

This document and any attachments are superseded by Comptroller's Handbook - Asset Management.

## Introduction to Marketable Securities

Marketable securities refer to the securities that are actively traded in recognized markets, where they may be readily valued, purchased or sold. Specifically, marketable securities include common and preferred stocks, U.S. Government securities, corporate bonds, municipal securities, mutual funds and cash management instruments. The relative liquidity of these instruments generally allows the trustee to convert them into cash more readily than other types of investments.

A savings association should thoroughly research and analyze a marketable security prior to making a decision to purchase, retain or sell it. Investment research may be performed internally or be provided by external research firms. There is no requirement that a savings association perform its own research and no prohibition against hiring an external firm to provide investment advice. No matter what method is used, the process should be fully detailed in the trust department's policies and operating procedures and all investment decisions should be supported by research material and analysis. An important aspect of the process is the ability to identify exceptions to the policy. Reasons or corrective action for such exceptions should be fully documented and monitored. Failure to do so will increase the risk profile of the savings association.

As trustee, a savings association may become invested in a large number of individual securities (stocks, bonds, mutual funds etc.). It may be highly inefficient to research and analyze each of these securities. Therefore, many trust departments have developed "approved lists" of securities to facilitate the process of investment management. The use of this list reduces the number of security holdings in discretionary accounts that are not actively followed by asset management personnel. If such lists are used, policies should specify the individuals having authority to make additions or deletions to the list. Appropriate personnel and/or committees should closely monitor the list and any changes resulting from current research should be considered, reviewed and approved. Finally, procedures should exist to monitor actual investment decisions made for compliance with the approved list.

Appropriate personnel should periodically conduct a review of all marketable securities held by fiduciary accounts. The review should consider financial data relevant to both the specific entity and the industry. The records of the savings association must document the reviews performed and the conclusions reached.

Presented below are some of the more commonly accepted advantages relative to the different types of marketable securities, followed by a list of some of the factors which should be considered prior to making an investment decision regarding the use of these securities. While the advantages are discussed separately, one of the most significant advantages is their use together. A portfolio, which is diversified with a mix of securities, will assist in minimizing the risk of large losses and account fluctuations.

**Common and Preferred Stocks:** The use of common stock in a fiduciary account's investment portfolio offers a number of advantages in terms of meeting investment objectives. One, income from dividend payments may be sufficient to cover a beneficiary's need for current income. Two, capital appreciation could increase the total value of the portfolio for the remainder beneficiaries. Three, for accounts that are not tax-exempt, any capital gains are in most cases taxed at a lower rate than ordinary income. Four, trading stocks on the open market results in easier and more efficient trading compared to other types of investments. Finally, holding stocks allows a portfolio manager to exercise "secondary" or additional investment strategies such as writing covered call options or equity swaps, which may increase the account's yield,

without substantially increasing the risk. The following is a partial list of the factors that should normally be considered in making an investment decision pertaining to common and preferred stocks:

- Quality and depth of company management
- Financial condition of the company, including its position in the industry
- Quality of earnings, both current and historical
- Future prospects, both for the company in terms of competition, growth, sales, etc.
- Impact upon the company of any anticipated legislation or any government, management, or labor activities
- Ability of the company to develop, upgrade and/or market products to expand into new lines of business
- Ratings received by financial rating services
- Opinions rendered by accountants on financial statements
- Impact of any pending or existing litigation

**Debt Securities:** Debt securities include U.S. Government and agency obligations, corporate bonds and notes and commercial paper. U.S. Government and agency obligations offer advantages of quality, security, stability of income, marketability and elimination of credit and liquidity risk. Corporate obligations offer the advantages of being senior in liquidation of stocks, general stability and regularity of income. In addition, since they are issued with varying maturity dates, their use allows a portfolio manager to ladder maturities to achieve investment goals and reduce interest rate risk. Commercial paper of large corporations provides an alternative to short-term Treasury bills and is often used for investing temporary funds for up to one year. Their advantage is greater when short-term yields are high and uncertainty is present in the market. The following is a partial list of factors to be considered when making decisions regarding investments in debt securities:

- Quality and depth of management
- Capitalization of the company, including consideration of the trend of capital expenditures and nature of the industry
- Issuer's earning power and income projections
- Ability of the issuer to repay
- Rating received from financial rating services
- Rate of interest
- Maturity and yield to maturity
- Present and future marketability of the issue

In addition, special types of debt securities may require consideration of other factors. For example, public utilities will require a consideration of the probability of rate increases, the effect of increased fuel costs and the effects of anticipated changes in demand.

