Other Trust Matters

This section contains an overview of Federal regulations and other matters related to fiduciary activities.

A. TRUST POWERS

Trust powers are granted to state-chartered banks under state law, which is usually administered through a bank's chartering authority. It is state law, therefore, which defines activities constituting fiduciary or trust powers. The FDIC always defers to state law in these matters.

State statutes and Corporation regulations do not always uniformly identify what functions constitute "fiduciary" activities requiring trust powers. Some state statutes define "trust activity" as serving in a (state's) legally defined capacities of trustee, executor or administrator of estates, or guardian of the estate of a minor or incompetent. However, the term "trust activity" is not as clear when a bank is performing an agency function which may, or may not, require trust powers. Some banks administer "managed agency accounts" wherein there is no "trust" relationship, yet the bank often assumes full control of cash and assets, including investment discretion. In these cases, the bank's responsibilities exceed those exercised in passive, or directed personal trust accounts, or in court directed estates and guardianships. While a bank may claim it is not acting in a "trust" capacity for such accounts, its activities may require trust powers under state law.

The term "fiduciary capacity" is neither universally defined, nor does it have identical meaning among the states in setting their requirements for trust powers. The term "fiduciary" is broadly defined. It can be almost any party performing a financial or other service for another party. For example, some banks operate corporate trust departments in which they do not serve as "trustee" for any account, but perform extensive financial services which require trust powers. Some states distinguish between "court" and "private" accounts, and require such things as a faithful performance bond or uninvested cash pledge for designated court accounts. Furthermore, the term "trustee" per se, is not always a determinative, since banks have been authorized to serve as "trustee" over certain types of accounts (IRA's) without having been granted trust powers.

It is also necessary to clarify the types of "agency functions" which are considered "trust activities" requiring state authorization. Many commercial banks are permitted to provide escrow, safekeeping, custodian, or similar directed agency services, without having a trust department or regulatory authorization to perform trust powers. This may include physical custody of assets, record keeping, collecting and remitting income, performing some administrative actions (as in escrow services), or similar activities. Whether any such activities are permitted without "trust powers" is wholly dependent upon state law.

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B. FDIC CONSENT TO EXERCISE TRUST POWERS

In 1958, the Corporation articulated its basis for requiring consent to exercise trust powers (refer to Appendix C, FDIC Memorandums Regarding Consent to Exercise Trust Powers, dated June 30, 1958), and established conditions for grandfathering consent. Banks granted trust powers by State statute or charter prior to December 1, 1950, regardless of whether or not such powers have ever been exercised, are not required to file an application with the Corporation for consent to exercise trust powers. Such consent is grandfathered with the approval for Federal deposit insurance.

Banks approved for Federal deposit insurance after December 1, 1950, are required to file an application to exercise trust powers, unless such filing was made simultaneously with the application for Federal deposit insurance.

FDIC Part 333 Consent Requirement

The Corporation does not grant trust powers but only gives its consent to exercise such powers as granted by state authorities. Section 333.2 of the FDIC Rules and Regulations prohibits an insured state non-member bank from changing the general character of its business without the Corporation's prior written consent. The test to determine when a change in character of business has occurred is left to the discretion of the Corporation. For trust powers, this normally occurs when a fiduciary relationship is created under the laws of the governing state authority. Therefore, it is general policy that unless a bank is exempted through the circumstances described in the background section above, it must file a formal application with the Corporation to obtain prior written consent before it may exercise trust powers.

It should also be noted that the statute applies only to banks. Separately chartered and capitalized uninsured trust company subsidiaries of banks need not apply for FDIC consent to exercise trust powers. Also, state non-member institutions that acquire or start registered investment adviser subsidiaries do not have to apply for FDIC consent to exercise trust powers under Section 24 of the FDI Act or Part 362 of the FDIC Rules and Regulations.

FDIC Part 303 Applications for Consent

Part 303 of the FDIC Rules and Regulations govern the administrative handling of applications for consent to exercise trust powers. Application procedures are set forth in Part 303, the Manual of Examination Policies (Manual), and the Case Managers Procedures Manual (CM Manual). Banks eligible for expedited processing under Part 303 (as defined therein) may file an abbreviated application. Application forms for both expedited and non-expedited processing can be downloaded or requested from an FDIC Regional Office.

Applications are reviewed in the context of the financial institution's ability to satisfactorily perform trust activities. In reviewing any such application, the statutory factors set forth in Section 6 of the Federal Deposit Insurance Act are considered along with the factors discussed in the Manual of Examination Policies and CM Manual applications sections.

