Interpretations– October 1 to December 31, 2001

		Page
Interpretive Letters		107

	Letter No.	Page
Laws		
12 USC 24(7)	916	107
15 USC 6802(d)	917,	109
	918	111
15 USC 6802(e)(1)	917,	109
	918	111
15 USC 6809(7)	917,	109
	918	111
Regulations		
12 CFR 7.4002(a)	916	107
12 CFR 7.4002(b)	916	107
12 CFR 7.4002(b)(1–4)	916	107
12 CFR 9.18	919,	112
	920	115
Subjects		
Order of check posting as a pricing decision	916	107
Borrower's loan numbers on recorded documents (joint letter)	917	109
Borrower's loan numbers on recorded documents (joint letter)	918	111
Cost allocation in model-driven funds	919	112
Admissions to and withdrawals from collective investment funds	920	115

Interpretive Letters

916– May 22, 2001

12 USC 24(7)
12 CFR 7.4002(a)
12 CFR 7.4002(b)
12 CFR 7.4002(b)(1-4)

Dear [ ]: This responds to your letter of February 21, 2001, in which you request the concurrence of this office that a decision by [ ] ("the bank") to change the order of check posting is a pricing decision authorized by 12 USC 24(Seventh) and 12 CFR 7.4002. You also request our concurrence with your view that the process followed by the bank in deciding to change the order of check posting is consistent with the safety and soundness considerations of 12 CFR 7.4002(b).

Based on our review of your letter and supporting materials and the relevant considerations set forth in our regulations, we agree that the bank may establish a given order of posting as a pricing decision pursuant to section 24(Seventh) and section 7.4002. We further agree that the process the bank used in deciding to change the order of check posting, as described in your submissions, is consistent with section 7.4002. The bases for these conclusions are described below.

I. Background

You have submitted materials[1] stating that the bank charges customers a fee (referred to in this letter as a not-sufficient funds ("NSF") fee) if they write checks against insufficient funds in their deposit accounts. The amount of the NSF fee will vary, based on (a) whether the bank pays the check or returns it unpaid and (b) the total number of items presented against insufficient funds in the same account during the preceding 12-month period.

The bank would like to change its current check-posting practice to post checks so that the largest check to be paid from an account would be paid first in a given 24-hour cycle. As a consequence, the available balance in any account will be depleted more quickly than if the items were posted in another order. The bank has offered several reasons for this decision, including the benefits of a standardized approach across the [ ] Group and the effect that the "high-to-low" check posting order would have on the bank's revenues.

The bank, which is doing business in California, has provided a copy of a provision in the California Commercial Code that states, in relevant part, "items may be accepted, paid, certified, or charged to the indicated account of its customer *in any order*." Cal. Com. Code § 4303(b) (West Cum. Pocket Part 2001) (emphasis supplied). The bank notes, however, that the California Code Commentary ("Commentary") to that section states—

> The only restraint on the discretion given to the payor bank under subsection (b) [of § 4303] is that the bank act in good faith. For example, the bank could not properly follow an established practice of maximizing the number of returned checks for the sole purpose of increasing the amount of returned check fees charged to the customer. On the other hand, the bank has the right to pay items for which it is itself liable ahead of those for which it is not. (1992 Senate Daily Journal 7350).[2]

This Commentary has prompted the bank to seek the OCC's views on whether the decision to post checks in a particular order is a pricing decision authorized by federal law.

II. Authority to Charge a Fee

Section 24(Seventh) authorizes a national bank to engage in activities that are part of, or incidental to, the business of banking[3] as well as to engage in certain specified activities listed in the statute. Pursuant to section 24(Seventh) and the OCC's regulations, a national bank may charge its customers a fee. The relevant section of the OCC regulation states:

> (a) *Customer charges and fees.* A national bank may charge its customers non-interest charges and fees, including deposit account service charges. For example, a national bank may impose deposit account service charges that its board of directors determines to be reasonable on dormant accounts. A national

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[1] The bank has requested confidential treatment of the submission, based on the bank's conclusion that the submission includes information that is exempt from disclosure under the Freedom of Information Act ("FOIA"), 12 USC 552(b). The FOIA exempts matters constituting "trade secrets and commercial or financial information obtained from a person and privileged or confidential."

[2] We note that, while this Commentary does not have the force of law, it provides persuasive evidence of legislative intent.

[3] The powers clause of section 24(Seventh) provides that a national bank may "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking. . . ." 12 USC 24(Seventh). *See NationsBank v. Variable Annuity Life Ins. Corp.*, 513 US 251 (1995) (the "business of banking" is not limited to the list of powers enumerated in section 24(Seventh)).

bank may also charge a borrower reasonable fees for credit reports or investigations with respect to a borrower's credit. All charges and fees should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding, or discussion with other banks or their officers.

