Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 26, 1999

Interpretive Letter #865
August 1999
12 CFR 9.18

Dear [ ]:

An Illinois-chartered member bank (Bank) seeks confirmation that its proposed common trust funds, as described below, would constitute common trust funds under 12 C.F.R. §9.18(a)(1).[1] For reasons described below, the proposed funds, as structured, would qualify as (a)(1) funds. We cannot, of course, address whether the funds are actually operated in conformity with OCC regulations since the Bank is not subject to OCC examination and supervision.

[1] The Bank proposes to obtain favorable tax treatment pursuant to 26 U.S.C. § 584, which provides, in relevant part, favorable treatment for

> a fund maintained by a bank--
> (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity--
> (A) as a trustee, executor, administrator, or guardian, or
> (B) as a custodian of accounts--
> (i) which the Secretary determines are established pursuant to a State law which is substantially similar to the Uniform Gifts to Minors Act as published by the American Law Institute, and
> (ii) with respect to which the bank establishes, to the satisfaction of the Secretary, that it has duties and responsibilities similar to duties and responsibilities of a trustee or guardian; and
> (2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks.

This letter addresses issues related to 12 C.F.R. § 9.18(a)(1) and does not opine on other applicable law, including federal securities or tax law.

BACKGROUND

As an adjunct to the Bank's custodial service, the Bank offers a securities lending program. The Bank seeks confirmation that its proposal to pool cash collateral held pursuant to securities lending agreements would qualify for common trust fund treatment under 12 C.F.R. § 9.18(a)(1).

Under a securities lending authorization agreement (SLAA) between a custodial client and a bank, custodial clients (securities lenders) lend eligible securities, which include U.S. and non-U.S. equities, corporate bonds, and government securities. Suggested minimum portfolio sizes for participation range from $10 million (non U.S. securities) to $500 million (U.S. equities and corporate bonds). A securities lender may establish certain guidelines in the SLAA regarding: (1) the borrowers to whom the Bank is authorized to lend securities on its behalf, (2) the permissible instruments in which cash collateral may be invested, (3) minimum collateralization requirements for securities loans, and (4) certain essential terms which must be contained in loan agreements between the Bank and borrowers. Within these guidelines, the Bank exercises discretion.

Under a securities borrowing agreement (SBA), qualified borrowers provide noncash collateral (such as government securities) or cash collateral in the form of wire-transferred or clearinghouse funds. Qualified borrowers are mainly securities broker-dealers and other financial participants involved in market making, hedging, and arbitrage transactions. The securities borrowing agreement grants a security interest in and a lien upon the cash and noncash collateral and provides that the Bank shall have the right to invest the cash collateral for the sole account of and risk of the securities lender. Under the SBA, the obligation of the securities lender is to return the cash in the same currency and in the same amount as the cash collateral provided at the outset of the loan.

In the cash collateral context, the security lender is compensated by the amount of revenue generated through the Bank's investment of the cash collateral (net of certain expenses) less a negotiated loan rebate fee paid by the securities lender to the securities borrower and less a fee paid to the bank. The loan rebate fee is negotiated between the Bank and the borrower at the outset of the loan. The securities lender pays a fee to the Bank from the assets in the securities lender's custody account measured as a percentage of the revenues earned by the securities lender as a result of the loan; this percentage is the same whether the securities borrower provides cash or noncash collateral.

The Bank proposes to commingle funds it receives as cash collateral in one or more common trust funds for collective investment, pursuant to a written plan establishing the common trust funds. The Bank will enter into a trust agreement with each securities lender, in which the securities lender would be the settlor and beneficiary, the Bank would be the trustee, and the body of the trust would consist of all of the security lender's rights with respect to cash collateral. These rights include the right to: (1) possess the funds constituting cash collateral, (2) invest the funds, and (3) retain the earnings on the investment of the funds. The Bank

would retain the discretion under the trust agreement with each client to manage cash collateral on a pooled or nonpooled basis. The Bank will provide related fiduciary administrative services in safekeeping the collateral, collecting the income due to the beneficiaries, and paying the income as directed under the trust agreements.

The Bank's common trust funds would seek to maximize income to the extent consistent with capital preservation and liquidity by investing in high quality fixed income or adjustable rate securities and other instruments. The units of each fund would entitle each participating trust to a pro rata share of the income, expenses, gains and losses of the fund. The Bank represents that the funds will be operated in compliance with all other aspects of Part 9 and any other applicable law.[2]

DISCUSSION

The definition of a collective investment fund for purposes of section 9.18(a)(1) is:

> A fund maintained by the bank, or by one or more affiliated banks, exclusively for the collective investment and reinvestment of money contributed to the fund by the bank, or by one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act.