Unauthorized Trust Activities

Commercial banks may be found performing fiduciary services without having obtained full or limited trust powers, or the Corporation's consent to exercise such powers. In these cases, the examiner should determine what services are being performed and review all written customer agreements. If a bank is acting in any capacity requiring trust powers, the examiner should:

- Cite an apparent violation of state law for performing fiduciary services without trust powers (if applicable);
- Cite an apparent violation of FDIC Section 333.2 for changing the character of its business without the Corporation's prior written consent; and
- Advise management of the following:

    - that it must discontinue accepting any additional appointments.
    - that it should (upon advice of counsel) discontinue performing fiduciary services, if it can do so without jeopardizing its accounts or incurring additional liability upon itself;
    - that it must apply to its state authority for trust powers (if applicable); and
    - that it must also apply to the Corporation for consent to exercise the powers.

Refer to the applications section of the Manual of Examination Policies for further information.

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C. MERGERS, ACQUISITIONS, AND TRANSFERS OF FIDUCIARY BUSINESS

Purchases, sales, or transfers of fiduciary business between banks and other entities can involve complex legal issues. Several statutes may govern such transactions, depending on individual case-specific circumstances. Mergers, acquisitions, and transfers are predominantly a safety and soundness issue and inquiries from bank management and examiners on this subject should generally be referred to the applicable FDIC Regional Office. The five items discussed below are intended to provide an appreciation of the regulations and risk management process that management should follow in mergers, acquisitions, or transfers of a "fiduciary book of business".

Federal Deposit Insurance Act Section 18(c)(1)

Section 18(c)(1) of the Federal Deposit Insurance Act is sometimes referred to as the Bank Merger Act (BMA). In general, the BMA is applicable whenever insured deposits are involved in a "merger" transaction. However, in instances where a trust department, or fiduciary "book of business", is "purchased" outright and is not involved in a "merger" transaction, it is not clear whether the Act is applicable. A critical determinant may be whether "deposits," as defined in Section 3 of the FDI Act, are part of an assumption or merger transaction. The Corporation's "Statement of Policy; Bank Merger Transactions" should be reviewed in determining BMA applicability. Where applicable, the BMA requires the prior written approval of the FDIC for any merger, consolidation, or purchase and assumption transaction. Refer to the Manual, Applications for Mergers, for further discussion of the application process.

Affiliates - Federal Reserve Act Sections 23A and 23B

Sections 23A and 23B of the Federal Reserve Act are made applicable to the activities of insured state nonmember banks by Section 18(j) of the FDI Act. These statutes are primarily directed toward the prevention of abusive relationships between banks and their affiliates in the area of commercial banking. These sections do, however, have applicability to purchases and sales of trust departments between affiliated entities.

Careful review of the definition of "affiliate" in each section, and the differences in the definition between the two sections, is necessary when reviewing trust related transactions. Section 23B specifically excludes banks from its definition of affiliates. The term "bank" is defined in both sections 23A and 23B to include trust companies. Thus, bank-to-bank transactions and bank-to-trust company transactions are outside the scope of Section 23B.

Applicability to Purchases and Sales of Trust Departments between a Bank and its Affiliates

In transactions where assets are purchased from an affiliate, Section 23A(a)(4) applies. It requires the transaction to be on terms and conditions consistent with safe and sound banking practices. Such provisions are designed to ensure inter-affiliate transactions occur on a commercially reasonable basis; and that compensation between the parties, where warranted, is reasonable.

In transactions where assets are sold to an affiliate, Section 23B applies in some cases. This Section requires the transaction to occur on terms, and under circumstances, such as those prevailing for non-affiliated entities. As previously noted, bank-to-bank and bank-to-trust company transactions are not covered by Section 23B.

It is important to note that, in transactions where a trust department or fiduciary business is purchased or sold, the "asset" involved is an intangible expected future flow of fee income arising from the underlying trust accounts. Incidental assets, such as premises and equipment used to conduct business, may also be involved in such transactions.

The following chart illustrates the applicability of Federal Reserve Act Section 23B to several types of transactions involving purchases or sales of fiduciary activities:

Application of FRB Section 23B [Re: Compensation] on the Purchase (or sale) of a trust department to (or From) Another Institution:

-	-	**TO:**	**TO:**	**TO:**	**TO:**	**TO:**	**TO:**
-	-	**OWN BANK**	**OWN BANK SUB**	**AFFILIATED INSURED BANK-SUB**	**BHC NONBANK SUB**	**NON-AFFIL INSURED BANK**	**NON-AFFIL UN-INS ENTITY**
FROM:	OWN BANK	N/A	No	No	**YES**	No	No
FROM:	OWN BANK SUB	No	No	No	**YES**	No	No
FROM:	BHC SUBSIDIARY	**YES**	**YES**	**YES**	No	No	No
FROM:	NON-AFFILIATED UNINSURED ENTITY	No	No	No	No	No	No

Expanded discussions of Federal Reserve Act Sections 23A and 23B are provided in Section 8.E.4 Conflicts of Interest and Section 4.3 of the Manual of Examination Policies.