12 CFR. 7.4002(a).

The bank's authority in this, as in all other, areas must be exercised in a manner that is consistent with safe and sound banking practices. Paragraph (b) of section 7.4002 sets out the factors that the bank should consider to ensure that its process for setting its fees and charges is consistent with safety and soundness:

> (b) *Considerations.* The establishment of non-interest charges and fees, and the amounts thereof, is a business decision to be made by each bank, in its discretion, according to sound banking judgment and safe and sound banking principles. A bank reasonably establishes non-interest charges and fees if the bank considers the following factors, among others:
>
> (1) The cost incurred by the bank, plus a profit margin, in providing the service;
>
> (2) The deterrence of misuse by customers of banking services;
>
> (3) The enhancement of the competitive position of the bank in accordance with the bank's marketing strategy; and
>
> (4) The maintenance of the safety and soundness of the institution.

If a bank uses a decisionmaking process that takes these factors into consideration, then there is no supervisory impediment to the bank exercising its discretionary authority to charge customers non-interest fees and charges pursuant to section 7.4002(a).[4]

A bank's authorization to establish fees pursuant to 12 CFR 7.4002(a) necessarily includes the authorization to decide how they are computed. Here, according to the information the bank has submitted, the amount of the NSF fee the bank charges depends on, among other factors, the number of items presented against insufficient funds in the same account during the preceding 12-month period. The number of items presented against insufficient funds is determined by the order of posting a bank uses. For example, the high-to-low posting order that the bank wishes to use will result in the bank's payment of the depositor's largest checks first. If the depositor has written a number of checks against insufficient funds that are presented on the same day, the high-to-low posting order may result in a greater number of checks being presented against insufficient funds than if the bank used a different posting order. Thus, posting order is one component that affects the bank's NSF fee-setting computation.

On this point, federal law governing national bank fees, as embodied in section 7.4002(a), is consistent with the check-posting provision of the California Commercial Code cited by the bank, which permits the bank to post checks "in any order." The Commentary to the California provision glosses this provision with the application of a "good faith" standard. While this letter does not address the applicability to the bank of the California Commercial Code check-posting provision or the standard articulated in the Commentary, we note that a relevant factor in evaluating good faith would be whether a bank's actions were inconsistent with the practices it had represented to its customers that it would follow. Based on the materials submitted, such is not the case here.

III. The Bank's Consideration of the Section 7.4002(b) Factors

The bank has provided analysis and supporting documentation demonstrating that the bank has considered each of the four factors listed in section 7.4002(b)(1)–(4) in its process of deciding to change the order of check posting.

The bank's submission contains projections showing that revenue is likely to increase as a result of adopting a high-to-low order of check posting. The bank also notes that the decision to use a high-to-low order of posting will standardize the bank's practices in the affected parts of the bank, thereby removing inefficiencies that currently exist.

The bank also has considered the deterrent effect that a high-to-low order of posting likely will have on its customers. The bank's submission contains a discussion of the bank's experience in the aftermath of decisions made by its competitors to adopt a high-to-low order of posting. The bank concludes that it needs to adopt the high-to-low order of posting so that customers who frequently write checks against insufficient funds do not do business with the bank primarily because the bank's fee for checks pre-

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[4] The OCC has recently proposed amendments to section 7.4002 that would eliminate certain ambiguities in the text of the regulation. *See 66 Fed. Reg.* 8178 (January 30, 2001) (the NPRM). As indicated in the preamble to the NPRM, however, these amendments would not affect the substance of the regulation or the way it operates.

sented against insufficient funds is lower than its competitors'.

The bank has considered the impact that the change in the order of check posting will have on the quality of service for its customers. The bank suggests that it is more difficult for its employees to handle customer interactions about overdraft processing if there is more than one order of posting. The bank concludes that standardization will simplify this task. This would improve the service the bank provides, thereby enhancing the competitive position of the bank.

The bank also has considered the impact that the high-to-low order of posting would have on the maintenance of the bank's safety and soundness. The bank states its belief that a high-to-low order of posting is consistent with the majority of its customers' preferences. The bank surmises that the intended order, which will result in a customer's largest bills being paid first, will have the consequence of the customer's most important bills (such as mortgage payments) being paid first. The bank thus concludes that a high-to-low order is aligned with the majority of its customers' priorities and preferences.[5]

Given the factors considered by the bank noted above, we conclude that the bank's process for deciding the order of check posting is consistent with the safety and soundness considerations set forth in section 7.4002(b) and that the bank may therefore post checks in the order it desires pursuant to the authority vested in the bank by section 7.4002(a) and section 24(Seventh) of the National Bank Act.[6]

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[5] While not required by any federal law, specific disclosure of the chosen order of check posting minimizes customer confusion and helps to address assertions that a bank has acted unfairly.

