of companies principally engaged in the business of investing, reinvesting, and trading securities, and whose own securities are held by the public. Mutual funds and other registered investment companies are subject to SEC operational regulations designed to protect the interests of investors and the public. The Act prohibits such companies from changing the nature of their business, or their investment policies, without the approval of their shareholders.

Among the most significant sections of the Investment Company Act of 1940 are the following:

- Section 9 bars persons convicted of securities fraud within the past 10 years from serving as officers or directors;
- Section 10 prevents underwriters, investment bankers or brokers from constituting more than a minority of such companies' board of directors;

- Section 13 prohibits such companies from changing the nature of their business or their investment policies without the approval of holders of a majority of their voting securities;
- Section 15 requires that management contracts (and material changes thereto) be approved by a majority of the holders of outstanding voting securities of such registered company;
- Section 17 prohibits transactions between such registered companies and their directors, officers, affiliated companies, principal underwriters, and promoters, except where the SEC grants an exemption based on a finding of the fairness of such transactions and no overreaching by the parties. It also identifies a bank as one of the acceptable custodians for a registered investment company. The GLBA amended Section 17(a) to allow loans from affiliates to mutual funds (effective May 12, 2001). The amendment is especially important to banks offering proprietary mutual funds. The original Section 17(a) prohibited affiliates from selling, purchasing, or borrowing money or property from mutual funds, but did not cover loans from affiliates to mutual funds. In addition, the SEC interpreted Section 18(f) of the 1940 Act to prohibit mutual funds from borrowing money except from a bank. The borrowing limit is one-third of the assets of the fund. Under the current regulations this could pose potential problems for banks offering proprietary mutual funds. The GLBA amended Section 17(f), custody of securities, to allow for a bank or its affiliates to serve as a custodian for proprietary mutual funds (registered investment companies).
- Section 18 prohibits registered "closed-end" investment companies from issuing senior securities, except under conditions and terms specified in that Section; and
- Section 20 prohibits "circular ownership" of such investment companies and "cross-ownership" of their securities under the terms listed in Section 20(c).
- Included among other provisions of the Investment Company Act are sections involving sales and repurchases of securities issued by investment companies (Section 22), periodic payment plans (Section 27), and face amount certificate companies (Section 28). Also, the GLBA allows a bank or its affiliate to serve as a custodian for a proprietary "unit investment trust" (Section 26).

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L. CONVERSION OF CIFS TO MUTUAL FUNDS

General Overview

Competitive pressures and changing securities laws contribute to banks converting CIFs into proprietary mutual funds. The banking industry has long taken the position that mutual funds offer greater advantages to both the bank and trust beneficiaries. But there is also risks, such as abusive conflicts of interest and increased reputation risk.

- One of the **incentives for converting** a CIF to a proprietary mutual fund is purely financial. There is a lucrative array of fees available under a mutual fund arrangement that is not available from bank sponsored CIFs. However, the desire for increased revenue must not take precedence over the fiduciary responsibility of the bank. Such a conflict must be resolved in favor of the account beneficiaries. If the desire for financial reward is dominant, the conflict could become abusive.
- One of the **potential disadvantages** to a bank is the public availability of the proprietary mutual fund's performance – a factor not generally confronted with CIFs. If a proprietary mutual fund performs poorly over an extended period of time, the bank's reputation may be harmed, especially if the poor performance continues without appropriate corrective action.

Conversions of existing CIFs to mutual funds typically take one of two forms. In both cases, the CIF terminates activity and is replaced by the mutual fund operation. The first type involves the liquidation-to-cash of a CIFs assets, with a simultaneous rollover of the cash proceeds into a mutual fund. The second type involves a one-time "in-kind" transfer of assets at market value from a CIF to a mutual fund.

Mutual funds may be sponsored by a non-bank affiliate of a state nonmember bank. However, they are currently predominantly sponsored by a nonaffiliated third party institution (including mutual fund companies and brokerage houses). In either case, the bank usually provides investment advisory, custodial, transfer agent, and other fee related services to the fund.

Tax Considerations of Conversion

Common Trust Fund Conversions

Prior to 1996, the conversion of common trust funds established for personal trust accounts was treated as a taxable transaction under the IRC. Years of lobbying Congress to enable a tax-free "in-kind" transfer were finally successful in August 1996, when IRC Section 584 was amended by Section 1805 of the "Small Business Job Protection Act of 1996". This legislation added new paragraph IRC Section 584(h), which permits tax-free conversions of Personal Trust CIFs (A-1 Funds). The conversion can be into one or more mutual funds. The basis of the mutual fund shares distributed to participant trusts must be equal to the basis of the common trust fund interests exchanged. In the event that the conversion involves more than one mutual fund, the basis of the common trust fund interests exchanged should be allocated proportionately to the mutual fund shares received. The amendment was effective for transfers after December 31, 1995.

This amendment makes the conversion tax-free for Federal taxation purposes only. Therefore, there may be remaining state income tax consequences. There are also accounting and other tax issues related to the rebating of fees, the amortization of bond premiums, and capital gain distributions, to name a few, that must be considered in conjunction with the conversion decision.

A copy of the 1996 amendment to IRC Section 584 is located in Appendix G.

Collective Investment Fund Conversion

Conversions of collective investment funds maintained for employee benefit accounts subject to ERISA do not face the same tax problems as those faced by common trust funds. Tax relief is granted because, although conversion is a taxable event, the participants can only be tax-exempt entities and, therefore, no tax liability is incurred.

