

**FEDERAL RESERVE BANK
OF NEW YORK**

AT. 10745(a)
November 28, 1994

INVESTMENT ADVISER ACTIVITIES

*To the Chief Executive Officers of All State Member Banks,
Bank Holding Companies, and U.S. Branches and Agencies
of Foreign Banks in the Second Federal Reserve District:*

Enclosed is an October 25, 1994 supervisory letter issued by the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System. It conveys the Board of Governors' concerns relating to the significance to banking organizations acting as investment advisers of having appropriate policies and procedures to address the management and operations of investment adviser activities.

The letter also reiterates the importance of examiners' following the Federal Reserve's established bank and bank holding company supervision policies and examination procedures that address the risks associated with acting as an investment adviser.

Questions regarding this supervisory letter may be directed to Jeannette Podgorski, Manager, Specialized Examinations Department at (212) 720-1593.

CHESTER B. FELDBERG,
Executive Vice President.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

October 25, 1994

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Investment Adviser Activities

Within the last several months, some bank holding companies whose subsidiaries act as investment advisers to proprietary money market mutual funds have provided financial support to their respective funds to offset declines in portfolio values resulting from reductions in the market value of complex investment products such as high risk CMOs and structured securities.¹ A few state member banks have had to address similar circumstances with respect to their trust departments' common investment funds (CIFs) that are advised by the bank.

These events underscore the importance to banking organizations acting as investment advisers of having appropriate policies and procedures that address the management and operations of investment adviser activities. These policies and procedures should assure that the adviser is aware of the risks associated with the investment products it recommends to its client funds, particularly with respect to complex derivative products, structured notes, and other high risk investments. Further, the adviser should determine that investment products are appropriate and consistent with the funds' prospectuses and stated objectives.²

Banking organizations that engage in investment adviser activities should have policies and procedures for addressing, monitoring, and controlling all significant risks associated with the advisory activity, including legal, operating, reputational, fiduciary, and financial risks. The latter includes the possible exposure associated with providing direct financial support to advised funds. Losses incurred by the advised fund

¹ Some bank holding companies have chosen, for business reasons, to provide the financial support necessary to maintain the \$1.00 per share net asset value of proprietary money market mutual funds even though the companies were under no legal obligation, barring a breach of fiduciary responsibility, to do so. In general, the support provided was treated as an expense by the bank holding companies.

² In a June 16, 1994 letter to the CEOs of large money market funds, the Chairman of the SEC strongly encouraged the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk. He also indicated that fund managers must implement policies to ensure that use of derivatives is fully consistent with the fund's investment objectives. In a June 30, 1994 follow-up letter to the ICI, SEC staff advised that funds should dispose of five types of structured securities, specifically, inverse floaters, cost-of-funds index floaters, constant-maturity Treasury floaters, dual-index floaters and range floaters.

could also pose an indirect financial risk to the advising banking organization if depositors or other providers of funds were to lose confidence in the organization, leading to possible deposit withdrawals or the termination of credit lines. Before commencing the activity of acting as investment adviser, banking organizations should assess all significant risks associated with the activity and should establish policies and systems to monitor and control such risks. In addition, all major policies and procedures pertaining to advisory activities should be reviewed periodically and approved by the organizations' boards of directors.

As a result of recent events, it is appropriate to reiterate the importance of the Federal Reserve's established bank and bank holding company³ supervision policies and examination procedures that address the risks associated with acting as an investment adviser. Reserve Banks are instructed to continue to monitor carefully investment adviser activities and, where necessary, to enhance their review and assessment of bank and bank holding company policies, procedures and internal controls in the investment adviser function during the examination of banks, bank holding companies, or nonbank subsidiaries that act as investment advisers to mutual funds or CIFs.

