Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #919
December 2001
12 CFR 9.18

November 9, 2001

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 C.F.R. § 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 C.F.R. § 9.18.[2] The index funds are collective investment 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.

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[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 C.F.R. § 9.18(a)(1). Section 9.18 collective investment funds also include funds consisting solely of assets of retirement, pension, profit sharing stock bonus or other trusts that are exempt from Federal income tax. 12 C.F.R. § 9.18(a)(2).

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;
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> (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
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> (3) the net difference (positive or negative) between:
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>> (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
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>> (b) the fund's execution price for such portfolio investments.[5]

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[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

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 C.F.R. § 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.

Discussion

Collective investment funds, established pursuant to 12 C.F.R. § 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]

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higher in foreign markets than in U.S. markets because the costs associated with purchases and sales of securities are higher in foreign markets.

[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 C.F.R. § 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 C.F.R. 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 C.F.R. 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

Model-driven funds, established pursuant to 12 C.F.R. § 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]

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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

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. 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.

Conclusion

Model-driven funds, established pursuant to 12 C.F.R. § 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.

Sincerely,

-signed-

Beth Kirby
Special Counsel
Securities and Corporate Practices

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).