Applicable State Law

State non-member banks, and other companies, must obtain authority to exercise trust powers from the applicable state in which they operate. Applicable state law may also address certain types of transactions involving consolidations of trust business. These provisions, if any, will ordinarily be found under a state's organization and merger statutes. State law will also typically address transfers, or substitutions, of fiduciaries. In some jurisdictions, and with some types of accounts, court approval may be required. Provisions related to this will usually be found in state statutes dealing with trusts. Where questions arise, the Regional Office or appropriate state authority should be contacted for guidance.

FDIC Consent

As discussed at the beginning of this section, if the acquiring or resulting entity is a state non-member bank, application to the Corporation for consent to exercise trust powers may be necessary in merger or other acquisition transactions. FDIC consent is nontransferable. Therefore, the act of purchasing a trust department from a bank which has such consent does not convey that consent to the purchaser. Consent must be applied for unless the acquiring bank already has such consent. In all instances where the acquiring entity is a state non-member bank, examiners should ensure the transaction was in compliance with FDIC Parts 303 and 333.

Nonstatutory Considerations

In addition to adherence to various Federal and state statutes, a host of other concerns attend the purchase, sale, or transfer of trust activities or accounts from one fiduciary to another. While several of these issues are discussed in depth elsewhere in this manual, they are listed here to facilitate a review of transactions involving institutional transfers of trust business. These issues necessarily emphasize the impact such transactions have on the safety and soundness of the institutions involved:

Compensation

The valuation of trust departments for purposes of a sale is not a well-defined process. Conventional business valuation methods may employ the use of average gross income generated by the activity, times some multiple, to arrive at a price or value. Present value analysis of expected cash flows from fees may also be used. In analyzing either a purchase or sale, the examiner should request and evaluate documentation of the basis for the sales price and terms. In some instances, no compensation may be warranted. In other instances, the lack of adequate compensation could be a Federal Reserve Act 23A or 23B issue (for non-exempt parties) or a general safety and soundness concern.

Written Agreement

Trust transfers and sales should be subject to a written agreement. The agreements should address:

- the effective date of the transaction.
- indemnification between the parties relevant to fiduciary actions, and in the event of future contingencies;
- provision allowing a due diligence process;
- division of fees between buyer and seller during transition;
- compensation, or a sales price, as discussed above;
- specific identification of accounts to be transferred;
- duties and responsibilities of each party in effecting the transfer of accounts and records;
- duties and responsibilities of each party in effecting the transfer of underlying assets;
- termination and modification provisions; and
- escape clauses, as necessary, to address such contingencies as failure to obtain regulatory approval.

Capabilities of the Fiduciary

The entity acquiring the trust business should be legally qualified to do so. State authority and FDIC consent to exercise the types of powers associated with the acquired business should be in place. Moreover, management should possess the skills necessary to administer the new accounts. Management should have evaluated the need for additional trust personnel, data processing capabilities, bank premises, and other facilities to accommodate the new business well in advance of the acquisition.

Resultant Earnings

Depending on the circumstances, pro forma projections of earnings may be requested as part of the FDIC application process. Regardless, management is expected to have evaluated the impact of such transfers on the bank's earnings. Economies of scale are often cited as a reason for acquiring or selling trust departments. While this is a legitimate factor, such economies are not guaranteed and may not materialize in every consolidation. Moreover, they do not always translate into improved bank earnings.

Capital Adequacy and Accounting Considerations

Engaging in fiduciary activities subjects an institution's capital to additional risk. Capital adequacy can be adversely affected by the acquisition of significant new accounts or new business lines if not properly managed. Related deposit growth from the acquisition may also place strains on capital.

Trust activities may be referred to as "off balance sheet" activities, in as much as there typically is no book value assigned to the business. In instances where a bank purchases or sells a group of trust accounts from another entity for some value, the bank will need to properly account for the transaction on its books. Where the bank purchases only fiduciary activities, the purchase price should normally be recorded on its statement of condition as "goodwill" or "trust department intangibles." This value: (1) should be amortized in accordance with generally accepted accounting principles, but (2) it should not be included in Tier 1 capital computations. In some instances, the purchase may also involve tangibles, such as fixed assets in which trust activities are conducted. Those assets should be accounted for in the usual fashion. In all cases, underlying trust account assets continue to be the property of the respective trusts. As such, they are not subject to purchase or sale between the buying and selling institutions. Where a bank sells its trust business, it will typically not have a basis, or book value, for the business. Consequently, the entire price it receives should be reported on its income statement as a nonrecurring income item and under "other operating income" on the Call Report.

Notification to Account Parties

Written notification to the respective account parties on each account transferred is mandatory from a prudence standpoint. In some states, state law may require such notification or otherwise address this issue.

Successor Fiduciary Issues

To the extent that the purchasing entity becomes a successor fiduciary of the acquired trust accounts, several well-recognized duties accrue. These are discussed both in Compliance - Personal and Charitable Accounts, and Compliance - Employee Benefit Accounts, Fiduciary Responsibilities.