[6] We note that the authority of the bank and other national banks to charge fees is not conditioned on obtaining an individual confirming opinion, since national banks are authorized to charge noninterest fees and charges as an inherent element of their authority to conduct the business of banking.

917– September 4, 2001

[Note: This OCC Interpretive Letter was released jointly by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Bureau of Consumer Protection of the Federal Trade Commission.]

15 USC 6802(d)
15 USC 6802(e)(1)
15 USC 6809(7)

Re: Borrower's Loan Number on Recorded Documents

Dear [Company A]:

This letter responds to your letter to the Board of Governors of the Federal Reserve System ("FRB"), Federal Deposit Insurance Corporation ("FDIC"), National Credit Union Administration ("NCUA"), Office of the Comptroller of the Currency ("OCC"), Office of Thrift Supervision ("OTS"), and Federal Trade Commission ("FTC") (collectively, "the Agencies"), dated June 8, 2001. You ask the Agencies whether it is permissible under the Gramm–Leach–Bliley Act ("GLBA"), Pub. L. No. 106–102 (Nov. 12, 1999), for an originating lender to place the borrower's loan account number on mortgages, deeds of trust, and assignments and releases of mortgages (collectively, "mortgage loan documents") that are then recorded in public records. For the reasons discussed below, it is our opinion that such practice falls within section 502(e)(1) of the GLBA, which excepts from the opt-out requirements disclosures of nonpublic personal information that are "necessary to effect, administer, or enforce the transaction" as that term is defined in section 509(7) of GLBA.[1] It also is our opinion that the practice is not prohibited by section 502(d) of GLBA, which, as a general rule, bans the disclosure of account numbers to nonaffiliated third parties for use in marketing.

You state in your letter that it is a longstanding common practice for a mortgage lender to place the borrower's account number on a mortgage loan document to enable the document to be tracked and placed in the proper file once the document is recorded and returned from the recording office. You also state that the return of the document might take several months, and you note that the presence of the account number provides an efficient

[1] The Agencies' rules implement section 502(e)(1) in 12 CFR 40.14 (OCC); 12 CFR 216.14 (FRB); 12 CFR 332.14 (FDIC); 12 CFR 573.14 (OTS); 12 CFR 716.14 (NCUA); and 16 CFR 313.14 (FTC).

method for the receiving party (who might be the purchaser or servicer of the loan) to correctly identify the file in which to place the instrument.

Your letter raises two issues. The first is whether the disclosure of account numbers fits within the exceptions to the opt-out requirements. The second is whether the practice you ask about is permissible in light of the prohibition against disclosing account numbers to third parties for use in marketing. These issues are addressed below.

Exceptions to opt-out requirements. A financial institution may not disclose nonpublic personal information unless either (a) the institution first informs a consumer that it intends to do so and gives the consumer an opportunity to opt out or (b) the disclosure fits within one of the exceptions to the opt-out requirement. You note that the lender will be disclosing nonpublic personal information by adding the account number to the mortgage loan document and then having it recorded, but you maintain that this disclosure fits within the exception to the opt-out rules for disclosures that are "necessary to effect, administer, or enforce a transaction requested or authorized by the consumer." GLBA, section 502(e)(1).

As you point out, the exception for disclosures that are "necessary to effect, administer, or enforce a transaction" applies to, among other things, a disclosure that is "required, or is a usual, appropriate, or acceptable method to carry out the transaction or the product or service business of which the transaction is a part, and record or service or maintain the consumer's account in the ordinary course of providing the financial service or financial product. . . ." *Id.* section 509(7)(A). Your letter suggests that, since the practice of placing account numbers on mortgages is so widespread and because the account number on a recorded instrument assists the recipient of the document in placing the instrument in the appropriate file, the disclosure of the mortgage account number under the circumstances you describe should be viewed as a "usual" and "appropriate" method of carrying out a transaction and of recording the instruments in question.

We agree that the presence of an account number on a mortgage loan document facilitates the appropriate handling of that document, and note that many mortgage lenders use account numbers on loan documents for this reason. In many cases, ownership of the loan will have changed hands between the time the document is submitted for recordation and the time it is returned from the recording office. The presence of the account number on the mortgage loan documents in such situations is particularly helpful to ensure proper filing. Thus, we believe that the disclosure of the account number on the mortgage loan document fits within the exception provided for by Congress in section 502(e)(1).