***Municipal Securities:*** The biggest advantage to state and municipal securities has been their exemption from federal income taxes. Beneficiaries in high income tax brackets have found these investments to be attractive. The following is a partial list of the factors to consider in making investment decisions pertaining to municipal securities:

- Sufficiency of actual and anticipated tax revenues to cover present and anticipated debt service
- Power and ability of the taxing authority to levy sufficient taxes to cover the debt service requirements
- Assessed property valuations and their relationship to tax burden
- Projected growth of tax base
- Historical trend of debt
- Budget considerations or constraints of the municipality
- Cash flow requirements
- Accuracy of past estimates of revenues and expenses

As with corporate debt, other special types of municipal securities may require additional considerations.

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# Marketable Securities Examination Program

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## Examination Objectives

To determine the adequacy and/or effectiveness of the trust department's administration of marketable securities. Consider whether:

- policies and procedures have been established to ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- adequate investment policies and monitoring procedures have been established;
- investment research and documentation adequately support investment decisions; and
- deficiencies are identified and corrective action promptly initiated.

## 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 Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform particular Level II procedures.

1. Review examination scoping materials related to the selection and monitoring process for marketable securities for the trust department. Scoping material should include:
  - Risk profile
  - Relevant PERK documents
  - Previous trust and asset management examination report
  - Workpapers from the previous examination
  - Previous safety and soundness examination report

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- Board of director and investment committee minutes
  - Most recent ADV
  - Examples of investment research materials utilized
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2. Evaluate the trust department's policies and procedures related to marketable securities. Note any significant changes. Consider whether they address:

- compliance with governing instruments, applicable law and accepted fiduciary principles;
  - the process and criteria, by which marketable securities are analyzed, selected, evaluated and approved;
  - documentation to support the selection and monitoring process;
  - use of outside firms to provide research and analysis; and
  - how exceptions to policies and procedures are handled.
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3. Evaluate whether management has the knowledge and expertise to select and monitor marketable securities. Note any significant personnel and/or organizational changes.

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4. Review and evaluate the analysis, selection, evaluation and approval process with respect to marketable securities. Give consideration to the following:

- Factors used in evaluating marketable securities
- The documentation maintained to support the evaluation and selection process
- The level of authority required to approve the selection of a marketable security or to remove a security from an approved status

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- The level of monitoring performed on approved securities
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5. If investment research and analysis is provided by an outside source, review the information obtained and determine:

- How the information is evaluated and used by management
  - If the evaluation process is effective
  - If written agreements are reviewed and if they address all pertinent issues
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6. Evaluate how information generated from the analysis, selection, evaluation and approval process is communicated to and used by applicable portfolio managers in the administration of trust and asset management accounts.

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7. Consider whether the following risk contributors (if applicable) have been addressed:

- Does management fully understand all aspects of risk with respect to marketable securities?
- Are policies and procedures adequate?
- Is investment research and analysis sound?
- Does management anticipate and respond well to market and technological changes?
- Are management information reports comprehensive and credible?
- Is the internal control environment adequate?
- Does management satisfactorily review and assess exceptions to policy?
- Does management quickly identify weaknesses and take appropriate action?

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- Have material issues noted in audit, compliance or examination reports been corrected?
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**The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.**

### 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.

1. If there are unresolved exceptions noted on internal or external audit, compliance or examination reports determine and evaluate the reasons for their presence. Evaluate management's plan to correct the exceptions.  

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2. Review and verify the accuracy of any applicable management exception reports.  

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3. Review management reports describing additions or deletions from the approved marketable securities list. Evaluate the reasons for additions or deletions to the list and who has the authorization approval. If management does not use an approved marketable securities list, determine how it monitors the addition/deletion of marketable securities and evaluate the effectiveness of this process.  

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4. Review the composition and quality of marketable securities in trust and asset management accounts. Note any changes from the previous examination in the number or type of securities. Consider:
- the reasons for the change in asset composition and whether management planned for this change; and
  - whether a risk assessment was factored into this change and if not, determine the reasons why it was not.

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5. Has the trust department purchased over five percent of a particular stock compared to the total stock outstanding for a company and is the holding supported?

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6. Are there any unusual concentrations of any one security in an account where the trust department exercises discretion?

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7. Are the investment policies sufficient to include the disposal of unsuitable assets delivered in kind and restructuring of the portfolio within a reasonable period of time?

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8. 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.

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**If the examiner cannot rely on the data contained in the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports; proceed to Level III.**

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### 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. Select a sample of discretionary accounts containing unapproved or nonrated securities to determine that proper authorization for the securities is present, such as a recent direction letter. If proper authorization is not present, what is the process for reducing the securities presence?