Supervisory Concerns of Conversion

The board of directors should specifically authorize or ratify the conversion of a CIF to a mutual fund. The advice of qualified legal counsel experienced in securities laws and fiduciary matters should be obtained to ensure that the conversion complies with all applicable laws and fiduciary obligations. The qualifications of the firms and individuals providing legal counsel should be documented and retained to support the adequacy of the decision-making process. At a minimum, the conversion decision-making process should address the following issues:

Fiduciary issues:

- The board's due diligence process should include a review of (1) customers' needs and how the conversion meets these needs, (2) any potential legal and other risks, (3) a stated reason to support the conversion, and (4) a method for obtaining customer approval (see points (c) and (d) below).
- The bank should address all related fiduciary issues in its written policies, including conflict of interest issues concerning the need for, and prudence of, converting CIFs into mutual funds, and the reasonableness of the ongoing investment.

  Internal policy should require investments in proprietary funds to be evaluated on the same basis as any other investment product and proprietary funds should meet a bank's own minimum investment selection standards.

  There is an additional concern when banks operate both proprietary mutual funds and CIFs. The investment of trust accounts in proprietary mutual funds that under perform own bank CIFs is troubling, since banks that operate proprietary mutual funds have additional monetary incentives (which are unavailable in CIFs) to invest trust accounts in the funds. In such cases, the fiduciary should document the rationale for investing trust accounts in proprietary mutual funds when CIFs with similar or identical investment objectives and strategies are available.

  Even when permitted by statute, these transactions should be made in good faith. The fact that such investments are allowed (permissive authority) does not relieve the fiduciary of its "duty of care and skill" in the investment selection process. A failure to properly address all conflict of interest and investment prudence issues casts doubt on whether the fiduciary has satisfied the traditional fiduciary duty of undivided loyalty, and could lead to litigation and loss.

- When necessary under local law or the governing instrument, banks should obtain the consent of CIF participants to convert their CIF units into mutual funds. Under IRC Section 584(h), "substantially all" (which was undefined at the time of this writing) CIF assets must be transferred into the mutual fund.
- Accounts not participating in the conversion due to customer non-consent, prohibition within governing instruments, or prohibition under local law, should be provided reasonable investment alternatives consistent with the governing account instrument.
- Investment in the mutual fund should also meet the tests of loyalty and prudent investment management.

  One such test is to compare the consistency of the mutual fund's investment objectives with the governing instruments of the accounts converted. When converting from a CIF to a mutual fund the investment objective could change, and what was once a suitable investment for an account may become inappropriate. Another consideration is when a proprietary mutual fund's performance lags comparable, but unaffiliated, alternative investments.

  Refer to Subsection F.4.a of Section 3 for additional guidance regarding proprietary mutual fund investments.

Regulatory issues:

- Where required, the bank should: (1) obtain the consent of its State regulatory supervisor to convert CIFs into mutual funds, and/or (2) provide it formal pre-conversion notification. At the time of this writing, institutions supervised by the FDIC, FRB, and OCC were not required to obtain the consent of state authorities or notify state authorities of planned CIF conversions.
- The bank should comply with all securities law requirements, including the registration of the mutual fund. If a bank subsidiary is involved in operating a mutual fund, it should also register as an investment adviser and, as needed, as a broker/dealer, in addition to the mutual fund registration.
- The bank should determine whether it is permitted to receive both fiduciary fees and proprietary mutual fund servicing fees under local law and the governing instruments. Fiduciary fees and mutual fund servicing fees should be reasonable, and consistent with local law and the governing instrument.

  One of the more complex issues involving the operation of proprietary mutual funds is the charging of fees. Virtually all states have enacted statutes expressly authorizing a bank fiduciary to invest trust assets in the shares of a mutual fund for which the bank, or affiliate, performs services and receives reasonable compensation. Some states require that the fiduciary offset its mutual fund fee or its trust administration fees by an amount that corresponds to the bank's compensation for performing investment advisory and/or other services for the mutual fund. If permitted to receive fees for both trust fiduciary services and for the services performed for the proprietary mutual fund, all fees should be reasonable and disclosed to the customer, especially upon the conversion of a common trust fund to a mutual fund. There may also be other state requirements regarding disclosures, as well as investment restrictions.
- The bank should provide participating accounts an initial prospectus of the mutual fund, and all necessary disclosures under Federal and State securities and banking laws. Participating accounts should continue to receive any prospectus and other disclosures required under these laws.

ERISA Considerations of Conversion

The conversion of a CIF to a mutual fund does cause ERISA concerns - in particular problems related to the prohibited transactions restrictions in Section 406 of ERISA. Section 406(a) of ERISA prohibits transactions between a plan and a party-in-interest. Section 406(b) prohibits transactions between a plan and a fiduciary with respect to a plan. Therefore, whenever plan assets are transferred to a mutual fund to which a fiduciary or party-in interest provides services, or whenever a fiduciary or party-in-interest receives compensation as a result of a plan's investment in a mutual fund, the prohibited transaction rules should be considered.

There are two outstanding ERISA class exemptions to help guide such conversion activity.

- **Cash-to-Cash** - Pursuant to Section 408 of ERISA, the Department of Labor issued Prohibited Transaction Class Exemption (PTE) 77-4 which provides an exemption from the prohibited transaction rules of ERISA, and the Internal Revenue Code, for the purchase of shares of a mutual fund for which the bank or its affiliates act as investment advisor. In applying PTE 77-4, the DOL requires banks to: (1) obtain the approval of an independent fiduciary, (2) provide disclosures to participating accounts, (3) obtain written consent for the conversion, and (3) adjust fees to ensure a double fee is not charged to accounts invested in proprietary mutual funds. These are in addition to the general supervisory concerns addressed in Subsection L.3. In Advisory Opinion 94-35, the DOL interpreted class exemption PTE 77-4 to apply only to "cash" (cash-to-cash) conversions which liquidate CIF assets and purchase shares of the mutual fund with the proceeds from the liquidation. In other words, the prohibited transaction exemption would not be applicable to conversions of "in kind" (asset to asset) transfers.