In addition to ensuring the prompt and orderly transfer of assets held in trust between fiduciaries, and ensuring the uninterrupted administration of the accounts, successors are obliged under general common law tenets to scrutinize the acts of their predecessors. Successor fiduciaries should seek redress for any wrongs committed by previous fiduciaries. This is considered an essential due diligence procedure. In doing so, successor fiduciaries should: (1) obtain and review an accounting from the previous fiduciary for each account acquired, and (2) request an indemnification from the prior fiduciary for all actions taken during its administration of an account.

Fidelity and Indemnity Coverage

Purchasing entities should alert their carriers early to the acquisition of new business. Bank management should ensure that coverage is afforded, including coverage for acts of all prior fiduciaries "discovered" following their acquisition of an account.

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D. METHODS USED TO DELIVER FIDUCIARY SERVICE

The trust department, as a separate and visibly distinct department of the bank, remains the most prevalent method for banks to deliver fiduciary services. However, the recent trend toward consolidation within the financial services sector has led to diverse restructuring and merger activity. In some instances, banks previously lacking trust product lines may have acquired them through mergers. In other cases, the "trust" line of business may have been purchased or sold by a bank. In some cases, trust services being provided by several individual banks owned by the same holding company may have been consolidated within one bank, or within a separately chartered trust company. In still other instances, a bank may have contracted with an unrelated outside party, to provide such services on-premises. Conversely, the bank under examination may provide such services to other banks. To effectively assess the risk such relationships, pose to the institution, the examiner may find it helpful to understand the organization, the legal structure of the delivery system, the reasonableness of the relationship, and the reasonableness of the compensation to the bank.

Trust Branches and Trust Service Offices

In some instances, banks may wish to establish "branch" offices of their trust departments. Where the trust branch is to be located within an existing intrastate branch of the bank, there are usually no legal barriers and no further legal hurdles. When a trust branch office is proposed at a location where the institution does not have an existing branch, the procedure is more complex.

If a trust branch (or "trust service office"), in the course of conducting its business, is an office where "deposits are received, or checks paid, or money lent" - (1) such office is considered by the FDIC as a "domestic branch" under Section 3 of the FDI Act, and (2) the bank must apply to the FDIC (and state) for permission to establish and operate a new branch.

This is due largely to the statutory definition of the term "deposit". Section 3(l) of the FDI Act defines the term deposit to include trust funds, whether held in the trust department, or held or deposited in any other department of the bank or savings association. The broad inclusion (within the statutory term "deposit") of virtually all trust monies which may be on hand anywhere in the bank, in any form, has implications. It will generally mean that the conduct of trust activities which involve accepting funds will also be considered to be branch banking or accepting deposits. This necessitates that banks either conduct trust activities in existing branches, or that they apply for a branch, if they intend to accept funds (other than non-cash assets) at the "trust branch" or "trust service office."

Interstate Trust Branch Offices

State non-member banks, and other companies, must obtain authority to exercise trust powers from the applicable state in which they operate. States may limit the authority of out-of-state entities to engage in fiduciary activities within their borders. Therefore, banks or other state-chartered entities which legally offer trust services in one state, typically need to obtain separate approval from another state before conducting trust business there.

In contrast with the foregoing, both the OCC and OTS have issued similar opinions effectively permitting national banks and federal savings associations to operate trust businesses on an interstate basis. A national bank with trust powers (under 12 USC 92a) may engage in trust activities to the same extent that state banks, trust companies, or other corporations in competition with national banks, are permitted to engage in. If a state permits the foregoing state licensed entities to compete with national banks in trust activities, but prohibits out-of-state companies from doing so, Section 92a may be used to preempt state law. This effectively permits national banks to engage in trust activities in any state in which its branches are located.

In 1996, the Conference of State Bank Supervisors (CSBS), the FDIC, and the Federal Reserve Board signed an interstate banking and branching agreement for state-chartered banks. This agreement, revised in December 1997, allows states to adopt laws permitting interstate operation of trust businesses. This permits state-chartered entities to be competitive, and complement the interstate activities in the commercial banking arena.

CSBS assisted in the drafting of the "Nationwide Cooperative Agreement for Supervision and Examination of Multi-State Trust Institutions" that was executed in June 1999. To date, 42 states have signed the agreement, which lays out the framework for the supervision and regulation of multi-state trust institutions. The agreement is on CSBS's web site at https://www.csbs.org/cooperative-agreements.

Trust Companies

Trust Companies

The term "trust company" can be misleading. In some states, a bank must have trust powers in order to have "trust" in its name. In other instances, banks have incorporated the term into their name, even when the bank does not have trust powers. Thus, the term may simply denote an insured bank.

In other instances, trust activities may be conducted from a separate corporate entity, or "trust company". In many cases, trust companies are subsidiaries of bank holding companies, but there are a few that are direct subsidiaries of insured banks. In other cases, the trust company may be owned by the parent company or it may be a truly independent "stand alone" trust company and have no parent organization.