Applicability of prohibition against disclosing account numbers for use in marketing. Section 502(d) generally prohibits a financial institution from disclosing account numbers of credit card accounts, deposit accounts, or transaction accounts to any nonaffiliated third party for use in telemarketing, direct mail marketing, or other marketing through electronic mail to a consumer. This prohibition overrides the exceptions to the opt-out requirements. Thus, if the disclosure of a mortgage account number on a mortgage loan document is deemed to be the disclosure of a "transaction account" number, the disclosure will be prohibited if it is "for use in marketing."

We believe that this prohibition does not apply to the disclosure of mortgage account numbers on mortgage loan documents. The disclosure in question is not "for use in marketing." The account number is placed on the mortgage loan document solely for the purpose of facilitating the accurate processing of the document, and the document is disclosed to the recording office solely for the purpose of recordation. Accordingly, the prohibition against disclosing account numbers for use in marketing would not apply.[2]

We trust that this is responsive to your inquiry.

J. Virgil Mattingly
General Counsel
Board of Governors of the Federal Reserve System

William F. Kroener, III
General Counsel
Federal Deposit Insurance Corporation

Robert M. Fenner
General Counsel
National Credit Union Administration

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel
Office of the Comptroller of the Currency

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[2] We do not address the issue in this letter of whether a mortgage account number is a "transaction account" number. As noted in the Agencies' final rules, a "transaction account" does not include an account to which a third party cannot initiate a charge. 12 CFR 40.12(c)(2) (OCC); 12 CFR 216.12(c)(2) (FRB); 12 CFR 332.12(c)(2) (FDIC); 12 CFR 573.12(c)(2) (OTS); 12 CFR 716.12(c)(2) (NCUA); and 16 CFR 313.12(c)(2) (FTC). For additional discussion of the limits on disclosures of transaction account numbers, see joint letter from the Chief Counsels and General Counsels of the OCC, FRB, FDIC, OTS, and NCUA, dated May 25, 2001, regarding Limits on Disclosing Account Numbers (retrievable in redacted form from the OCC's Web site at http://www.occ.treas.gov/foia/int910.pdf).

Carolyn J. Buck
Chief Counsel
Office of Thrift Supervision

Howard Beales
Director
Bureau of Consumer Protection
Federal Trade Commission

918– September 4, 2001

[Note: This OCC Interpretive Letter was released jointly by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Bureau of Consumer Protection of the Federal Trade Commission.]

15 USC 6802(d)
15 USC 6802(e)(1)
15 USC 6809(7)

Re: Borrower's Loan Number on Recorded Documents

Dear [Company B]:

This letter responds to your letter to the Board of Governors of the Federal Reserve System ("FRB"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), Office of Thrift Supervision ("OTS"), and Federal Trade Commission ("FTC") (collectively, "the Agencies"[1]), dated June 8, 2001. You ask the Agencies whether it is permissible under the Gramm–Leach–Bliley Act (GLBA), Pub. L. No. 106–102 (Nov. 12, 1999), for an originating lender to place the borrower's loan account number on mortgages, deeds of trust, and assignments and releases of mortgages (collectively, "mortgage loan documents") that are then recorded in public records. For the reasons discussed below, it is our opinion that such practice falls within section 502(e)(1) of the GLBA, which excepts from the opt-out requirements disclosures of nonpublic personal information that are "necessary to effect, administer, or enforce the transaction" as that term is defined in section 509(7) of GLBA.[2] It also is our opinion that the practice is not prohibited by section 502(d) of GLBA, which, as a general rule, bans the disclosure of account numbers to nonaffiliated third parties for use in marketing.

You state in your letter that it is a longstanding common practice for a mortgage lender to place the borrower's account number on a mortgage loan document to enable the document to be tracked and placed in the proper file once the document is recorded and returned from the recording office. You also state that the return of the document might take several months, and you note that the presence of the account number provides an efficient method for the receiving party (who might be the purchaser or servicer of the loan) to correctly identify the file in which to place the instrument.

Your letter raises two issues. The first is whether the disclosure of account numbers fits within the exceptions to the opt-out requirements. The second is whether the practice you ask about is permissible in light of the prohibition against disclosing account numbers to third parties for use in marketing. These issues are addressed below.

Exceptions to opt-out requirements. A financial institution may not disclose nonpublic personal information unless either (a) the institution first informs a consumer that it intends to do so and gives the consumer an opportunity to opt out or (b) the disclosure fits within one of the exceptions to the opt-out requirement. You note that the lender will be disclosing nonpublic personal information by adding the account number to the mortgage loan document and then having it recorded, but you maintain that this disclosure fits within the exception to the opt-out rules for disclosures that are "necessary to effect, administer, or enforce a transaction requested or authorized by the consumer." GLBA, section 502(e)(1).