- **In-kind** - Pursuant to Section 408 of ERISA, the Department of Labor issued PTE 97-41, which permits an employee benefit plan (the Client Plan) to purchase shares of a registered investment company (the Fund) that also serves as a fiduciary of the Client Plan. The investment advisor for the Fund may be a bank or plan advisor registered under the Investment Advisors Act of 1940. The exemption pertains to the exchange for plan assets transferred in-kind to the Fund from a CIF maintained by the Bank or Plan Advisor. It involves a complete withdrawal of a Client Plan's assets from the CIF.

  In applying PTE 97-41, the DOL requires banks to follow minimum guidelines. Additional information is found in Section 5 of the manual, Subsection H.7.f(10). These are in addition to the general supervisory concerns addressed in Subsection L.3.

The failure to convert the CIF within the confines of the proper exemption generally results in the purchase of proprietary mutual fund shares being considered a prohibited transaction under Section 406 of ERISA.

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M. MUTUAL FUND AND CIF MERGER RULES

Sections 17(a)(1) and (2) of the Investment Company Act of 1940 restrict merger activities of registered mutual funds with affiliated funds (registered mutual funds or unregistered CIFs). To provide guidance in this area, the SEC issued Rule 17a-8, Mergers of Affiliated Companies (17 CFR 270.17a-8).

SEC Rule 17a-8

SEC Rule 17a-8, Mergers of Affiliated Companies permitted the merger of affiliated funds, if the funds were affiliated solely because they had common investment advisers, officers, and/or directors. However, the SEC expanded Rule 17a-8 in 2002 to include all affiliated funds regardless of the nature of their affiliation. In addition, the amended rule provides an updated set of requirements that need to be met in order to qualify for Sections 17(a) (1) and (2) exclusion. Mergers that do not meet Rule 17a-8 must be presented to the SEC for review on a case-by-case basis.

The purpose of the change was to expand the scope of Rule 17a-8 to more funds and thereby reduce the burden of obtaining Commission approval for mergers that presented little risk of overreaching.

SEC Rule 17a-8 governs mergers between affiliated mutual funds and also mergers between mutual funds and unregistered bank CIFs. The updated rule provides the following:

Board review

Mutual fund boards must thoroughly review merger transactions and their terms. Each mutual fund's board - including a majority of disinterested directors - must determine that the merger is in the best interests of the mutual fund and will not dilute the interests of shareholders. Directors must request and evaluate any information reasonably necessary to their determinations, and give appropriate weight to all pertinent factors in making their findings under the rule, and in fulfilling the overall duty of care they owe to the fund's shareholders. According to the SEC, in making their determination, boards should consider relevant factors including:

- Any fees or expenses that will be borne directly or indirectly by the fund in connection with the merger;
- Any effect of the merger on annual fund operating expenses and shareholder fees and services;
- Any change in the fund's investment objectives, restrictions, and policies that will result from the merger; and
- Any direct or indirect federal income tax consequences of the merger to fund shareholders.

Shareholder approval

The acquired fund must have shareholder approval, if the merger materially alters the investment held by the fund shareholders.

SEC Rule 17a-8 as amended, requires a majority of the shareholders of the acquired fund to approve the merger if:

- Any policy of the acquired fund that under Section 13 of the Exchange Act could not be changed without a vote of a majority of its outstanding voting securities is materially different from a policy of the acquiring fund;
- The acquiring fund's advisory contract is materially different from that of the acquired fund, except for the identity of the funds as parties to the contract;
- After the merger, directors of the acquired fund who are not interested persons of the acquired fund and who were elected by its shareholders will not comprise a majority of the directors of the acquiring fund who are not interested persons of the acquiring fund; or
- After the merger, the acquiring fund will be authorized to pay charges under a plan that provides for use of fund assets for distribution ("rule 12b-1 plan") that are greater than charges authorized to be paid by the acquired fund under such a plan.

Unregistered CIF

Rule 17a-8 was expanded to permit mutual funds to merge with affiliated CIFs, provided that the survivor is a registered investment company. The SEC had written no-action letters to mutual funds seeking to merge with CIFs. When the SEC revised Rule 17a-8, it warned that mutual funds engaging in mergers on or after the compliance date of the final rule (October 25, 2002) should not rely on the no-action letters, but must either comply with the final rule or obtain an exemption from the SEC.

The SEC also requires that the board of directors of a mutual fund that merges with a CIF, in making its determination that the interests of the fund's shareholders will not be diluted as a result of the merger, approve the procedures for valuation of the securities (or other assets) that the unregistered entity will convey to the fund. These procedures must provide for the preparation of a report by an independent evaluator that sets forth the fair market value of the assets for which market quotations are not readily available. The independent evaluator's report must be included in the records of the merger.

Record Retention

Rule 17a-8 contains a requirement that each investment company that survives the merger preserve written records that document the merger and its terms. The records must include, among other things, the minute books setting forth the determinations of the funds' boards and the bases for those determinations, any supporting documents provided to the directors in connection with the merger, and documentation of the prices at which securities were transferred in the merger. The recordkeeping requirement ensures that examiners have adequate information to assess the merging funds' compliance with the rule.

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N. OTHER POOLED INVESTMENT VEHICLES

Below are examples of other types of pooled investment vehicles. The information presented is generic, since each institution can design the product to meet the needs of its clients.

Master Deposit Accounts

A master deposit account is a single interest-bearing deposit account in which the temporary funds of individual trust accounts are commingled. The master deposit account is often a money market deposit account of the fiduciary institution. Only deposits are involved, no other types of assets are held in a master deposit account. The number of trust accounts invested in and the balance of the master deposit account may vary from day-to-day. This is not a common or collective investment fund. The concerns with a master deposit account include, management's ability to:

- identify the amount of funds attributable to each trust account invested in the master deposit account,
- ensure that the funds of each trust account is not left in the master deposit account as a long term investment,
- determine how FDIC insurance applies to the trust account invested in the master deposit account, and

- identify conflicts of interest.

