Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 21, 1998

Interpretive Letter #841
November 1998
12 C.F.R. 9.18

Re: [*Bank*]: Collective Investment Funds

Dear [ ]:

This responds to your letters on behalf of [ ](Bank), requesting that the Office of the Comptroller of the Currency (OCC) confirm the permissibility of the Bank's proposed method of distribution for certain of its collective investment funds (CIFs) under 12 C.F.R. § 9.18(b)(5)(iv) (1998). Based on the representations in your letters and in subsequent phone conversations, and subject to the conditions set forth below, the Bank may proceed with its proposal.

I. Background

The Bank currently maintains numerous CIFs operated pursuant to the requirements of 12 C.F.R. § 9.18(b). Among those CIFs is the [ ] (SIF), established pursuant to 12 C.F.R. § 9.18(a)(1).[1] Participant investors in the SIF are [ ] (DTs) for which the Bank or an affiliate serve as trustee. DTs are long-term investment vehicles established for the purpose of funding the future [ ] of [ ]. Participants in the SIF are limited to DTs. You state that DT income generally is taxable, but that Section [ ] of the Internal Revenue Code (IRC) provides advantageous tax treatment for certain qualified portions of the DTs.[2]

You represent that the SIF participants have common goals and objectives because each participating DT is established and maintained as a long-term investment vehicle for funding

[1] The SIF is designed to replicate the composition of the S&P 500 Index.

[2] [ ] U.S.C. § [ ].

the future [ ] of [ ]or [ ]. Further, you state that given the need for long-term investment, SIF participants prefer to defer the payment of any kind of tax. Consequently, the Bank manages the SIF taking into consideration the DTs' need for: [1] long-term investment; [2] any special tax rate applicable only to DTs; [3] any investment restrictions applicable to DTs; [4] cost-effective economic management of assets; [5] minimization of taxes; and [6] diversification.

In addition to the SIF, you represent that the Bank intends to establish and operate additional index CIFs in the future (collectively Future Index Funds (FIFs)) for DT investment. Those funds will also be established under 12 C.F.R. § 9.18(a)(1) and will operate in substantially the same manner as the SIF. Like the SIF, the FIFs will replicate the composition of a third party securities index. Similarly, any organization creating and maintaining an index replicated by the FIFs must be either: [1] engaged in the business of providing financial information, evaluation, advice or securities brokerage services for institutional clients; [2] a publisher of financial news or information; or [3] a public stock exchange or association of securities dealers. Moreover, the Bank will use only those indices of organizations that are independent of the Bank and its affiliates and those that are generally accepted, but not specifically tailored, for use by the Bank or its affiliates, *e.g.*, the Russell 2000 Index.

To accommodate the long-term, low cost funding objectives of the SIF and FIFs, the Bank wishes to amend or establish the relevant fund documents to mandate that withdrawals in amounts below a specified value must be in cash, while withdrawals in amounts at or above that specified value will occur in kind.[3] To insure that the Bank's proposed method of distribution for the SIF and the intended FIFs is consistent with Part 9's distribution requirements, the Bank seeks OCC confirmation of the permissibility of the proposed distribution procedures or, a waiver to permit the Bank's proposed method of distribution.

II. The Proposal

The Bank proposes that distributions to participants withdrawing from the SIF be divided into two components:

[1] TOTAL WITHDRAWALS - Withdrawals of a DT's total investment in the SIF must be made on an in kind basis unless the value of the investment is less than $5,000,000 in which case the withdrawal must be made on a cash basis.

[2] PARTIAL WITHDRAWALS - Withdrawals of a portion of a DT's investment in the SIF must be made on an in kind basis and must be $5,000,000 or more. If a DT's total investment

[3] A ratable "in kind" distribution of the SIF's assets to a DT account would consist of a distribution that reflects the account's proportionate interest in all the SIFs assets, *i.e.,* securities that replicate the composition of the S&P 500 Stock Index.

in the SIF immediately prior to the withdrawal is less than $5,000,000, withdrawals must be made in cash.

The Bank also proposes that [1] and [2] above apply to distributions to a DT account withdrawing from its FIFs, except the threshold dollar amount will vary depending on the index. The Bank, in its fiduciary capacity, will determine the threshold amount for each FIF in a manner similar to that used for the SIF. For example, the Bank will determine what threshold dollar amount is needed for a pro rata withdrawal of the stock held in a FIF tracking the Russell 2000 index.