As you point out, the exception for disclosures that are "necessary to effect, administer, or enforce a transaction" applies to, among other things, a disclosure that is "required, or is a usual, appropriate, or acceptable method to carry out the transaction or the product or service business of which the transaction is a part, and record or service or maintain the consumer's account in the ordinary course of providing the financial service or financial product. . . ." *Id.* section 509(7)(A). Your letter suggests that, since the practice of placing account numbers on mortgages is so widespread and because the account number on a recorded instrument assists the recipient of the document in placing the instrument in the appropriate file, the disclosure of the mortgage account number under the circumstances you describe should be viewed as a "usual" and "appropriate" method of carrying out a transaction and of recording the instruments in question.

We agree that the presence of an account number on a mortgage loan document facilitates the appropriate handling of that document, and note that many mortgage

[1] The National Credit Union Administration (NCUA), while not a recipient of your letter, joins in this response.

[2] The Agencies' rules implement section 502(e)(1) in 12 CFR 40.14 (OCC); 12 CFR 216.14 (FRB); 12 CFR 332.14 (FDIC); 12 CFR 573.14 (OTS); 12 CFR 716.14 (NCUA); and 16 CFR 313.14 (FTC).

lenders use account numbers on loan documents for this reason. In many cases, ownership of the loan will have changed hands between the time the document is submitted for recordation and the time it is returned from the recording office. The presence of the account number on the mortgage loan documents in such situations is particularly helpful to ensure proper filing. Thus, we believe that the disclosure of the account number on the mortgage loan document fits within the exception provided for by Congress in section 502(e)(1).

Applicability of prohibition against disclosing account numbers for use in marketing. Section 502(d) generally prohibits a financial institution from disclosing account numbers of credit card accounts, deposit accounts, or transaction accounts to any nonaffiliated third party for use in telemarketing, direct mail marketing, or other marketing through electronic mail to a consumer. This prohibition overrides the exceptions to the opt-out requirements. Thus, if the disclosure of a mortgage account number on a mortgage loan document is deemed to be the disclosure of a "transaction account" number, the disclosure will be prohibited if it is "for use in marketing."

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We trust that this is responsive to your inquiry.

J. Virgil Mattingly
General Counsel
Board of Governors of the Federal Reserve System

William F. Kroener, III
General Counsel
Federal Deposit Insurance Corporation

[3] We do not address the issue in this letter of whether a mortgage account number is a "transaction account" number. As noted in the Agencies' final rules, a "transaction account" does not include an account to which a third party cannot initiate a charge. 12 CFR 40.12(c)(2) (OCC); 12 CFR 216.12(c)(2) (FRB); 12 CFR 332.12(c)(2) (FDIC); 12 CFR 573.12(c)(2) (OTS); 12 CFR 716.12(c)(2) (NCUA); and 16 CFR 313.12(c)(2) (FTC). For additional discussion of the limits on disclosures of transaction account numbers, see joint letter from the Chief Counsels and General Counsels of the OCC, FRB, FDIC, OTS, and NCUA, dated May 25, 2001, regarding Limits on Disclosing Account Numbers (retrievable in redacted form from the OCC's Web site at http://www.occ.treas.gov/foia/int910.pdf).

Robert M. Fenner
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Office of Thrift Supervision

Howard Beales
Director
Bureau of Consumer Protection
Federal Trade Commission

919– November 9, 2001

12 CFR 9.18

RE: Model-Driven Funds

Dear [ ]:

This is in response to your request for confirmation that the OCC permits model-driven funds, established pursuant to 12 CFR 9.18, to allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds. Based on your representations and for the reasons set forth below, we conclude that model-driven funds, as defined below, may allocate costs to individual participants in the manner described below.[1]

Background

You represent a national bank that administers index funds and model-driven funds, established pursuant to 12 CFR 9.18.[2] The index funds are collective investment

[1] You have represented that the proposed allocation, if properly disclosed, complies with applicable law, including the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to the extent that the model-driven funds have assets of clients subject to ERISA. The OCC has not addressed and does not opine whether the proposed allocation complies with ERISA or applicable federal securities law and state law.

[2] Section 9.18 collective investment funds include funds maintained by the bank, exclusively for the collective investment or reinvestment of money contributed to the fund by the bank, or one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act. 12 CFR 9.18(a)(1). Section 9.18 collective investment funds also in-

funds that seek to replicate the performance of a specified index, such as the Standard and Poor's 500 Index. Trading decisions are made according to a formula that tracks the rate of return of the index by replicating the entire portfolio of the index or by investing in a representative sample of that portfolio.