Wrap Accounts, Also Known as Asset Allocation Programs

This may be considered a pooled investment vehicle, even though assets of individual accounts are not necessarily pooled. By definition, these are accounts where a money manager (trust department) invests and manages a group of investments for a set annual fee. The term wrap comes from the idea that the customer pays a single fee for services, rather than a fee for individual trades. The fee may be a flat fee or based upon the market value of the individual account. There are two general types of wrap accounts "traditional", comprised of a combination of securities in order to achieve a specific investment goal, and "mutual fund", comprised of a combination of mutual funds in order to achieve a specific investment goal. In a wrap account, a customer's funds are invested according to pre-established guidelines, often in the form of an asset allocation model.

For example, a client's objective may be aggressive growth and the institution has developed an asset allocation program using mutual funds or stocks to achieve this objective. The model is periodically adjusted. When the model is adjusted the client's holdings are automatically adjusted to match the model.

The pooling aspect occurs because there are a number of accounts in the program. Since all of the accounts invested in the program are adjusted at the same time, it may appear that management has created a nonregistered mutual fund made up of *discretionary* accounts. The appearance is further enhanced if the customer does not have the ability to adjust the investment mix, or if the *wrap account agreement* delegates full investment authority to the fiduciary.

Many departments employ asset allocation models to administer the majority of their discretionary trusts in order to gain economies of scale in asset management. The mere existence of asset allocation models does not indicate that the department is offering wrap accounts and could therefore be operating a nonregistered mutual fund.

SEC regulation 270.3a-4 provides guidance on wrap accounts and a "non-exclusive" safe harbor against inadvertently operating a nonregistered mutual fund.

Key provisions of the safe harbor include:

- provisions for individualized management of client accounts
- specific initial and ongoing client contact
- the ability of the client to impose reasonable restrictions on investments
- quarterly account statements
- client retention of ownership of the securities

If the provisions are met such accounts offered by the department will not be deemed a mutual fund. There are also exceptions if all provisions of the "nonexclusive" safe harbor are not met.

Private Equity Fund of Funds

A private equity fund of funds typically invests directly in private companies in one of several formats. A fund of funds is a general partnership that aggregates investor capital and provides professional selection and management of a portfolio of private equity funds. The formats include venture capital, buyouts, and mezzanine investments. Each fund will have its own investment objective, like a mutual fund, and a fund manager. Individuals often choose these funds when they want to passively invest in private equities.

Most private equity funds are not registered with the SEC under the Investment Company Act of 1940 (1940 Act). They are exempt from registering under the 1940 Act provided they meet specific restrictions. The exemptions from registration are found in Sections 3(c)(1) 100-Person Fund and 3(c)(7)-Qualified Purchaser Fund of the 1940 Act.

- The 100-Person fund is limited to 100 or fewer beneficial owners (partners) and may not be made available to the general public. One of the beneficial owners will be the general partner, for example the bank, and the remaining will be limited partners. It is also limited to "accredited investors". An "accredited investors" is generally defined as a person having a net worth of at least $1 million or income for two years of at least $200,000. Even though not required to register under the 1940 Act, the private equity fund is still subject to the Act's limitation on performance based compensation (fees) does apply.

- The Qualified-Purchaser fund does not have the 100-person limit, but may only be purchased by "qualified purchasers" and may not be made available to the general public. Generally, the term "qualified" means an individual or married couple having at least $5 million in investments. Certain trusts, even with smaller amounts under management, may also invest, provided that investments are made by a "qualified purchaser" and the trust was not formed for the purpose of participating in the fund. This fund type is limited to 500 partners.

In 1999, the SEC issued guidance on a number of issues involving Sections 3(c)(1), 3(c)(7), and 2(a)(51)(A) of the 1940 Act. The SEC Letter Regarding Private Investment Companies (Private Collective Funds) under ICA of 1940 is located in Appendix G.

Bank Managed "Pooled Income Funds" Organized by Outside Organizations

“Pooled Income Funds” are defined under IRC Sections 642(c)(3) and 642(c)(5). These pooled funds consist of charitable gifts from donors which are maintained in a commingled investment fund by organizations described in IRC Section 170(b)(1)(A), including churches, educational institutions, hospitals, etc. The securities law exemptions for these funds are contained in: Section 3(a)(4) of the Securities Act of 1933, Section 3(a)(12)(A)(v) of the Securities Exchange Act of 1934, and Section 3(c)(10)(B) of the Investment Company Act of 1940.

Banks may be appointed as administrator or investment manager for these funds. The funds are not treated as bank CIFs under Federal tax and securities laws, nor operated under CIF requirements. Banks should not operate "Pooled Income Funds" as their own CIFs. To be operated in compliance with, and fall under the exemptions of, Federal tax and securities laws, these funds must be established, sponsored, and held in trust by the outside organization under a written governing instrument. Banks may, however, "manage" the portfolios of the pooled funds for outside organizations in the capacities of administrator, investment advisor, or investment manager.

An assessment of the management of "Pooled Income Funds" typically includes a:

- determination of management's familiarity with applicable laws,
- review of the fund's governing documents and management’s conformance with applicable provisions,
- review of documentation attesting to the charitable organization’s qualification under IRC 501(a) and/or its authority to offer the funds under IRC Section 170(b)(1) (A), and
- review of the organization's corporate authority, or bylaws, enabling it to establish such a fund.

Banks lacking such documentation, or awareness of applicable laws, should be advised to obtain the documentation and seek qualified counsel. As with all other fiduciary matters, banks lacking expertise should be cautioned against continuing to offer these services until they obtain ample working knowledge of the product offered.