12 C.F.R. § 9.18(a)(1). The general requirements governing the establishment of a Section 9.18(a)(1) common trust fund are the existence of valid trusts and a true fiduciary purpose in managing the trust funds collectively.[3] The Bank believes that the proposed funds fall within this definition of an (a)(1) fund. The Bank represents that valid Illinois trusts will be created

---

[2]The Bank asserts that each fund will rely on the exclusion to the definition of the term "investment company" provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended. Thus, the Bank would not cause any of the funds to be registered as an "investment company" because units in each fund would either be beneficially owned by not more than 100 persons or would be sold exclusively to "qualified purchasers." Qualified purchasers are natural persons and certain trusts who have at least $5,000,000 in investments (as defined by the SEC) and an institutional investor that has at least $25,000,000 in investments, in each case net of any debt incurred to acquire such investments. 15 U.S.C. §§ 80a-2(a)(51)(A), 3(c)(1), 3(c)(7). The Bank states that units of the common trust funds would not be registered under the Securities Act because there would no public offering. *See* 15 U.S.C. § 77d(2). We express no opinion on the applicability of federal securities law. We also express no opinion on compliance with the specific requirements of 12 C.F.R. § 9.18(b) in the Bank's operation of the fund(s).

[3]*See Investment Company Institute v. Camp*, 401 U.S. 617 (1971)(distinguishing a plan in which customers' appoint the bank as managing agent to invest funds collectively from the situation in which the bank commingles assets received for a true fiduciary purpose); *Investment Company Institute v. Conover*, 790 F.2d 925, 936 (DC Cir.), *cert denied*, 479 U.S. 939 (1986)(finding commingled IRA funds permissible and stating "we cannot say that the Comptroller unreasonably determined that Citibank's Trust represents a *bona fide* fiduciary service."); *Investment Company Institute v. Clarke*, 789 F.2d 175 (2d Cir.), *cert. denied*, 479 U.S. 940 (1986)(finding commingled IRA funds permissible); *Investment Company Institute v. Clarke*, 793 F.2d 220 (9th Cir.), *cert. denied*, 479 U.S. 939 (1986)(finding commingled retirement funds permissible).

on behalf of each securities lender and the Bank will be trustee. The Bank will collectively invest, through the proposed common trust fund(s), cash collateral received from securities borrowers.

The Bank appears to have established valid trusts under these arrangements. The Bank represents that under Illinois law, the requirements to create an express trust are: (1) an intent to create a trust which may be shown by the declaration of trust by the settlor or circumstances which show the settlor intended to create a trust; (2) a definite trust res; (3) ascertainable beneficiaries; (4) a specification of the purpose of the trust and how it is to be performed; and (5) the delivery of the trust property to the trustee.[4] The Bank represents that under Illinois law, any right or interest that may be the subject of property can be granted in trust.[5]

The money that the Bank proposes to contribute to the contemplated common trust funds for collective investment and reinvestment would be held by the Bank under various trust agreements naming the Bank as trustee of the individual trusts. Thus, the lenders will have expressed their intent to create the trust, and the purpose of the trust will be clearly laid out. The body of the trust will consist of all of the settlor's rights in the funds representing the cash collateral. These rights include: the right to possess the money during the term of the securities loan, the right to invest the money for the settlor's own account and at its own risk, and the right to retain the resulting earnings. Thus, under the proposed arrangements, there is a definite body of the trust and ascertainable beneficiaries. The securities lender, as settlor, would make delivery of the trust property by causing the cash collateral to be transferred into a trust account established by settlor and controlled by the Bank as trustee. The Bank therefore receives all rights that the settlor possesses. Accordingly, the funds received by the Bank for management under 12 C.F.R. § 9.18(a)(1) are subject to valid trust agreements.

Finally, the Bank will clearly exercise a true fiduciary purpose in managing these funds collectively. As trustee, the Bank will exercise discretion in managing cash received by the Bank as collateral for securities it lends under the SLAA. In addition to providing this service, the Bank will also provide related fiduciary administrative services, including safekeeping the collateral, collecting the income due to the beneficiaries, and paying income as directed under the trust agreements. By exercising discretion in managing funds received under the trust agreements, and by providing related administrative services under the trust agreements, the Bank has a true fiduciary purpose in operating the Section 9.18(a)(1) fund(s) under the circumstances.

---

[4] *See e.g., In re Estate of Michael H. Davis*, 255 Ill. App. 3d 998, 589 N.E.2d 154, 162 (1992); *In re Estate of Audrey Zuckerman*, 218 Ill. App. 3d 325, 578 N.E.2d 248, 251 (1991).

[5] *See* Fratcher, 1 SCOTT ON TRUSTS § 82, 460 (4th Ed. 1988). *See also*, 53A AM. JUR. 2D, *Money*, § 22 (1996)("since possession of money vests title in the holder, title to money passes with delivery to a person who acquires it in good faith and for valuable consideration.").

Accordingly, based on the Bank's representations and description of the arrangements as set forth above, the proposed fund(s) would fulfill the requirements to qualify under 12 C.F.R. § 9.18(a)(1).

If you have any questions, please contact Nancy Worth, Senior Attorney, at 202-874-5210.

Sincerely,

/s/

Dean Miller
Senior Adviser