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2. Pull a sample of discretionary accounts and review these accounts to determine whether there is evidence of excessive trading (churning) within the account. Consider:
  - the number and frequency of trades;
  - the amount of commissions generated;
  - the account's investment objectives relative to the assets traded;
  - the degree of control the savings association or a broker has over an account;
  - the appropriateness of trades between accounts, if applicable; and
  - whether the quality of the account portfolio was downgraded as a result of the trading activity.

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3. Select a sample of accounts containing marketable securities that were reviewed by the audit and/or compliance functions. Determine if the findings of the audit/compliance review are consistent with examination findings.

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4. Review the approved marketable securities list and select a sample of securities to review. Include common and preferred stocks, corporate bonds, municipal securities, mutual funds

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(unless reviewed under program 830) and cash management instruments. Consider:

- The supporting research and analysis and assess whether the research and analysis is adequate to support management's decision.
  - The research and analysis performed conforms to policies and procedures and appropriate documentation is retained.
  - Whether appropriate internal approvals were obtained to include the security on the approved list.
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5. Review the master list of marketable securities and determine if any unapproved securities are present. Select a sample of securities to review. Consider:

- Whether unapproved securities are included on management's exception report. If unapproved securities are not on the exception report, determine the reason for this lapse and how management monitors unapproved marketable securities.
  - Whether there is a retention process and the reasons for retention are well documented.
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6. Select a sample of discretionary accounts with investments in marketable securities. Evaluate the following:

- Are the marketable securities in the account on the approved list? If not, determine the reasons, assure appropriate internal approvals were obtained and verify that it is on the exception report.
  - Are the marketable securities in the account 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?
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### Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

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#### References - 820P

##### Laws

Investment Advisors Act of 1940  
Investment Company Act of 1940

##### Code of Federal Regulations

12 CFR 550.140	Policies and Procedures
12 CFR 550.240	Trust Powers (General)
12 CFR 550.260	Investment of Funds Held as Fiduciary

##### Office of Thrift Supervision Publications

TB 76-2	Conflicts of Interest Related to Fiduciary Accounts
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##### Other

Scott on Trusts, 3<sup>rd</sup> Ed.  
Bogert and Bogert, Trust and Trustees, 2<sup>nd</sup> Ed.  
Restatement (Second and Third) of Trusts

#### Workpaper Attachments - 820P

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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***

<ul style="list-style-type: none"><li>• Are the policies adequate to properly administer marketable securities?</li></ul>
<ul style="list-style-type: none"><li>• Do the policies consider quality and depth of management when evaluating a security?</li></ul>
<ul style="list-style-type: none"><li>• Do the policies require a comparison of investment performance to applicable benchmarks?</li></ul>
<ul style="list-style-type: none"><li>• Are the following factors considered when investing in publicly traded companies?<ul style="list-style-type: none"><li>• Financial condition and position of the company in the industry?</li><li>• The quality of earnings and historical growth of the company?</li><li>• The future prospects of the company, projected earnings and competition?</li><li>• The anticipated availability of raw materials and employee resources to sustain the company's future growth?</li><li>• The potential impact of anticipated legislation and possible government intervention?</li><li>• The ability of the company to develop new products and/or upgrade existing products?</li></ul></li></ul>
<ul style="list-style-type: none"><li>• Does management require the following factors to be assessed before investing in publicly traded companies?<ul style="list-style-type: none"><li>• The liquidity of the market issuer?</li><li>• The potential litigation pending against the issuer?</li><li>• The ability of the borrower to repay debt?</li><li>• Ratings assigned by third party providers?</li><li>• Trends in capital expenditures?</li></ul></li></ul>

### ***Investment Decisions***

<ul style="list-style-type: none"><li>• Are decisions based on adequate research and analysis (whether performed in-house or acquired from outside sources), including an evaluation of relevant factors pertaining to the type of security under consideration?</li></ul>
<ul style="list-style-type: none"><li>• 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?</li></ul>
<ul style="list-style-type: none"><li>• Are decisions adequately supported and well documented?</li></ul>

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### ***Discretionary Accounts***

<ul style="list-style-type: none"><li>• Are at least one of the ratings agencies utilized, such as Standard and Poor or Moodys decisions?</li></ul>
<ul style="list-style-type: none"><li>• Does management periodically review sources of investment research to determine the quality of research provided?</li></ul>
<ul style="list-style-type: none"><li>• 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?</li></ul>
<ul style="list-style-type: none"><li>• For securities not rated, or whose ratings do not conform to stated guidelines, does management review to determine if sufficient justification exists for holding the security? Justification might include, for example, an investment decision based on independent research and supported by a thorough analysis or holding the security to defer tax loss.</li></ul>

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