Regulation D Exempted Securities Offerings

[Rules Governing the Offer and Sale of Securities Without Registration Under the Securities Act of 1933 (the Act)]

The SEC adopted Regulation D under the Securities Act of 1933 (17 C.F.R. 230.501 to 508) to facilitate the application of both the nonpublic offering exemption under Section 4(2) of the Act, and the "small offering" exemption under Section 3(b) of the Act. Regulation D (described in more detail below) is intended to be a basic element in a uniform system of Federal and State limited offering exemptions consistent with the provisions of Sections 18 and 19(c) of the Act (involving state jurisdiction over securities transactions, and Federal and State coordinated regulation). In those states that have adopted Regulation D, or any version of it, compliance with state law is also required.

Regulation D affords banks the opportunity to offer pooled investment funds without having to register the funds as securities under the act. However, banks need to be aware that the funds themselves (1) continue to be viewed as securities by the SEC, and (2) may still come under the definition of a mutual fund ("investment company") under the Investment Company Act of 1940 (1940 Act).

The regulation provides an exemption from the Act's Section 5 securities registration requirements under very specialized circumstances.

- The regulation exempts issuers from registering certain securities offerings. It is available only to the issuer of the securities. It is not available to any affiliate of the issuer, or any other person engaged in selling of the securities. Caution: The exemptions apply only to the transactions in which the securities are offered or sold by the issuer, not to the securities themselves.
- It prohibits the offer or sale of these securities by means of any general solicitation or advertising.
- It limits the resale of the securities without registration. Use of the regulation is not available to any issuer for any chain of transactions which, although technically in compliance with the regulation, is viewed by the SEC as a method or scheme for evading registration under the Act. Issuers which continuously sell investment products under Regulation D, and which establish a new investment product each time the current product reaches regulatory limits, may be viewed by the SEC as evading securities registration laws.

Securities offered and sold outside the U.S. in accordance with Regulation S (17 C.F.R. 230.901 to 904 - rules governing securities transactions made outside the U.S.) do not have to be registered under the Act. Transactions in accordance with Regulation S, even where coincident with Regulation D transactions, are not counted towards the number of purchasers under Regulation D.

Properly applied, Regulation D permits securities issuers (including banks) to issue a security which:

- does not have to be registered under Federal securities laws, and
- does not have to be established and operated as a Regulation 9.18 CIF.

Therefore, some banks have used the exemptions afforded under Regulation D to collectively invest accounts which would not otherwise be permissibly invested in Regulation 9.18 CIFs, including, but not limited to, agency accounts and IRAs.

To avoid both securities registration and mutual fund treatment under Federal securities laws, Regulation D must be applied in concert with investment company exemptions allowed under Section 3(c)(1) of the 1940 Act:

- For purposes of the exemption categories in SEC Rule 505 (limited offers and sales of securities not exceeding $5 million) and Rule 506 (limited offers and sales without regard to the dollar amount of offering), Regulation D limits ownership to 35 investors plus an unlimited number of "Accredited Investors".
- Section 3(c)(1) of the 1940 Act limits ownership to 100 investors.
- Therefore, banks wishing to avail themselves of these exemptions must limit investors to no more than 100, with no more than 35 of that number being non "Accredited Investors."

In addition to restrictions on the number and sophistication of investors, Regulation D imposes numerous restrictions and requirements upon the issuer. Fluency with: Federal securities laws, current and past SEC positions on securities and mutual fund exemptions, Internal Revenue Code exemptions relating to pooled funds, trusts, and qualified employee benefit plans, Regulation 9.18, and applicable local securities and tax laws, is of paramount importance for any potential issuer of securities under these regulations.

The operation of such investment products requires a high degree of technical sophistication. Consequently, examiners encountering investment pools that have purportedly been established under Regulation D should review the following:

- Management's due diligence analysis of the product. Banks that have not performed a due diligence analysis should be cautioned.
- Outstanding legal opinions. Prior to establishing such funds, bank management should seek and obtain the written advice of qualified securities counsel. Examiners should recommend that management obtain a legal opinion from counsel familiar with such matters before selling additional participations in existing funds and before creating any additional funds.
- SEC No-Action Letter. Only by obtaining a letter can management be certain that their product conforms to Federal securities law requirements and meets with SEC approval.

Failure to comply with Federal securities laws may result in fines and other enforcement action by the SEC. Further, failure to qualify under both securities and tax laws could result in significant monetary losses to the fund, its investors, and ultimately, the bank.

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O. BANK AS INVESTMENT ADVISER TO CIFS AND MUTUAL FUNDS

Interagency Policy Statement

A bank may serve as the investment advisor for affiliated or non-affiliated pooled investment vehicles (CIFs, mutual funds, or other pooled investments). If a bank is advising registered mutual funds, the bank must register and comply with the Investment Advisors Act of 1940. Additional information is provided in Appendix D, Bank as Investment Adviser.

Transactions between a bank and its advised funds are restricted by the following regulations: 23A and 23B of the Federal Reserve Act, OCC Regulation 9, the Investment Company Act of 1940, the Investment Advisors Act of 1940, and ERISA. The regulatory restrictions and prohibited transactions address conflict of interest and self-dealing.

On January 5, 2004, The Federal Bank Regulatory Agencies issued a joint Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates. The purpose of the Policy Statement was to alert bank directorate and management to the safety and soundness implications and legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries or affiliates. The Policy Statement was issued in response to the elevated market volatility risk, credit risk, and interest rate risk present in advising money market mutual funds and other investment funds. The Policy Statement, located in Appendix G, provides risk management policy and procedural guidance for bank investment advisory activities.

