MEMO# 6387

November 14, 1994

FEDERAL RESERVE LETTER ON BANK INVESTMENT ADVISER ACTIVITIES

November 14, 1994 TO: BANK INVESTMENT MANAGEMENT MEMBERS NO. 32-94 BOARD OF GOVERNORS NO. 117-94 RE: FEDERAL RESERVE LETTER ON BANK INVESTMENT ADVISER ACTIVITIES ____ The Federal Reserve Board recently sent the attached letter to the supervisory officers at each Federal Reserve Bank. The letter states that some bank holding companies recently have provided financial support to money market funds advised by their subsidiaries. The letter also notes that a few state member banks have taken similar action with respect to their common investment funds. The letter states that banks should have policies and procedures concerning their investment adviser activities that assure that the adviser is aware of the risks associated with the investment it recommends to its client funds, particularly with respect to derivatives. These policies and procedures should address "the possible exposure associated with providing direct financial support to advised funds." The letter also states that management's failure to understand the risks in complex derivative products can constitute an unsafe and unsound practice. According to the letter, Federal Reserve Bank examiners should determine whether an adviser has policies and procedures to ensure that its fund portfolios "are operated in a manner fully consistent with the funds' objectives or, if applicable, SEC requirements." Investment advisers should periodically subject their funds to "stress testing" or contingency planning to determine if the investments will continue to conform to the funds' objectives in periods of market uncertainty and volatility. We will keep you advised of further developments in this regard. Paul Schott Stevens General Counsel Attachment