

## financial services lawflash

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## OCC Issues Updated Guidance on Collective Investment Funds

*The update to the Comptroller's Handbook highlights the Office of the Comptroller of the Currency's enhanced expectations regarding the overall risk management of collective investment fund activity and provides insight into areas of current regulatory concern.*

The Office of the Comptroller of the Currency (OCC) recently released a long-awaited update to the Asset Management series of its *Comptroller's Handbook* on collective investment funds (CIF Handbook).<sup>1</sup> The CIF Handbook revises the 2005 version and provides detailed guidance on the expectations of the OCC regarding the offering and administration of collective investment funds (CIFs)—including common trust funds for fiduciary assets, employee benefit plan collective funds, and other pooled investment funds operated under the OCC's fiduciary activities regulations—by national banks and federal savings associations. The CIF Handbook is drafted as guidance to examiners, but it is an essential reference tool for banks that offer and manage CIFs as it sets out, in detail, both the OCC's revised and enhanced expectations and the checklists and evaluation criteria that the OCC's examiners will use.

Consistent with the OCC's general emphasis on risk management, the CIF Handbook devotes substantial and significantly more detailed attention to CIF risk identification and management issues. The OCC will expect banks to have more robust and active management and board oversight of CIF activity as well as substantive and clear documentation of various decisions and calculations that are required in the course of managing a CIF. The CIF Handbook revises the examination procedures for CIFs and establishes two broad categories of inquiry for examiners, with detailed guidance regarding questions to ask and materials to request: (1) quantity of risk (i.e., low, moderate, high) and (2) quality of risk management (strong, satisfactory, weak).

The OCC identifies the primary risks associated with offering and managing CIFs as compliance, operational, strategic, and reputation. In addition, the OCC expresses concern about investment risks to which CIF sponsor banks are exposed, especially liquidity risk. The OCC notes that a manager of a CIF must balance ensuring adequate liquidity to meet customer redemption needs with the need to ensure that the fund meet its benchmarks and provides a competitive return. Stress testing, including regular testing of any contingency financing sources, is expected.

### Risk Management Expectations

The CIF Handbook establishes the expectation that a bank will have effective risk management processes that specifically

- establish strategic direction, risk appetite, and an ethical culture consistent with the bank's strategic goals and objectives for its funds;
- establish an appropriate organizational structure for bank CIFs, with clear delineation of authority, responsibility, and accountability through all levels of the organization;

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1. The Collective Investment Funds handbook is available at <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/am-cif.pdf>.

- develop and implement a comprehensive and effective risk management system; and
- monitor the implementation of investment management risk strategies and the adequacy and effectiveness of risk management processes for the bank's CIFs.

Furthermore, administrative processes established by the bank should ensure that the bank

- establishes and maintains funds in accordance with a written plan;
- maintains CIF documents in a central repository;
- has a formal process through the bank's board of directors, or a committee appointed by the board, to approve or terminate CIFs;
- uses qualified counsel;
- evaluates fees to ensure they are reasonable; and
- maintains adequate board and committee oversight.

The CIF Handbook references and incorporates previous OCC guidance on a variety of matters, including third-party investment advisory and other outsourcing arrangements.<sup>2</sup> The OCC emphasizes that banks may not "rent their charters" to third parties that wish to engage in offering CIFs and that there must be clear disclosures that the CIF is offered and managed by the sponsoring bank. The OCC cautions that it will "closely scrutinize" third-party arrangements to ensure compliance and the presence of a strong risk management system.

The CIF Handbook also discusses new detailed expectations regarding asset allocation, benchmarks, valuation, and securities lending. The OCC expects banks offering and managing a CIF to determine the appropriateness of fund investments and to have a well-defined process for evaluating the potential performance of the proposed fund portfolios to ensure they follow the fund's documented risk limits. If the CIF uses leverage to enhance returns, the bank must have processes in place to calculate the leverage risk in the fund's portfolio, and the bank must monitor and manage that leverage risk.

Furthermore, a bank is expected to have detailed policies that set out the decision-making process for selecting the most appropriate benchmark for the CIF. The bank is expected to document its process for selecting the benchmark for the CIF, and it must have policies and procedures in place, including specific risk-adjusted return measures, for monitoring the performance of the CIF against its benchmark.

The process of assigning asset value should be subject to well-defined management oversight and management information reporting; well-delineated policies, procedures, and processes; and a well-articulated system of internal controls. The CIF Handbook states that it is "critical" that valuations and the calculation of a CIF's net asset value be made by persons independent of those with investment management responsibilities for the CIF. Asset values for assets that are difficult to price should be obtained from an unaffiliated provider when possible.