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P. OVERVIEW OF FEDERAL LAWS

The operation of bank's pooled investment vehicles is directly linked to Federal securities, internal revenue, and banking laws. Failure to operate in conformity with the laws may jeopardize or cause the loss of securities and/or tax-exemptions to the collective fund or other pooled investment, its units of participation and, ultimately, its investors (trust accounts). Any losses sustained by investors by reason of a bank's failure to comply with these laws, whether through negligence or incompetence, would be the responsibility of the bank, both as a fiduciary, and as the issuer and operator of the pooled investment vehicle. Excerpts and summaries of some of the major applicable Federal securities and tax laws, regulations, and rulings follow.

Federal Securities Law

Federal securities laws empower the SEC to investigate any person or institution, including banks, suspected of violating Federal securities laws and SEC rules and regulations. The SEC has the authority to issue cease and desist orders, bring action in Federal courts to issue injunctions, impose monetary penalties on securities laws violators, and to bar individuals from serving as officers or directors of public companies. The SEC also has the authority to revoke licenses and impose civil money penalties in administrative proceedings against broker/dealers, municipal securities broker/dealers, government securities broker/dealers, transfer agents, and clearing agencies. Failure to adhere to Federal securities laws governing the operation of common trust funds, and tax and banking laws tied to securities law compliance, may not only result in the loss of a fund's exempt status under these laws, but also fines and censures against banks and bank officers administering the funds.

Securities Act of 1933 (1933 Act):

One of the primary purposes of the Securities Act of 1933 (1933 Act) is the regulation of interstate securities transactions. The 1933 Act accomplishes this by: defining what constitutes a security; requiring the registration and regulation of securities; and, regulating interstate securities transactions. Unless a specific exemption is available, a "security" must be registered under the 1933 Act. Among other types of investments, a mutual fund, or the sale of participations in a pooled portfolio of investments, is regulated as a "security."

Exempted Securities

Section 3(a)(2)	Section 3(a)(2) [Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts] Funds maintained by a bank for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian. Section 3(a)(2)(A) [Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans] Funds maintained by a bank which interest is issued in connection with a stock bonus, pension, or profit sharing plan, which meets the requirements for qualification under Section 401 of the IRC. Section 3(a)(2)(C)(ii) [Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans] Funds, exempted by the Commission, which interest is issued in connection with a stock bonus, pension, or profit sharing plan which covers employees who are employees within the meaning of Section 401(c) of the IRC.
Section 3(a)(4)	[Non-Bank-Operated Commingled Investment Funds] "Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

Intrastate Exemption

Section 3(a)(11)	[Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans] Intrastate exemption for securities sold only to persons of a single state by an issuer incorporated and doing business in the same state.

Small Offering Exemption

Section 3(b)	SEC jurisdiction for ruling on securities registration exemptions for issues not exceeding $5,000,000.

Exempted Transactions

Section 4(2)	Securities registration exemption for transactions by an issuer not involving any public offering.

Registered Securities

Section 5	Registration requirement for securities sold interstate.

State Jurisdiction Over Securities Transactions

Section 18	Affirmation of state jurisdiction over securities and persons involved in securities transactions (preserving so-called "Blue Sky" laws supervising securities broker/dealers, and securities transactions at the state level).

Coordination of Federal and State Securities Regulation

Section 19(c)	Declaration of policy to cooperate and coordinate securities regulation with state authorities.

SEC Rule 180 (Sophisticated Investor Rule) under the 1933 Act:

17 C.F.R 230.180 SEC Rule 180 provides what is often termed the "sophisticated investor" exemption for Keogh accounts. To qualify, the employer (plan sponsor):

- must be a law firm, accounting firm, investment banking firm, pension consulting firm, or investment advisory firm, the nature of whose business requires a familiarity with financial matters which would reasonably be expected to permit the employer to adequately represent its employees, or
- must obtain expert financial advice before adopting the plan from an entity which is independent of the bank operating the CIF.

  In addition, to qualify for the exemption, the Keogh plan must only cover employees of a single employer or employees of interrelated partnerships. For more information, refer to Keogh Account information in Section H.2 and Appendix G, 17 C.F.R. Section 230.180-"Sophisticated Investor Rule".

Regulation D under the 1933 Act:

17 C.F.R230.501 to 508: Regulation D

[Summary of Rules Governing the Offer and Sale of Securities Without Registration Under the Securities Act of 1933]

The rule provides exemption from Section 5 securities registration requirements for issuers of small nonpublic offerings. It also prohibits the offer or sale of securities by means of any general solicitation or advertising, and provides for limited resale of the securities (by the issuers) without registration.

The securities themselves, while exempt from securities registration when offered for sale by the issuer: (1) continue to be viewed as securities by the SEC and (2) may still come under the definition of a mutual fund ("investment company") under the Investment Company Act of 1940 (1940 Act).

To avoid both securities registration and mutual fund treatment under Federal securities laws, Regulation D must be applied in concert with investment company exemptions allowed under the 1940 Act (Section 3(c)(1) of the 1940 Act). More information on Regulation D can be found in Subsection N.5. Regulation D Exempted Securities Offerings.

For purposes of the exemption categories in SEC Rule 505 (limited offers and sales of securities not exceeding $5 million) and Rule 506 (limited offers and sales without regard to the dollar amount of offering), Regulation D limits ownership to 35 investors plus an unlimited number of "Accredited Investors". However, Section 3(c)(1) of the 1940 Act limits ownership to 100 investors. Therefore, banks wishing to avail themselves of these exemptions must limit investors to no more than 100, with no more than 35 of that number being non "Accredited Investors".