Review of Investment Adviser Activities

Examiners should give special attention to the organization's policies and procedures pertaining to investment adviser activities and to contingencies that could arise with this activity. The Federal Reserve's examination guidelines and related procedures pertaining to investment advisory activities of bank holding companies and their nonbank subsidiaries and state member banks' trust departments are contained in the Bank Holding Company Supervision Manual (Section 3130)⁴ and the Trust Examination Manual (Sections 4 and 5), respectively. These examination procedures indicate that an adviser is obligated to provide advice that is consistent with the stated investment objectives as set forth in the prospectus and with the liquidity needs applicable to a fund or account.

In addition, a recent supervisory letter on structured securities⁵ which focused on the use of these instruments by banking organizations in trading, investment, or trust operations, emphasized that failure of management to understand adequately the dimensions of the risks in complex derivative products can constitute an unsafe and

³ This supervisory letter is applicable throughout to foreign banking organizations and their U.S. branches and agencies.

⁴ See SR 91-4 (SA), dated February 8, 1991, which also incorporated previously issued supervisory policy and procedures contained in earlier supervisory letters.

⁵ SR 94-45, dated August 5, 1994.

unsound practice. Similarly, an investment adviser is expected to understand fully the risks involved in any investment product recommended to its client funds and how these risks relate to the funds' stated investment objectives.

In this regard, examiners should determine whether an investment adviser has policies and procedures to ensure that the fund portfolios it advises are operated in a manner fully consistent with the funds' objectives or, if applicable, SEC requirements. Investment advisers should have policies and procedures that subject advised funds to appropriate "stress testing" or contingency planning on a periodic basis in an effort to determine whether the investments will continue to conform to the funds' objectives in periods of market uncertainty and volatility.

Examiners should also determine that the investment adviser has policies and procedures in place that ensure compliance with applicable laws and SEC requirements such as those pertaining to the permissibility of certain high risk investments for money market mutual funds. Further, the adviser should have procedures to ensure that management of advised funds is fully informed of the risk character of the overall portfolio, including the presence of any complex investment products or other high risk investments. This is necessary to ensure that the funds' management and their distributors are able to make any necessary disclosures to investors in conformance with SEC requirements.

With regard to the inspection of the parent bank holding company, examiners should determine that the holding company's senior management and its board of directors have policies and procedures in place to monitor the activities of investment adviser subsidiaries to ensure that the risks associated with the conduct of this activity are not in conflict with the parent company's overall risk tolerance parameters. The parent should be able to assess at all times the extent of its exposure to financial, litigation, or reputational risk, if any, that stems from the investment advisory activities conducted by subsidiaries, and whether any such exposure would have a material adverse effect on the parent company's ability to act as a source of strength to its banks. In addition, the parent bank holding company should assure that the internal audit function monitors the activities of the investment adviser for compliance with any limits or internal controls that are intended to restrict its activities.

The examination frequency of investment adviser activities historically has been dependent on the volume and scope of advisory activities and the results of previous Reserve Bank (or SEC) examinations. Given the significance of investment advisory activities and the potential for off-balance sheet risk, such activities should generally be examined as part of the bank holding company's or bank's annual safety and soundness or trust examination. Particular attention should be focused on an investment adviser that places orders directly on behalf of a fund, or provides other portfolio management services such as safekeeping of securities or recordkeeping. As in the past, Reserve Banks should consider using trust examiners to conduct or participate in

examinations and inspections of investment advisory activities because of their familiarity with the subject.⁶

It is requested that you distribute a copy of this letter to bank holding companies, state member banks, and state-licensed U.S. branches and agencies of foreign banks in your district that are engaged or intend to engage in the activity of providing investment advisory services to mutual funds or trust department CIFs. Should you have any questions regarding this letter or the examination of investment advisory activities, please contact either Howard Amer (x2958) or Angela Desmond (x3497).



Richard Spillenkothen
Director

Cross Reference: SR 81-216, 88-11, 91-4, 94-45

⁶ See Section 3130.1.3 of the Bank Holding Company Supervision Manual and SR 88-11, dated April 28, 1988.