FDIC-Insured Trust Companies

Trust companies may be an insured bank which does almost all of its business as a trust institution. They qualify for deposit insurance under 12 C.F.R. § 303.14, which states that a single non-trust deposit of at least $500,000 would meet the statutory standard of Section 3(a)(2)(A) of the Federal Deposit Insurance Act. An institution with a single non-trust deposit of at least $500,000 will be considered "... in the business of receiving deposits, other than trust funds ..." and, thus, qualifies for Federal deposit insurance. These institutions may receive a bank charter from the state or the OCC, or a federal savings bank charter from the OTS. These insured trust banks are examined the same as other insured banks.

Non-FDIC-Insured Trust Companies

Most trust companies are not insured by the FDIC. These companies are chartered and regulated by the state or by the OCC. Trust companies which are owned by a bank holding company are also subject to supervision by the Federal Reserve Board. Trust companies that are owned by banks are subject to examination and supervision by the parent bank's primary regulator.

A trust company that is a direct subsidiary of an FDIC supervised bank is viewed as a separately chartered and separately capitalized entity. As such, its trust powers are granted solely by the chartering agency, and the trust company is not required to seek the FDIC's consent to exercise trust powers. In like manner, the trust company's parent bank is not required to have the FDIC's consent to exercise trust powers if all of its trust activities are conducted by the separately chartered subsidiary trust company.

Instructions for Call Report Schedule RC-T states that the schedule should be completed on a fully consolidated basis, i.e., including any trust company subsidiary (or subsidiaries) of the reporting institution.

As noted under Section E. Examination Authority, trust companies that are direct subsidiaries of FDIC supervised banks may be examined by the FDIC. However, such examinations are not required under GM-1 requirements. However, they may be examined if the supervisory Regional Office determines that their activities have a material and substantive impact on the parent bank. Also, refer to coverage of the Gramm-Leach-Bliley Act (GLBA) concerning examinations of affiliates. Examination reports furnished by the trust company's primary regulatory agency may also be reviewed for normal monitoring of the trust company's activities.

If an examination of a trust company that is a direct subsidiary of an FDIC supervised bank is performed, examiners should determine that its activities are generally consistent with the Statement of Principles of Trust Department Management. If examiners suspect that the uninsured trust company is being utilized to generate deposits for the parent bank in an unauthorized fashion, the activity should be investigated and compared with the Section 3(o) of the FDI Act definition of a domestic branch and applicable State Law. Consult with the respective Regional Office, if corrective action is needed.

Trust Referral Arrangements

Some institutions ("host banks") have entered into third-party agreements with unaffiliated trust institutions and registered investment advisers for the offering of fiduciary services to "host bank" customers. The "host bank" does not need trust powers because the fiduciary relationship is between the client and the third party and typically receives a one time or annual referral fee based on the assets of the referred clients. While the "host bank" does not have any investment or fiduciary powers, it may retain administrative responsibilities and receive administration fees in addition to the referral fee. All trust referral arrangements, regardless of whether the bank retains any administrative duties, should be governed by a written agreement that outlines the responsibilities of all parties.

Additionally, the client should be sufficiently informed of the general terms of this relationship with reasonable and meaningful disclosures. For example, disclosures should be given upon the establishment of an account and periodically (but not less frequently than annually) thereafter. The disclosures should be sufficient to identify to the client the party that is administering the client's account. If the third party is responsible for making such disclosures, the host bank should ensure that the disclosures are provided, and, if appropriate disclosures have not been made, should take the necessary actions to provide the disclosures.

Some banks have entered into arrangements whereby customers are referred to third parties who are not located on bank premises. Such arrangements can include referrals by trust department personnel that may involve the sale of non-deposit products (NDPs). The bank may receive a fee or other monetary benefit for making such referrals.

The Interagency Statement on Retail Sales of Nondeposit Investment Products applies to trust activity under the following two circumstances:

- When non-institutional customers direct investments for their fiduciary accounts, such as self-directed IRA and KEOGH plans in trustee or custodial accounts. For such accounts, the three minimum disclosures from the Interagency Statement apply.
- When the customer has sole investment discretion for an agency account. For such accounts, the entire statement would be applicable.

The above two circumstances were outlined in Regional Director Memorandum "Nondeposit Investment Products (NDIP) and Recordkeeping Requirements Questions and Answers, issued June 23, 1998. The memorandum states that self-directed employee benefit accounts such as 401(k) accounts are not subject to the Interagency Statement, as ERISA laws considers them to be fiduciary accounts. The Statement also does not apply to custodial accounts (other than self-directed retirement accounts) where the institution is performing ministerial acts such as collecting interest and dividend payments for securities held in the accounts and handling the delivery or collection of securities or funds in connection with a transaction.