If the Bank's proposal is deemed permissible by the OCC, the Bank will notify SIF participants of the impending changes to be made to the SIF's withdrawal provisions. Existing SIF participants would then be afforded the opportunity to withdraw from the SIF under the existing withdrawal and distribution provisions or to remain invested in the SIF and become subject to the new provisions. All new SIF participants would be informed of applicable withdrawal and distribution procedures prior to investing in the SIF. The FIFs would have the proposed withdrawal and distribution procedure in place from the inception of each FIF.

The Bank believes that in kind distributions, if feasible, are often less costly to an index CIF and its participants. Conversely, in the case of relatively small distributions, the Bank believes that the strict portfolio requirement of distributing ratably in kind for an index CIF makes cash withdrawals preferable from the CIF's perspective.

To illustrate, the tax consequences of in kind distributions are often more preferable for an index CIF and its participants than cash distributions. Regardless of whether an index CIF participant receives an in cash or in kind withdrawal, the withdrawing participant would recognize a gain or loss measured by the difference between the sum of the cash and fair market value of the property received and the participant's adjusted basis in the interest redeemed. In the case of a cash withdrawal, the index CIF and all of the participants would also recognize a gain or loss from the sale of assets. Conversely, neither the index CIF nor its participants would recognize a gain or loss based on an in kind distribution, although the redeeming participant would take a basis in the property received equal to its fair market value at the time of redemption. Accordingly, where practicable, it is often advantageous to an index CIF and its participants for the index CIF to pay redemptions through the distribution of assets (*i.e.*, in kind) rather than in cash because the sale of assets to make a cash distribution could result in a substantial taxable gain to the index CIF and all of its participants.

In kind distributions are also beneficial to SIF participants in the context of brokerage costs. Brokerage costs must be borne by participants withdrawing from the SIF.[4] In kind

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[4] The documents establishing the SIF require brokerage costs to be borne by withdrawing participants.

distributions defer brokerage costs to a later sales date. Consequently, participants withdrawing in kind benefit by being able to manage the time for payment of brokerage costs. It is true a participant withdrawing in kind bears the market exposure between the time of the withdrawal and the time of sale. Nevertheless, since DTs are long-term investors, they are likely to want continued exposure to the market. If the DTs do not want that exposure, they can sell the assets on or immediately after the withdrawal date.

Conversely, the general benefits of in kind distributions do not apply to relatively small distributions from an index CIF. Certain withdrawals from an index CIF may be too small to permit a pro rata share of each security in the index to be distributed on an in kind basis. For example, to distribute securities in the SIF ratably, approximately 500 stocks must be distributed. Since stocks held in the SIF are weighted according to certain factors, such as economic size in the marketplace, the number of shares distributed in kind for each company varies in proportion to the weighting. In the case of smaller distributions, the Bank represents that attempting to make the distribution on an in kind basis would result in substantial disruption (and expense) to the SIF.

Consequently, the Bank has determined that in kind withdrawals from the SIF are only practicable in amounts of $5,000,000 or more. The Bank believes an amount less than $5,000,000 would not give the withdrawing participant enough shares of each stock to be representative of the index. Moreover, when in kind withdrawals are less than $5,000,000, the cost to buy and sell stock in order to retain the SIF as an index fund could be significant when compared to the amount withdrawn. As a practical matter, the Bank expects that many of the DTs participating in the SIF will have assets well in excess of $5,000,000. In the case of a distribution in excess of $5,000,000, where the portfolio of the SIF will not be seriously disrupted by a pro rata in kind distribution, given the objectives of the SIF described above, the Bank represents that an in kind distribution would be in the best interests of the SIF and its participants.

The Bank believes that the proposed distribution procedures provide an equitable balance beneficial to the operation and administration of SIFs, FIFs, and their participants. Further, the Bank believes that the OCC's CIF rules expressly permit fund distributions to be structured in this manner.

III. Discussion

OCC regulations generally govern the administration of CIFs by national bank trustees.[5] A national bank administering a CIF must make distributions to accounts withdrawing from the CIF in accordance with 12 C.F.R. § 9.18(b)(5)(iv) (1998). Specifically, a national bank must make those distributions [1] in cash, [2] ratably in kind, [3] by a combination of cash and ratably in kind, or [4] in any other manner consistent with applicable law in the state in which the bank maintains the fund.[6] National banks administering a CIF must admit or withdraw participant accounts on the basis of the valuation as of the valuation date set in the bank's written plan.[7] Depending on the type of fund or the assets held by a CIF, the value of a CIF's assets may be based on market value, fair value or cost.[8] A bank must disclose the terms and conditions governing the admission and withdrawal of participating accounts in the bank's written plan.[9]