Securities lending by a CIF to certain creditworthy borrowers should be evaluated for not only operational risk, but also for investment risk. The OCC is particularly concerned with the risks presented by the nature of collateral accepted by the bank in exchange for the lent security. Illiquid collateral could result in the bank being forced to sell the collateral at "fire sale prices" in order to have sufficient cash to take back the lent security. The OCC notes that bank CIF sponsors experienced losses during the 2008 financial crisis because of illiquid collateral.

## Updates to Administrative Requirements Under 12 C.F.R. 9.18(b) (CIF Regulations)

The CIF Handbook updates the OCC's commentary and guidance on the various administrative requirements imposed on banks with respect to offering and managing CIFs. Although the CIF Handbook does not contain

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2. OCC Bulletin 2013-29, Third-Party Relationships: Risk Management Guidance, *available at* <http://www.occ.treas.gov/news-issuances/bulletins/2013/bulletin-2013-29.html>; OCC Bulletin 2011-11, Collective Investment Funds and Outsourced Arrangements, *available at* <http://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-11.html>.

material departures from prior OCC guidance, some notable revisions include the following:

- **Stable Value Fund (SVF) Withdrawals:** Certain SVFs may transact withdrawals at different prices on the same day—employee-directed benefit-responsive withdrawals at one price (amortized cost) and employer-directed withdrawals at another price (market value)—provided that there are adequate disclosures, the differential in withdrawal prices is expressly authorized by the SVF’s plan, and wrap protection is otherwise unavailable at a reasonable price to the fund.
- **Conflicts of Interest:** If a CIF invests in deposit products of its offering bank, the bank must (1) have a process to ensure the fund receives a competitive interest rate and (2) periodically retain an independent third party to evaluate the bank’s process for setting rates to ensure that the rates offered to the CIF are competitive.
- **Management Fees and Expenses:** Under very limited circumstances, and with express OCC approval, a fund plan may authorize the sponsoring bank to pass through to all fund participants certain brokerage, transaction, and other fees associated with the admission or withdrawals of accounts.

## Observations

Since the 2008 financial crisis, the OCC has focused its supervision efforts, in large part, on ensuring that banks have in place risk management frameworks that the OCC deems adequate and appropriate for the level of risk faced by the bank. Accordingly, the new CIF Handbook represents a natural extension of the OCC’s overall supervisory emphasis on national bank risk management activities and, in this respect, contains few major surprises for national bank collective fund managers. At the same time, the new CIF Handbook is materially more detailed as to the nature of and the risks presented by CIF activities as well as the policies and processes a bank is expected to have in place to manage these risks.

Some of the specific topics addressed in the CIF Handbook, including CIF liquidity management, conflicts of interest, valuations, and securities lending activities, reflect some of the problems that bank CIFs encountered during the financial crisis, and it is not surprising that the OCC would choose to address, in some detail, these issues. Similarly, the OCC devotes materially more attention to the issue of third-party service provider retention and oversight and sets forth, in considerable detail, its expectations and requirements for bank managers. The OCC, however, also continues to focus on recurring regulatory issues, such as CIF admission and withdrawal activities, compliance with bank and securities regulatory requirements for common and collective fund management activities, and participant eligibility requirements, albeit again with a greater degree of detail.

OCC examiners will use the CIF Handbook as a core reference tool and checklist in their examinations of national bank CIF activities, and national banks that sponsor and administer CIFs therefore must pay careful attention to the revised expectations and examiner guidance set out in the CIF Handbook. The OCC will look for clear documentation, processes, and policies that demonstrate adherence to guidelines and expectations set out in the CIF Handbook, and national banks that fail to adhere to these standards could face examiner criticism or worse. Furthermore, as the revised expectations in the CIF Handbook are implemented, banks should expect any CIF activity to be a source of inquiry during their next OCC examination.

The CIF Handbook is also important for state banks and trust companies that engage in CIF activities. Although state banking organizations are not directly subject to OCC regulatory requirements or OCC examination and supervision, OCC supervisory guidance on CIF activities is given significant weight by numerous state regulatory authorities as well as by the Federal Reserve Board and the Federal Deposit Insurance Corporation at the federal level. In addition, a number of state fiduciary laws either incorporate or reference OCC fiduciary and collective investment fund regulations, as does section 584 of the Internal Revenue Code in the case of tax-qualified common trust funds. In turn, OCC regulatory guidance in this area becomes all the more relevant for affected bank CIF managers of all charters.

# Morgan Lewis

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