Determining whether a bank offering such trust products on the premises of another bank is in fact, operating a "domestic branch" can be difficult. One critical determinant may be whether the bank offering trust products is "receiving deposits." A variety of contractual provisions may also impact the final determination, including the use of the host-bank as a "correspondent bank" to accept trust customer deposits. In some instances, it has been held that banks may contract with other banks to act as their agent in conducting certain limited activities, including the taking of deposits, without being deemed to be operating a branch. Refer to FDIC Advisory Opinions 93-57 and 95-22 for additional information.

But, the process of "offering trust services" goes beyond the receipt of deposits. In the absence of established examination policies, examiners should ascertain the facts, document the contractual provisions and practical operation of the arrangement, and forward the information to the Regional Office for its determination.

Private Banking Services

The USA PATRIOT Act, Section 312, provides the following definition of a "private banking account" as it applies to the Act. The term 'private banking account' means an account (or any combination of accounts) that--(i) requires a minimum aggregate deposit of funds or other assets of not less than $1,000,000; (ii) is established on behalf of 1 or more individuals who have a direct or beneficial ownership interest in the account; and (iii) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Generally, a bank might offer "private banking" services to a select group of its more wealthy customers - high net worth individuals and their corporate interests. Such services will usually provide the customer with all conventional banking products at one location and through one bank officer, or a team of such officers, thus eliminating the need for the customer to physically visit several separate departments. Typically, a private banking department will provide an array of personal and financial services, including estate and financial planning, trust and investment advisory services, personal loans, and maintenance of deposit relationships. Many private banking clients choose this method of financial management for the personalized service and confidentiality provided.

Private banking services have increased in popularity in recent years as more banks have begun to rely on the income generated by this service. The structure and sophistication of private banking services varies by bank size and business structure. Examiners are also reminded that smaller institutions may offer similar services to certain customers while not designating it as private banking. Without the implementation of appropriate oversight, policies, and risk management systems, management may expose itself to increased reputational and legal risks inherent in this business.

Management Oversight - Private Banking

As with all significant business lines, senior management has a responsibility to formulate a sound risk management and control environment. A business plan outlining the targeted client base, range of services provided, and financial risk objectives and tolerance levels should be implemented. The scope and depth of coverage typically vary depending upon the size and complexity of services offered. However, management has a responsibility to define acceptable targets and review for compliance with such targets.

Policies - Private Banking

As with other areas of the bank, suitable written policies provide a basis upon which to operate. If appropriate policies and internal controls have not been implemented, there may be cause for concern. Management may expose the institution to reputational and legal risks, if compliance with USA PATRIOT Act and Anti-Money Laundering regulations are lacking. A sound private banking operation will typically have written customer due diligence guidelines to assist in the prevention of illicit acts.

Some standard customer due diligence guidance includes:

- obtaining identification and basic background information on clients,
- describing the clients' source of wealth and lines of businesses,
- requesting references and handling referrals,
- and identifying suspicious transactions.

The USA PATRIOT Act requirements for a customer identification program promotes a risk-focused approach {Section 1.H.2 USA Patriot Act Compliance}. For example, Section 312 of the Act requires private banking accounts involving foreign persons to be considered for enhanced due diligence.

- Section 312(a)(i)(1): IN GENERAL - Each financial institution that establishes, maintains, administers, or manages a private banking account or a correspondent account in the United States for a non-United States person, including a foreign individual visiting the United States, or a representative of a non United States person shall establish appropriate, specific, and, where necessary, enhanced, due diligence policies, procedures, and controls that are reasonably designed to detect and report instances of money laundering through those accounts.

- Section 312(a)(i)(3): Minimum Standards For Private Banking Accounts - If a private banking account is requested or maintained by, or on behalf of, a non-United States person, then the due diligence policies, procedures, and controls required under paragraph (1) shall, at a minimum, ensure that the financial institution takes reasonable steps--`(A) to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, such account as needed to guard against money laundering and report any suspicious transactions under subsection (g); and `(B) to conduct enhanced scrutiny of any such account that is requested or maintained by, or on behalf of, a senior foreign political figure, or any immediate family member or close associate of a senior foreign political figure that is reasonably designed to detect and report transactions that may involve the proceeds of foreign corruption.

Risk Management - Private Banking

Management should be able to identify, measure, monitor and control the reputational, fiduciary, legal, credit and operational risks inherent in private banking. This should include relationship documentation and due diligence standards, controls over the flow of client funds, adequate management information systems, and procedures to identify and report suspicious activity.

State law in most cases continues to require that a separate set of books and records for trust services be maintained. (This is required by the Statement of Principles of Trust Department Management, also.) This will hold even though they may be located in several areas of the bank, and not integrated with the records of the trust department. Examiners will thus need to ascertain the particulars of recordkeeping for all trust activities in banks under examination. Examiners should also ensure that the fiduciary assets of private banking activities are reported in the bank's Call Report Schedule RC-T.