The former Part 9 distribution provisions provided that distributions to withdrawing accounts could be made [1] in cash, [2] ratably in kind, [3] or partly in cash and partly in kind; *Provided*, that all distributions as of any one valuation date were made on the same basis.[10] Those distribution provisions did not expressly state that national banks could make distributions in any manner other than that consistent with the Federal standard. The OCC's recent revisions to Part 9 do expressly permit distributions under the Federal standard *and* other distributions consistent with applicable state law. Here, the Federal distribution standard

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[5] 12 C.F.R. § 9.18 (1998). Part 9, including 12 C.F.R. § 9.18, was amended effective January 29, 1997. 61 *Fed. Reg*. 68,543 (1996). Part 9 was revised in response to the changes in national banks' fiduciary business over the past 35 years, including the nature and scope of the fiduciary services that banks offer and the structures and operational methods that banks use to deliver those services. The OCC's primary goal in revising Part 9 was to accommodate those changes by removing unnecessary regulatory burden and facilitating the continued development of national banks' fiduciary business consistent with safe and sound banking practices and national banks' fiduciary obligations. *Id.*, at 68,544.

[6] 12 C.F.R. § 9.18(b)(5)(iv) (1998).

[7] 12 C.F.R. §§ 9.18(b)(4)(ii) and (5) (1998).

[8] 12 C.F.R. § 9.18(b)(4)(ii) (1998).

[9] National banks are required to establish and maintain each CIF in accordance with a written plan approved by a resolution of the bank's board of directors or by a committee authorized by the bank's board of directors. 12 C.F.R. § 9.18(b)(1) (1998).

[10] 12 C.F.R. § 9.18(b)(6) (1996). Options [1], [2], and [3] have been collectively referred to as a "Federal standard". 60 *Fed. Reg*. 66,169 - 70 (1995).

is incorporated by reference as the applicable CIF distribution standard in the relevant state law provisions.[11]

The OCC's Federal distribution standard allows the Bank's proposed method of distribution. The Federal standard does not permit one form of distribution to the exclusion of another. Rather, the Federal distribution standard allows a national bank to make CIF distributions to an account in cash or ratably in kind or both, provided that the distribution is made on the basis of the valuation of CIF assets (either market value, fair value or cost, as applicable) as of the valuation date set forth in the bank's written plan.[12] Of course, the terms and conditions governing the withdrawal and distribution and the basis and method of valuation must be included in the Bank's written plan.[13]

IV. Conclusion

Based on the foregoing facts and analysis, the representations in your letters and subsequent phone conversations, and subject to the conditions contained herein, we conclude that the Bank's proposed method of distribution is consistent with the OCC's CIF distribution rules. Part 9's Federal distribution standard expressly permits CIF distributions as of any one valuation date to be made in cash or ratably in kind. Accordingly, the Bank may proceed with its proposed method of distribution.[14]

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[11] Applicable state law in this case is Pennsylvania law because the CIF at issue is maintained in Pennsylvania. Pennsylvania law provides that CIFs that meet the criteria of Title 7, Section 404(b)(i) of the Pennsylvania Statutes are subject to the OCC's CIF regulations. *See* 7 P.S. § 404(b)(i) (1997) (Section 404(b)(i)); 10 Pa. Code § 15.2 (1997). Section 404(b)(i) CIFs are those qualified for exemption from Federal income taxation and maintained exclusively for fiduciary accounts eligible to participate in the CIFs. *See* 26 U.S.C. § 584;
7 P.S. § 404 (b)(i) (1997). Section 584 of the IRC exempts CIFs from Federal income taxation in instances where a bank maintains those funds in conformity with the OCC's rules and regulations pertaining to the collective investment of trust funds by national banks. 26 U.S.C. § 584; Rev. Rul. 79-43; Rev. Rul. 78-290; Rev. Rul. 69-133. You represent that the SIF at issue is a Section 404(b)(i) CIF, and that the FIFs would also be Section 404(b)(i) CIFs. Accordingly, you have concluded that the Bank's SIF and FIF distributions must comply with the Federal distribution standard in the OCC's CIF regulations.

[12] 12 C.F.R. §§ 9.18(b)(4) and (5) (1998).

[13] 12 C.F.R. § 9.18(b)(5)(iv) and (vi) (1998).

[14] We make this representation on the condition that the Bank is in compliance with all other laws applicable to the SIF and FIFs.

I trust this letter responds to your inquiry. If you have any further questions, please contact Tena M. Alexander, a Senior Attorney with the Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

/s/

Dean E. Miller
Senior Advisor for Fiduciary Activities