Section 230.504	Exemption for Securities Offerings Not Exceeding $1 million
Section 230.505	Exemption for Securities Offerings Not Exceeding $5 million
Section 230.506	Exemption for Securities Offerings Without Regard to Dollar Amount of Offering

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (1934 Act) regulates the interstate trading of securities in the marketplace. The 1934 Act also provides for ongoing public dissemination of securities disclosures, the regulation and supervision of securities exchanges and marketplaces, and the regulation and supervision of securities brokers and dealers.

Exempted Securities

Section 3(a)(12)	Section 3(a)(12)(A)(iii) [Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts] Funds maintained by a bank for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian. Section 3(a)(12)(A)(iv) and (C)(i) [Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans] Funds maintained by a bank which interest is issued in connection with a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under Section 401 of the IRC. Section 3(a)(12)(C)(iii) [Collective Investment Funds - 9.18(a)(2) Funds - Government Plans] Funds maintained by a bank which interest is issued in connection with a governmental plan as defined in Section 414(d) the IRC. Section 3(a)(12)(C)(iii)(I) [Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans] Funds, exempted by the Commission, which interest is issued in connection with a stock bonus, pension, or profit sharing plan which covers employees who are employees within the meaning of Section 401(c) of the IRC. Section 3(a)(12)(A)(v) Exempted Security [Non-Bank-Operated Commingled Investment Funds] "Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

Investment Company Act of 1940:

The Investment Company Act of 1940 (1940 Act) provides for the regulation of "investment companies," including mutual funds. Investment companies are issuers of securities which are engaged in the business of investing, trading, and holding securities. The sale of interests in a pool of investments may, under the 1940 Act, require the registration and regulation of the "investment company," or issuer of securities.

Investment Company Exemption

Section 3(c)	Section 3(c)(1) Any issuer whose outstanding securities are beneficially owned by not more than 100 persons, and which refrains from making a public offering of its securities. Section 3(c)(3) [Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts] Any bank which maintains a common trust fund for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian. Section 3(c)(11)(A) [Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans] Any bank which maintains a collective trust fund for the investment of assets which are derived solely from a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under Section 401 of the IRC of 1986, or any governmental plan described in Section 3(a)(2)(C) of the Securities Act of 1933, or both. Section 3(c)(11)(B) [Collective Investment Funds - 9.18(a)(2) Funds - Government Plans] Funds maintained by a bank which interest is issued in connection with a governmental plan as exempted from securities registration by Section 3(a)(2)(C) of the Securities Act of 1933. Section 3(c)(10)(B) [Non-Bank-Operated Commingled Investment Funds] "Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

Investment Advisers Act of 1940:

The Investment Advisers Act of 1940 (Advisers Act) requires the registration and supervision of investment advisers, including those who advise "investment companies" as defined in the Investment Company Act of 1940. Prior to the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), banks were expressly exempted from the Advisers Act. Refer to Section 202 for the revised definitions in the Investment Advisors Act.

Definition of a Bank

Section 202(a)(2)	A bank is defined as a banking institution organized under the laws of the United States, a member of the Federal Reserve System, or any banking institution or trust company doing business under the laws of any state or of the United States, a substantial portion of its business consisting of receiving deposits or exercising fiduciary powers similar to those permitted to national banks.

Investment Adviser Exemption

Section 202(a)(11)	Pre-GLBA, the definition of investment adviser did not include a bank, or any holding company, as defined in the Bank Holding Company Act of 1956, which is not an investment company. Post-GLBA, the revised definition of an investment adviser now includes banks and bank holding companies that provide investment advice to registered mutual funds. However, the bank exemption

	allowing for investment advisory services to individuals and those other than mutual funds (registered investment companies) continues to be intact (no registration required). Note: Per Thrift Supervision (OTS), the bank exemption of this particular section does not apply to thrifts.

Federal Banking Law

Banking Act of 1933:

The Banking Act of 1933 (codified into various sections of Title 12 of the U.S. Code), commonly referred to as the Glass-Steagall Act (Act), was intended to separate commercial banking activities from investment banking and securities activities. It generally prohibited banks from directly engaging in securities activities. However with the passage of the GLBA many of the prohibitions have been removed.

Codified to 12 U.S.C. Section 24 Seventh

Section 16	Prohibits a national bank from underwriting, buying or selling securities for its own account. National banks are permitted to invest in marketable debt obligations for their own account, which are not in excess of 10% of its capital and surplus. This section is applicable to state member banks by virtue of the Federal Reserve Act. State nonmember banks are not subject to this section, but are subject to similar restrictions under Section 21 of the Act.

Codified to 12 U.S.C. Section 378

Section 21	This section is the only provision of the Act that is directly applicable by its terms to state nonmember banks. It makes it unlawful for organizations engaged in the issuing, underwriting, selling, or distributing of securities to engage in the business of receiving deposits. These restrictions also apply to banks. In Board of Governors of the Federal Reserve System v. Investment Company Institute, the Supreme Court ruled, however, that the restrictions do not apply to non-banking affiliates of banks (450 U.S. 46, 58, 59 n.24 (1981)). This section allows state nonmember banks to purchase or sell securities for their own accounts. However, Section 24 of the Federal Deposit Insurance Act (12 U.S.C. Section 1831a) made state nonmember banks generally subject to the same limitations as apply to national banks, thereby limiting their advantage over national and state member banks.

Codified to 12 U.S.C. Section 78

Section 32	The Gramm-Leach-Bliley Act repealed Section 20 of the Banking of Act of 1933. Refer to Appendix D for additional details. This section did not apply to state nonmember banks.

