
Mutual Funds Examination Program

Examination Objectives

To assess the level and quality of oversight of the trust department's selection and monitoring of mutual funds. Consider whether:

- effective policies, procedures and internal controls for the selection and monitoring of mutual funds have been established;
- compliance with governing instruments, applicable law and accepted fiduciary principles is ensured;
- documentation to support investment decisions is maintained; and
- corrective action is taken when violations of governing instruments, applicable law or accepted fiduciary principles occur.

Examination Procedures

Wkp. Ref.

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether new products and/or services have been introduced. If items of concern are uncovered during a Level I procedure or if problems are identified during the preexamination monitoring and scoping, the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to mutual fund selection and monitoring. Scoping material should include:
 - Risk profile
 - Relevant PERK documents
 - Previous trust and asset management examination report
 - Work papers from the previous examination
 - Board of director and other appropriate committee minutes

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 1 of 11

Mutual Funds Examination Program

Wkp. Ref.

- Examination reports of subordinate, functionally regulated entities
- Savings association's web page
- Recent ADV and any amendments

2. Evaluate the trust department's policies and procedures concerning the selection and monitoring of mutual funds as investments for trust and asset management accounts. Consider:

- How compliance with applicable law, standards of fiduciary conduct and policies and procedures are ensured.
- The process and criteria used to select and monitor mutual funds as investments for discretionary accounts, including the use of outside firms to provide research and analysis.
- The process used to determine that proprietary mutual funds and mutual funds in which the savings association or its affiliate receives an economic benefit, meet the appropriate prudent investment state law standards.
- The process used to determine that proprietary mutual funds and mutual funds, in which the savings association or its affiliate receives an economic benefit, address the conflict of interest inherent in such an investment. This includes a determination of the appropriate state statute permitting such an investment, if applicable, and a system for determining that all state statute requirements have been met.

3. Evaluate whether management has the knowledge and expertise necessary to formulate and carry out mutual fund investment policies and procedures. Note any significant personnel and/or organizational changes.

4. Review and evaluate the analysis, selection and approval process with respect to mutual funds.

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 2 of 11

Mutual Funds Examination Program

Wkp. Ref.

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5. If investment research and analysis is obtained from an outside source, evaluate the quality and timeliness of information obtained.
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6. Determine and evaluate how information generated from the analysis, selection and approval process is communicated to and used by staff involved in the administration of trust accounts.
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7. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, determine the reasons for their presence. Evaluate management's plan to correct these exceptions.
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8. Consider whether the following risk contributors (if applicable) have been addressed:
- Does management fully understand all aspects of risk with respect to mutual fund investments?
 - Are policies and procedures adequate?
 - Does management anticipate and respond well to market and technological changes?
 - Is investment research and analysis sound?
 - Are management information reports comprehensive and credible?
 - Is the internal control environment adequate?
 - Does management satisfactorily review and assess exceptions to policy?
 - Does management monitor fund analysts for adverse comments on mutual funds held by discretionary accounts?

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 3 of 11

Mutual Funds Examination Program

Wkp. Ref.

- Does management quickly identify weaknesses and take appropriate action?
 - Are there material unresolved mutual fund issues noted in audit, compliance or examination reports?
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Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of the Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures include any significant verification procedures.

1. If changes in the amount, type or quality of mutual funds in discretionary accounts since the previous examination result in a change in the savings association's risk profile, determine:
 - the reasons for the change;
 - if management's risk assessment considered this change; and
 - if not, determine the reasons why it was not considered.

2. Review management reports describing additions or deletions from the approved mutual fund list. Evaluate the reasons for additions or deletions to the list.

3. If proprietary mutual funds are used as investments for discretionary accounts, determine that procedures are in place to monitor compliance with OTS TB 76-2. Confirm that:
 - a copy of the mutual fund prospectus is provided to interested parties;
 - there is adequate documentation in the account file showing that the mutual funds are

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Page 4 of 11

Mutual Funds Examination Program

Wkp. Ref.

prudent investments for the account;

- appropriate disclosures are made regarding the affiliate relationship, the nature of services provided and the amount of fees paid to an affiliate; and
- discretionary accounts are being invested in the appropriate class of the mutual fund, e.g. an institutional class vs. a retail class.

4. If investment authority has been delegated to an affiliate or third party that invests in proprietary mutual funds of the affiliate or third party, determine that management conducts an appropriate review of the activity to ensure that actions taken by the affiliate or third party meet OTS TB 76-2 regarding conflicts of interest and prudent investment of discretionary accounts.

5. If management does not produce an exception report, determine how it monitors unapproved mutual funds and conclude if this process is reasonable and effective.

6. If proprietary mutual funds are present in discretionary accounts, review management reports comparing the performance of the funds to benchmarks. Evaluate the benchmarks being used to compare the performance of the proprietary funds.

7. If there has been a conversion of a savings association's common and/or collective investment funds into the savings association's proprietary mutual funds, coordinate with the examiner performing the common/collective investment funds program, and determine whether the savings association considered all applicable law requirements as well as fiduciary principles before the conversion occurred.

8. Review and verify the accuracy of any applicable management information or exception reports.

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 5 of 11

Mutual Funds Examination Program

Wkp. Ref.