Segregation of Duties, Compliance and Audit - Private Banking

Many successful private banking operations employ the principle of segregation of duties in order to maintain an effective internal control environment. The effective segregation of duties enhances compliance with policies and procedures by facilitating the identification and correction of errors and the detection and investigation of irregularities. The compliance program should be independent of management to enhance its effectiveness. Reviewing for compliance with customer due diligence guidelines, bank policies, and other laws and regulations is an essential part of a compliance program. Lastly, an effective independent audit function can provide assurance that the internal control structure of the private banking function is being maintained and operated adequately.

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E. EXAMINATION AUTHORITY OF SUBSIDIARIES AND AFFILIATE

An expanded discussion of the Corporation's authority to conduct examinations of affiliates is contained in Section 4.3 of the Manual of Examination Policies (Manual) and the Case Manager's Procedures Manual (CM Manual). Relevant statutory provisions are discussed below.

FDI Act Section 10 and the Gramm-Leach-Bliley Act

Section 10(b) of the FDI Act empowers examiners to make a thorough examination of insured institutions and their affiliates, while Section 10(c) of the Act gives the Corporation limited authority to examine other entities which may not be affiliated with the financial institution in question. An assessment of whether a review of affiliated entities is needed should be determined during the pre-examination risk-scoping process. Examiners must support the need for affiliate examinations and must undertake no affiliate examination without prior approval from the Regional Office.

Prior to initiating formal procedures seeking to exercise statutory authority to examine third parties, it is expected that informal, voluntary avenues (simply asking the bank to request the third party to provide data) will have been exhausted. In all cases, the examiner should consult with the Regional Office on such matters.

The enactment of the Gramm-Leach-Bliley Act (GLBA) provides additional guidance on the review of affiliates. The GLBA reserves the FDIC's authority under Section 10 of the FDI Act to examine affiliates and subsidiaries of insured depository institutions to the extent it is necessary for the FDIC to determine the relationship between the institution and the affiliate and the effect the relationship has on the depository institution. However, before conducting an examination, visitation, or investigation of a functionally regulated subsidiary or an affiliate of a bank, the examiner should communicate with the functional regulator. Examiners should determine whether a review of an affiliate's activities is necessary during the pre-examination risk-scoping process. Contact with the functional regulator should be made in accordance with Regional Office guidance.

Bank Service Corporation Act

Section 7 of the Bank Service Corporation Act provides statutory authorization for primary federal regulators of the banks which are principal investors of the service corporation to examine service corporations. To the extent that an entity is definable as a bank service corporation, the statute provides that the entity may be examined, not only by regulators of banks owning the entity, but also by regulators of non-shareholder banks serviced by the entity. The Act can be referenced at www.fdic.gov under Miscellaneous Statutes and Regulations. While the Act has specific applicability to corporations providing data processing services for banks, it may also apply when other types of services, such as fiduciary, are being provided. However, the narrow definition of bank service corporation (especially in regard to ownership) serves to substantially limit the Act's scope.

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F. GLBA - SECURITIES ACTIVITIES

SEC Registration Requirements

The passing of the GLBA in 1999 permits institutions to adopt a financial holding company structure, wherein financial institutions are permitted to conduct securities and insurance activities through affiliated entities.

The GLBA rules also affect various securities activities which may be present in a bank or bank trust department. If bank's activities do not meet specified exemptions or exceptions from the definition of "broker," the bank must register as a broker or dealer with the Securities and Exchange Commission (SEC) and would be subject to applicable SEC regulations. The exemption and exceptions and possible registration for banks as 'broker', 'dealer', and 'investment adviser' are discussed below and in Appendix D. If the bank is claiming an exemption or exception under the broker or dealer designations, recordkeeping requirements established by the Federal bank regulatory agencies must be met. These recordkeeping rules are expected to be finalized in late 2008.

Appendix D - Securities Law contains further examination guidance, statutory excerpts, and SEC rules related to bank securities activities.

Registered Broker

Section 201 of the GLBA repealed the blanket exemption of banks from the definition of "broker" under the Securities Exchange Act of 1934 and replaced it with 11 specific exceptions from the Exchange Act definition of "broker." Under the statute, banks that engage in securities activities must either satisfy the conditions for one of the specific GLBA exceptions or other exemptions provided by Regulation R (discussed below) or conduct those activities through a registered broker-dealer subsidiary or affiliate. For this reason, the broker exceptions are referred to as the "push-out" rules, since an institution that cannot qualify for an exception or exemption must "push-out" its securities activities to a registered entity. The exception-related activities are detailed GLBA and can be found in Appendix D, Bank as Broker.