Title 12 C.F.R. 9.18

<u>Regulation 9.18</u>

National Banks derive their powers from the National Bank Act, enacted in 1863. The trust powers of national banks are set forth in 12 U.S.C. Section 92a. Initially, national banks were conferred the authority to act in a fiduciary capacity under Section 11(k) of the Federal Reserve Act of 1913. As early as 1927, banks were sponsoring collective investment funds. However, formal Federal bank regulation of bank-sponsored funds was not introduced until the Federal Reserve Board issued Regulation F in 1937. The modern equivalent of collective funds emerged a year earlier when Congress amended Federal tax laws, first granting tax exemption to the funds. In 1956, the IRS extended the scope of CIF tax exemption to include CIFs of retirement plans qualified under IRC Section401. Regulation 9.18 emerged as the successor to Regulation F, when the Congress transferred CIF supervisory authority from the Federal Reserve Board to the OCC in 1962. The operation of CIFs in state nonmember banks rely on IRC Section 584 to achieve tax-exemption and must comply with OCC regulations. These CIFs are usually limited to personal trust CIFs, as compliance with OCC regulations is not mandatory for state nonmember banks operating employee benefit CIFs in compliance with RR 81-100.

Federal Tax Laws

Internal Revenue Code (IRC)

Definition of "Bank"

IRC Section 581	Defines a "bank" for the purposes of IRC Sections 582 and 584. By virtue of this section of the IRC, both banks and nondeposit trust companies are permitted to operate common trust funds.

Common Trust Funds

IRC Section 584	Describes requirements and procedures for the operation of bank operated common trust funds. This section primarily pertains to the operation of common trust funds for personal accounts (personal trusts, estates, guardianships, and accounts created under a Uniform Gifts to Minor Act). Section 584 provides that any CIF which obtains its tax-exempt status from that section of the Code must comply with OCC Regulation 9.18. As a result, FDIC-supervised banks operating CIFs in accordance with the tax-exemption in IRC Section 584 must comply with OCC Regulation 9.18. State or local laws do not exempt state banks from compliance with this provision, as compliance is mandatory to achieve CIF tax-exemption under Section 584. Banks may also rely on the tax-exempt treatment afforded CIFs by Section 584 when establishing funds exclusively for employee benefit and certain other tax-exempt fiduciary accounts administered in the capacity of trustee.

Collective Investment Funds

RR 81-100	This Revenue Ruling applies to the collective investment of trust and agency accounts of employee benefit plans which obtain their tax-exempt status from Section 401 of the Internal Revenue Code, or IRA accounts which obtain their tax-exempt status from Section 408 of the Internal Revenue Code. IRAs are effectively barred from CIFs and, for all practical purposes, may only be collectively invested in registered mutual funds.

	These CIFs are typically established in a form identical to that outlined by OCC Regulation 9.18(a)(2). However, unlike mandatory compliance with OCC Regulation 9.18(a)(1) with respect to personal trust CIFs (by virtue of IRC Section 584), there exists no similar Federal requirement that FDIC-supervised banks comply with OCC Regulation 9.18(a)(2). Unless local law requires state nonmember banks to comply with 9.18(a)(2), that regulation should be regarded as a prudent industry standard and as guidance in the operation of employee benefit CIFs, but not obligatory. The Revenue Ruling requires: each participating employee benefit plan to adopt the group trust (CIF declaration of trust) itself as part of the plan; that the group trust prohibit CIF assets from being diverted to any purposes other than the exclusive benefit of participating plan beneficiaries; that the group trust prohibit assignment of any CIF assets by any of the participating plans; and that the group trust be established and maintained as a domestic U.S. trust.

Pooled Income Fund

IRC Section 642(c)	Pooled funds comprise charitable gifts from donors which are maintained in a commingled investment fund by organizations described in IRC Section 170(b)(1)(A), including churches, educational institutions, and hospitals. Securities law exemptions for these funds are contained in: Section 3(a)(4) of the Securities Act of 1933; Section 3(a)(12)(A)(v) of the Securities Exchange Act of 1934; and Section 3(c)(10)(B) of the Investment Company Act of 1940. Banks may be appointed as administrator or investment manager of these funds, which are not treated as bank CIFs under Federal tax and securities laws.

Partnership

IRC Section 761	A partnership is defined to include groups, pools, or other unincorporated organizations through which a business is conducted, including investment activities (such as bank operated CIFs).

Tax Returns for Bank Common Trust Funds

IRC Section 6032	U.S. Treasury Regulation Section 1.6032.1 and IRC Section 6032 require banks (as defined in IRC Section 581) operating CIFs to file annual informational returns with the IRS for each fund established under Section 584 of the IRC. No specific form has been created by the IRS for this purpose. However, Schedule K-1 of Form 1065 (Partner's Share of Income, Credits, Deductions) is typically used to satisfy the reporting requirement. The return is required to include for each fund participant: name, address, their proportional share of taxable income or losses, and capital gains or losses. This informational return is required, regardless of the taxable income earned during the reporting period. The aforementioned Treasury regulation also requires banks to file a full copy of the CIFs declaration of trust, and any amendments thereto, at least once with the return. Employee benefit CIFs operated in accordance with RR 81-100, and which derive their tax-exemption under IRC Section 501(a), are not required to file any informational returns with the IRS. However, collective investment funds maintained by a bank, trust company, or similar institution, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations are defined by the Department of Labor as Direct Filing Entities (DFE). Such collective investment funds are required to file DOL Form 5500. The DFE Form 5500 is also an integral part of the annual report of each participating plan. As a result, the administrator of a plan may be subject to

	penalties for failing to file a complete annual report unless both the DFE Form 5500 and the plan's Form 5500 are properly filed. Refer to Subsection 5.J.1.and Subsection 5.I.2. for information regarding various reporting requirements.

State Statutes

Common law places restrictions on commingling. All states and the District of Columbia now have enabling legislation which permits operation of collective funds. In many states, the Uniform Common Trust Fund Act is the *basis* of the enabling legislation that authorizes the operation of CIFs. State law may also include additional requirements, such as a requirement to furnish periodic accountings to a particular court and/or the state supervisory authority.