Introduction to Mutual Funds

The biggest advantage to investing in mutual funds is the ability to readily achieve a diversified portfolio to meet investment objectives. A diversified portfolio helps reduce risk by offsetting losses from some securities with gains in others. There are four basic types of mutual funds: stock (equity), bond, hybrid and money market. Money market funds are referred to as short-terms funds because they invest in securities that generally mature in one year or less, while stock, bond and hybrid funds are known as long-term funds. An investor in a mutual fund is a shareholder who owns shares of the fund. A share is typically represented by its net asset value (NAV). Each share represents proportionate ownership in all of the fund's underlying securities. The securities are selected by a professional investment adviser to match the fund's objectives as described in the prospectus. Below is a partial listing of factors to consider when making investment decisions regarding the use of mutual funds:

- Quality and experience of investment company management, specifically the fund manager
- Risk adjusted rates of return for the fund and their consistency over various time periods and comparisons to other related funds (benchmarks)
- Compliance with the investment style of the fund as described in the prospectus ("style drift")
- Quality of existing holdings
- Tax efficiency of the fund
- Mutual fund fee structure

Proprietary Mutual Funds

A proprietary mutual fund is a fund that the thrift or thrift affiliate acts as an investment adviser. When acting as a discretionary trustee, the savings association should determine whether applicable law would allow the purchase of shares of a proprietary mutual fund as such a purchase would be a conflict of interest. Many states have adopted statutes that would permit the purchase of shares of a proprietary mutual fund for a discretionary fiduciary account. The statutes are very different in regards to fees that may be charged, disclosures and consent. Savings associations should make sure that they are carefully following every aspect of the appropriate state statute. Even if there is a state statute that permits purchases of proprietary mutual fund shares for discretionary fiduciary accounts, a savings association must determine whether such an investment meets the prudence requirements of the applicable state law. The prudence analysis should be documented and available for review by examiners. The savings association should provide beneficiaries who are entitled under state law to receive account statements a copy of the mutual fund's prospectus. It is good risk management practice to also provide disclosure of the affiliated relationships, the nature of the services provided and the amount of fees paid to the savings association, its subsidiaries or affiliates.

If the savings association is acting as a trustee or other fiduciary for employee benefit accounts, it should be fully aware of all the ERISA restrictions regarding such conflict of interest transactions and meet any applicable Department of Labor (DOL) guidelines. The DOL has issued a prohibited transaction class exemption (PTE 77-4) that permits the investment of employee benefit accounts for which a savings association is a fiduciary in a proprietary mutual fund, provided certain conditions are met. The DOL has also issued several advisory opinion letters (93-12A and 93-13A) that address secondary services provide by a bank to a proprietary mutual fund without a waiver or credit of fees.

Mutual Fund Fee Structure

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Mutual funds have certain costs of operating. Costs are important because they lower the return of the fund. A fund that has a sales load and high expenses will have to perform better than a low-cost fund just to stay even with the low-cost fund. Information regarding the costs to the fund can be located in the fee table near the front of the fund's prospectus. The fee table can be used to compare the costs of different funds. The fee table breaks costs into two main categories: 1) sales loads and transaction fees (paid when a fund share if bought, sold or exchanged), and 2) ongoing expenses (paid periodically during the investment in the fund).

Sales Loads: The first part of the fee table will indicate if the fund charges any sales loads. No-load funds do not charge sales loads. There are no-load funds in every major fund category. Even no-load funds have ongoing expenses, however, such as management fees. When a mutual fund charges a sales load, it usually pays for commissions to people who sell the fund's shares, as well as other marketing costs. A front-end load is a sales charge that is paid when shares are bought. This type of load, by law, cannot be higher than 8.5 percent. An example of a front-end load would be where an investor has $1,000 to invest in a mutual fund with a 5 percent front-end load, $50 will go to pay the sales charge and $950 will be invested in the fund. A back-end load (also called a deferred load) is a sales charge that is paid when shares in the fund are sold. It usually starts out at 5 or 6 percent for the first year and gets smaller each year after that until it reaches zero (say, in year six or seven of the investment). An example of a back-end load would be where an investor has $1,000 invested in a mutual fund with a 6 percent back-end load that decreases to zero in the seventh year. Assume for purposes of this example that the value of the investment remains at $1,000 for seven years. If the shares were sold during the first year, the investor would receive $940 (ignoring any gains or losses). $60 would go to pay the sales charge. If shares were sold during the seventh year, the investor would receive back $1,000.