The model-driven funds are collective investment funds that seek to outperform a specified index or benchmark based on a pre-determined investment strategy.[3] In the model-driven funds, a computer model selects the identity and amount of securities contained in the funds. The model is based on prescribed objective criteria, using independent third party data that is not within the control of the fund manager.

Proposal

The bank has proposed to charge or credit fund participants who are admitted to, or withdraw from its model-driven funds with the costs, expenses and related adjustments (collectively, the "costs") involved in the acquisition of securities when the participants are admitted to the funds, and the disposition of securities upon the participants' withdrawal from the funds.[4] The bank currently charges or credits fund participants who are admitted to, or withdraw from its index funds in this manner. With respect to domestic model-driven funds, these costs would include:

(1) commissions paid by the fund to broker/dealers on purchases or sales, as applicable, of portfolio investments relating to the participant's contribution or redemption, respectively;

(2) Securities and Exchange Commission fees on sales of portfolio investments of U.S. listed and traded securities by the fund relating to the participant's redemption; and

(3) the net difference (positive or negative) between:

(a) the market value of the portfolio investments purchased or sold by the funds, relating to the participant's contribution or redemption, on the date the fund's investments are valued for purposes of determining the number of units in the fund to be issued to or redeemed for the participant, and

(b) the fund's execution price for such portfolio investments.[5]

The bank has represented that it will inform all participants in the model-driven funds it manages that these costs will be allocated to contributing and redeeming participants.

You contend on behalf of the bank that allocating costs in this manner is appropriate for two reasons. First, you believe that allocating costs to individual participants entering or exiting the fund will be fair and equitable to all the participants in the fund. You believe that a procedure that did not allocate costs to a contributing or withdrawing participant could be unfair to other participants in the fund because these other participants would bear the expenses and charges attributable to the contributing or withdrawing participant.

Second, you note that the OCC has previously permitted section 9.18 index funds to charge brokerage fees and expenses to accounts that are purchasing or selling units of the index fund. You believe that model-driven funds should be treated in the same manner as index funds for purposes of allocating costs, given the similarities between these types of funds. You note that both index funds and model-driven funds limit the discretion of fund managers, are based upon certain pre-specified formulae or algorithms, and are quantitative in nature.

For these reasons, you believe the OCC should permit model-driven funds, established pursuant to 12 CFR 9.18, to allocate costs to individual participants being admitted

clude funds consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts that are exempt from federal income tax. 12 CFR 9.18(a)(2).

[3] The index or benchmark must represent the investment performance of a specific segment of the public market for debt or equity securities. In addition, the index or benchmark must be established and maintained by an independent organization that is in the business of providing financial information or brokerage services to institutional clients, a publisher of financial news or information or a public stock exchange or association of securities dealers. The index or benchmark must be a standardized index of securities that is not specifically tailored for the use of the manager.

[4] The bank has represented that trades would be effected in a prudent and expeditious manner. The bank has committed that the fund would not engage in any "market timing" (*i.e.*, the fund would not seek to "time" the transactions in anticipation of broad market movements).

[5] With respect to international model-driven funds investing in foreign securities, these costs would include items (1) and (3) listed above, as well as the following: (1) transaction-related charges to convert, as applicable, the participant's contribution of U.S. dollars to the relevant foreign currencies or the proceeds on sales relating to the participant's redemption to U.S. dollars from the relevant foreign currencies, and any applicable stamp taxes or other types of transfer fees imposed by a foreign jurisdiction or a foreign exchange; and (2) bank custodian charges paid by the fund representing fees levied on a per-portfolio transaction basis relating to the participant's contribution or redemption, as applicable. In general, you state that the charges to contributing and redeeming participants are higher in foreign markets than in U.S. markets because the costs associated with purchases and sales of securities are higher in foreign markets.

to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds.

Discussion

Collective investment funds, established pursuant to 12 CFR 9.18, generally are not permitted to charge individual participants with the cost of entering or exiting a fund.[6] The OCC has determined, however, that funds with certain characteristics may charge individual participants the costs associated with being admitted to or withdrawing from a fund. In particular, the OCC has permitted a section 9.18 index fund to charge brokerage fees and expenses to accounts that are purchasing or selling units of the index fund provided that the fund document authorizes such charges.[7]

Model-driven funds, established pursuant to 12 CFR 9.18(a)(2), have characteristics similar to section 9.18 index funds. In particular, both index funds and model-driven funds do not involve any significant exercise of investment discretion by investment managers managing the funds. For example, an investment manager of an index fund makes investments according to a formula that tracks the rate of return, risk profile, or other characteristics of an independently maintained index by either replicating the entire portfolio of the index or by investing in a representative sample of such portfolio designed to match the projected risk/return profile of that index.