9. Determine how proxies for proprietary mutual fund shares are voted when held by discretionary accounts. Is there a process in place for voting these proxies in the best interests of the accounts invested in the proprietary funds?

10. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion, proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

1. Pull a sample of discretionary accounts and determine if “load” mutual funds are used. Determine whether the use of “load” funds are prudent by comparing the performance of “load” mutual fund to mutual funds that have no sale charges or “loads.”

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 6 of 11

Mutual Funds Examination Program

Wkp. Ref.

2. Pull a sample of discretionary accounts and review them to determine whether funds that have approved a 12b-1 fee arrangement are an appropriate investment for the account. When reviewing employee benefit accounts determine if the Department of Labor guidelines are being followed.

3. Select a sample of discretionary accounts and review their mutual fund investments. Include in the sample those accounts invested in proprietary mutual funds as well as funds in which the savings association or its affiliate is receiving an economic benefit. Determine if the mutual funds in the account are appropriate in view of the investment objectives of the account, characteristics and risk tolerances of the beneficiaries, the type of account and other pertinent factors.

4. Select a sample of discretionary accounts with investments in mutual funds. Consider whether the mutual funds in the account are appropriate in view of the investment objective of the account, characteristics and risk tolerances of the beneficiaries, the type of account and other pertinent factors.

5. Review the mutual funds held in discretionary accounts and compare them to the approved mutual fund list. If any unapproved funds are present, select a sample of those funds to review. Consider:

- Whether unapproved mutual funds are included on the exception reports.
 - The reasons for the unapproved mutual funds and whether the exception has been approved and properly documented. If the unapproved mutual fund is not on the exception report, determine the reason for this lapse and assess the appropriateness of the investment.
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Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Page 7 of 11

Mutual Funds Examination Program

Wkp. Ref.

6. Select a sample of discretionary accounts containing mutual funds reviewed by the audit and/or compliance functions. Determine if the findings of the audit/compliance review are consistent with examination findings.

7. Select a sample of nondiscretionary accounts containing mutual fund investments to determine that proper authorization for the mutual fund is present, such as a current direction letter.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Page 8 of 11

Mutual Funds Examination Program

Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

<ul style="list-style-type: none">• Are policies and procedures adequately documented?
<ul style="list-style-type: none">• Are the policies developed and approved by the board of directors or an appropriate committee of the board?
<ul style="list-style-type: none">• Do the policies outline standards to safeguard against conflicts of interest and self-dealing?
<ul style="list-style-type: none">• Do the policies discuss the process for use of proprietary mutual funds for discretionary accounts?
<ul style="list-style-type: none">• Do the policies establish standards and procedures to evaluate and monitor mutual fund quality?
<ul style="list-style-type: none">• Do the policies outline the process and criteria for selecting and evaluating potential mutual funds?
<ul style="list-style-type: none">• Do the policies outline the process for monitoring existing mutual funds?
<ul style="list-style-type: none">• Do the policies outline the standards for developing and amending approved lists of mutual funds?
<ul style="list-style-type: none">• Do the policies outline the process for approving deviations from established policy guidelines, as well as a process for monitoring policy deviations?

Delegation of Investment Responsibility

<ul style="list-style-type: none">• Are the delegated investment activities permissible under applicable law?
<ul style="list-style-type: none">• Is there a written agreement that addresses all pertinent issues?
<ul style="list-style-type: none">• Was the decision to delegate made in accordance with policy?
<ul style="list-style-type: none">• Is the selection and monitoring process effective?
<ul style="list-style-type: none">• Does a policy exist that outlines the delegation decision making process, the investment activities to be outsourced and the criteria for selecting and monitoring third parties?

Investment Decisions

<ul style="list-style-type: none">• Are decisions based on adequate research and analysis (whether performed in-house or acquired from external sources), including an evaluation of relevant factors pertaining to the type of security under consideration?
<ul style="list-style-type: none">• Are decisions based on an evaluation of relevant factors pertaining to the type and characteristics of the account for which the decision is being made?
<ul style="list-style-type: none">• In making decisions regarding mutual fund investments, does management consider:<ul style="list-style-type: none">• Quality of investment company management, specifically the fund manager;• Risk adjusted rates of return for the fund and their consistency over various time periods and

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Mutual Funds Examination Program

comparisons to other related funds (benchmarks);
<ul style="list-style-type: none">• Compliance with prospectus guidelines including diversification and compatibility with funds objectives (“style drift”);• Quality of existing holdings;• Tax efficiency of the fund; and• Mutual fund fee structure.
<ul style="list-style-type: none">• Are decisions adequately supported and well documented?

Investment Research

<ul style="list-style-type: none">• Does management investment analysis include one of the ratings agencies, such as Morningstar, Lipper or Value Line to assist in the mutual fund selection decision?
<ul style="list-style-type: none">• Does management periodically review sources of investment research, to determine the quality of research provided?
<ul style="list-style-type: none">• Does management review research material, to determine if adequate justification exists to support investment decisions, including information relating to the company’s management and financial condition, such as balance sheets, annual report and position in the industry?

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____