Ongoing expenses: The second part of the fee table indicates the kinds of ongoing expenses that will be paid while remaining invested in the fund. The table shows expenses as a percentage of the fund's assets, generally for the most recent fiscal year. High expenses do not assure superior performance. Higher expense funds do not, on average, perform better than lower expense funds. But there may be circumstances in which it is appropriate to pay higher expenses. For example, higher expenses will be incurred for certain types of funds that require extra work by its managers, such as international stock funds, which require sophisticated research. Higher expenses may also be paid for funds that provide special services, like toll-free telephone numbers, check-writing and automatic investment programs. A difference in expenses that may look small can make a big difference in the value of the investment in the fund over time. An example of this would be where an investor has $1,000 invested in a fund. Assume for purposes of this example that the investor receives a flat rate of return of 5 percent before expenses. If the fund has expenses of 1.5 percent after 20 years, the investor would end up with roughly $1,990. If the fund has expenses of 0.5%, the investor would end up with more than $2,410. This is a 22 percent difference.

One type of ongoing fee that is taken out of fund assets has come to be known as a rule 12b-1fee. It most often is used to pay commissions to brokers and other salespersons and occasionally to pay for advertising and other costs of promoting the fund to investors. It usually is between 0.25 percent and 1.00 percent of assets annually. A rule implemented in 1993 effectively capped 12b-1 fees at 0.75 percent but this rule also permitted "administrative service fees" of an additional 0.25 percent per year. Funds with back-end loads usually have higher rule 12b-1 fees.

A savings association should document carefully its reasons for choosing particular mutual funds as investment vehicles for discretionary accounts. These reasons could include the specific characteristics of a unique investment style or that the investment return supports increased fees. If the institution does not adequately support its decision making process, it may be subject to questionable prudent investment practices.

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

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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

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- 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.

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5. If investment research and analysis is obtained from an outside source, evaluate the quality and timeliness of information obtained.

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.

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.

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?

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

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

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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.

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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.”

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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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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.

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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

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Laws

ERISA	Section 406

Code of Federal Regulations

12 CFR 550	Trust Powers of Federal Associations (General)
12 CFR 550.40	Investment Authority
12 CFR 550.140	Policies and Procedures
12 CFR 550.260	Investment of Funds Held as Fiduciary
12 CFR 270.12b-1(a)(2)	12b-1 Fees

Office of Thrift Supervision Publications

TB 76-2	Conflicts of Interest Relating to Fiduciary Activities

Other

DOL Advisory Opinions	93-12A, 93-13A

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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

• Are policies and procedures adequately documented?
• Are the policies developed and approved by the board of directors or an appropriate committee of the board?
• Do the policies outline standards to safeguard against conflicts of interest and self-dealing?
• Do the policies discuss the process for use of proprietary mutual funds for discretionary accounts?
• Do the policies establish standards and procedures to evaluate and monitor mutual fund quality?
• Do the policies outline the process and criteria for selecting and evaluating potential mutual funds?
• Do the policies outline the process for monitoring existing mutual funds?
• Do the policies outline the standards for developing and amending approved lists of mutual funds?
• 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

• Are the delegated investment activities permissible under applicable law?
• Is there a written agreement that addresses all pertinent issues?
• Was the decision to delegate made in accordance with policy?
• Is the selection and monitoring process effective?
• 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

• 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?
• 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?
• In making decisions regarding mutual fund investments, does management consider: • 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

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comparisons to other related funds (benchmarks); • 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.
• Are decisions adequately supported and well documented?

Investment Research

• 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?
• Does management periodically review sources of investment research, to determine the quality of research provided?
• 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?

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