Similarly, an investment manager of a model-driven fund makes investments based upon a formula by which an "optimal" portfolio is created to implement a pre-determined investment strategy that is either based upon or measured by an independently maintained index of securities. A computer model must select the identity and the amount of the securities contained in a model-driven fund. Although managers may use their discretion to design the computer model, the model must be based on prescribed objective criteria using third party data, not within the control of the managers, to transform an independently maintained index.[8]

This limited management discretion helps ensure that all fund participants, including those entering or exiting a fund, will be treated fairly and equitably. For example, the bank has committed that fund participants being admitted to or withdrawing from a fund will have the same access to and benefit from cross-trading opportunities and other low cost trading mechanisms as other fund participants.[9] For these reasons, we conclude that model-driven funds, as defined in this letter, should be permitted to allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as index funds.[10]

Model Validation and Testing

As noted above, trading decisions in model-driven funds are made by computer models, based on pre-determined investment strategies and prescribed objective criteria.

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[6] Section 9.18(b)(10) permits a bank that manages a collective investment fund to charge reasonable expenses (except expenses incurred in establishing or reorganizing a collective investment fund) to the fund as long as those expenses are permissible under state law and are fully disclosed to fund participants. 12 CFR 9.18(b)(10).

[7] OCC Fiduciary Precedent 9.5980, which interpreted the former Part 9, stated, among other things, that the OCC will not object to an index fund charging brokerage fees and expenses to accounts that are purchasing or selling units of an index fund provided the fund document authorizes such charges. *See* OCC Fiduciary Precedent 9.5980, *Comptroller's Handbook for Fiduciary Activities* (September 1990). *See also* OCC Trust Interpretive Letter No. 228 (August 8, 1989), where the OCC permitted an index fund to charge individual participants with brokerage expenses and certain trading or market gains or losses. Part 9, including 12 CFR 9.18, was amended effective January 29, 1997. 61 *Fed. Reg.* 68,543 (1996). The fiduciary precedents and trust interpretive letters preceding the January 29, 1997 effective date of 12 CFR Part 9 are interpretations of the former regulation. Those precedents and interpretations can still be persuasive in interpreting the language in the new Part 9, however. Furthermore, in many instances the precedents and interpretations have become industry practice or simply articulate sound fiduciary principles.

[8] Fund managers do not have discretion to override trading decisions made by the computer model. Fund managers may, however, verify the data the computer model is relying on and make adjustments to the model output to correct inaccuracies or outdated information. Fund managers may not make such adjustments for arbitrary reasons or to benefit the fund manager, its affiliates, of any party in which the manager or its affiliates have an interest. In addition, any adjustment must be made in compliance with written policies and procedures.

[9] Cross-trading refers to a practice where an investment manager offsets an order to buy a particular security with an order to sell a particular security between two or more accounts under its management without a broker acting as intermediary. The Department of Labor has granted the bank exemptive authority to engage in cross-trading securities with regard to its index funds and model-driven funds.

[10] The Department of Labor has recognized these similarities in its proposed class exemption for model-driven funds and index funds under ERISA. The proposed class exemption would treat model-driven funds and index funds identically for purposes of allowing certain cross-trades of securities under ERISA. The proposed class exemption is based on the limited management discretion associated with these types of funds. *See* 64 *Fed. Reg.* 70057, 70069 (December 15, 1999). The DOL has adopted this same approach for many years with respect to numerous individual prohibited transaction exemptions relating to cross-trading. *See, e.g.*, PTE 95–96, Mellon Bank, N.A., 60 *Fed. Reg.* 35,933 (July 12, 1995); PTE 94–47, Bank of America National Trust and Savings Association, 59 *Fed. Reg.* 32,021 (June 21, 1994); and PTE 94–43, Fidelity Management Trust Company, 59 *Fed. Reg.* 30,041 (June 10, 1994).

These computer models are designed to systematically control risk and costs and achieve above benchmark returns. Computer models that are improperly validated or tested, however, may expose the bank to risks from erroneous model input or output or incorrect interpretation of model results. To mitigate those risks, the bank should ensure that its computer models are frequently verified, validated and reviewed. To ensure proper validation and testing, the bank should develop formal written policies and procedures consistent with the guidance provided in OCC Bulletin 2000–16 on Risk Modeling and Model Validation (May 30, 2000).

Conclusion

Model-driven funds, established pursuant to 12 CFR 9.18(a)(2), may allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds, provided the fund document authorizes such charges. If you have any questions, please do not hesitate to contact me at (202) 874–5210.

Beth Kirby
Special Counsel
Securities and Corporate Practices

920– December 6, 2001

12 CFR 9.18

Subject: [ ] Trust Company—[ ] Fund

Dear [ ]:

This is in response to your request for an exemption under 12 CFR 9.18(c)(5) to permit annual admissions to and withdrawals from a collective investment fund established by [ ] Trust Company. For the reasons discussed below, we have concluded that annual admissions and withdrawals are permitted under 12 CFR 9.18 and, therefore an exemption from 12 CFR 9.18 is not required.

Proposal

[ ] ("trust company"), a [ ] trust company, seeks to establish a collective investment fund, [ ] ("CIF"), exclusively for the collective investment and reinvestment of money contributed to the fund by the trust company in its capacity as trustee of certain trusts. The trust company is forming the CIF in order to enable several small trusts for which it serves as trustee to invest in [ ] ("limited partnership"), a limited partnership formed by the trust company. Those trusts are not qualified to invest directly in the limited partnership because of their size.

The limited partnership invests in third-party investment partnerships engaged in hedge fund investing. The limited partnership will receive cash flow from its partnership investments once a year. As a result, the limited partnership will only allow annual admissions and withdrawals. Because the limited partnership only permits annual admissions and withdrawals, the trust company has proposed that the CIF only allow annual admissions and withdrawals.

The CIF will be valued quarterly. The trust company will use the valuation reports provided to it from the third-party investment partnerships that constitute the underlying investments of the limited partnership to determine the fund's fair value. To comply with 12 CFR 9.18(b)(4)(ii), the trust company must determine that the valuation provided by the limited partnerships represents the fair value of the fund's assets as of the date of the valuation.

Discussion

The OCC's regulation governing collective investment funds does not mandate the frequency of admissions and withdrawals from collective investment funds. The regulation requires that the written plan governing the administration of the CIF include appropriate provisions related to the terms and conditions governing the admission and withdrawal of participating accounts.[1]

In addition, the regulation provides that admissions and withdrawals may only be "on the basis of the valuation described in paragraph (b)(4)." Section 9.18(b)(4), in turn, provides in part that,

> A bank administering a CIF shall determine the value of the fund's assets at least once *every three months.* However, in the case of a fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, the bank shall determine the value of the fund's assets *at least once a year*.[2]

These provisions require that bank trustees use the valuation derived under section 9.18(b)(4) to determine the

[1] The regulation also provides that certain funds may require a prior notice period of up to one year for withdrawals. 12 CFR 9.18(b)(5)(iii).

[2] 12 CFR 9.18(b)(4)(i). Section 9.18(b)(4) also establishes the method of valuation. In general, bank trustees are required to value fund assets at market value as of the date set for valuation, unless the bank cannot readily ascertain market value, in which case the bank shall use a fair value determined in good faith. *See* 12 CFR 9.18(b)(4)(ii)(A). Different valuation methods apply to short term investment funds. *See* 12 CFR 9.18(b)(4)(ii)(B).

amount participants are entitled to when they are admitted to or withdraw from a fund. It does not mandate the frequency of admissions and withdrawals.[3] National banks and institutions that must comply with this regulation to receive favorable tax treatment should have valid reasons for limiting admissions and withdrawals, however. In addition, the admissions and withdrawal policies must be consistent with fiduciary duties.

In this case, you have represented that the CIF will not have sufficient liquidity to permit admissions and withdrawals more than once a year because the CIF is invested in a limited partnership that only permits annual admissions and withdrawals. You also have represented that the amount of the investment that each participating trust will make in the CIF will not impair the liquidity of the participating trusts. The CIF is designed as, and will be used as, only one part of an overall investment strategy for the participating trusts.

Based on these representations and consistent with applicable law, the trust company may permit annual admissions and withdrawals from the CIF. The proposed schedule of admissions and withdrawals must be disclosed to fund participants in the CIF's written plan.

I trust this is responsive to your inquiry. Please do not hesitant to contact me if you have any questions.

Beth Kirby
Special Counsel
Securities and Corporate Practices

[3] OCC Trust Interpretive Letters interpreting the prior version of 12 CFR 9.18 concluded that admissions and withdrawals must occur as frequently as valuations. *See e.g.*, Trust Interpretive Letter #13 (February 14, 1986). Upon closer examination of the regulation, however, we have concluded that the regulation does not mandate the frequency of admissions and withdrawals.