On October 13, 2006, the Financial Services Regulatory Relief Act of 2006 (FSRRA) was signed into law. Among other things, the FSRRA required the Federal Reserve and the SEC to jointly issue a regulation implementing the GLBA broker exception rules. In doing so, the Federal Reserve was required to consult FDIC, OCC, and OTS. In addition to implementing certain of the GLBA exceptions from the definition of "broker," which required further guidance, the joint rule, designated as Regulation R, provided additional administrative exemptions from the definition of the term "broker" as defined in the Exchange Act. The joint FRB/SEC final Regulation R was published in the Federal Register on October 3, 2007. See Exchange Act Release No. 34-566501: File No. S7-22-06.

<u>Regulation R</u>

Regulation R details the requirements for a bank to qualify for a number of the GLBA exceptions and other administrative exemptions from the definition of "broker," including the trust & fiduciary exception; the custody and safekeeping exemption; the networking exception; and the sweep accounts exception. Other administrative exemptions provided in Regulation R include exemptions for transactions in Regulation S securities, non-custodial securities lending activities, referrals of high net worth/institutional clients under a third-party networking arrangement, as well as certain exemptions from the Exchange Act's Section 3(a) (4)(C)(i) trade execution requirements. These are discussed in greater detail below.

Trust & Fiduciary Exception

The Trust & Fiduciary exception allows a bank, in its capacity as trustee or fiduciary, to effect securities transactions for the accounts it administers if the following conditions are satisfied:

- Transactions are effected in the bank's trust department or other department that is regularly examined for compliance with fiduciary principles and standards;
- The bank does not publicly solicit brokerage business;
- The bank is "chiefly compensated" for its trust and fiduciary activities on the basis of:

  - An administrative or annual fee; or
  - A percentage of assets under management; or
  - A flat or capped per order processing fee equal to not more than the cost incurred; or
  - A combination of the above; and

- Trades are effected in compliance with Exchange Act Section 3(a)(4)(C), which requires trades to be effected:

  - By a registered broker-dealer; or
  - Via a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary in a manner that is not contrary to fiduciary principles; or
  - In some other manner that the SEC permits.

Fiduciary capacity, for the purposes of Regulation R, is defined by the Office of the Comptroller's Part 9. Fiduciary capacity includes acting as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minors act, or as an investment adviser if the bank receives a fee for its investment advice, or in any capacity in which the bank possesses investment discretion on behalf of another.

The prohibition on solicitation of brokerage business restricts the extent to which a bank can advertise that it effects securities transactions. In its advertisements, a bank may only indicate that it effects securities transactions in connection with its trust and fiduciary services. The fact that a bank effects securities transactions cannot be made more prominent than the material advertising the bank's provision of trust and fiduciary services.

- Chiefly Compensated

  Regulation R defines what it means to be "chiefly compensated" for trust and fiduciary services on the basis of an annual/administrative fee, a percentage of assets under management, a flat or capped per order processing fee equal to no more than the cost of executive, or a combination of these. Whether a bank satisfies the chiefly compensated requirement depends on the amount of "relationship" compensation in relation to total compensation. Thus, the ratio of relationship compensation, discussed below, to total compensation, either for each trust and fiduciary account or on a bank-wide basis, must equal or exceed a specific percentage. The chiefly compensation ratio calculation is discussed in more detail below.

  Chiefly Compensated Test

  The chiefly compensated test consists of calculating the ratio of relationship compensation to total compensation for the preceding year and the year preceding that year. The ratio for each year is expressed as a percentage and the percentages for the two years are averaged. Thus, whether a bank satisfies the chiefly compensated test is determined by calculating the moving average of the relationship compensation to total compensation percentages for the two immediately preceding years. Banks may use either a calendar or fiscal year as the basis for the yearly percentages to be calculated. The two-year moving average must be computed within 60 days following the end of that year. Since the compliance period begins in the first fiscal year commencing after September 30, 2008, the first calculation of chiefly compensated test will occur by March 2011, for banks using a calendar year. While the calculation is only required within the two months following the end of the year, banks are encouraged to monitor the percentage throughout the year in order to be able to identify and address any problems that might emerge.

  Banks have two options regarding the basis on which the chiefly compensated test is calculated. The test may be determined on an account-by-account basis. Under the account-by-account methodology, the bank would determine the ratio of relationship compensation to total trust and fiduciary compensation attributable to each account for each trust and fiduciary account, except for those accounts that Regulation R requires or allows to be excluded from the test. The bank meets the chiefly compensated test if the chiefly compensated percentage for each account is greater than 50%.

The second option allows a bank to determine compliance with the chiefly compensated test on a bank-wide basis. Under the bank-wide methodology, the bank would calculate a single percentage for each year. The single percentage would include total relationship compensation from all trust and fiduciary accounts required to be included in the computation and the total compensation received by the bank in connection with its provision of trust and fiduciary services. Under this method, the bank satisfies the chiefly compensated test if the percentage is greater than or equal to 70%. Relationship and total compensation are addressed below.

Relationship Compensation

Relationship compensation is any compensation a bank receives that is attributable to a trust or fiduciary account, or to trust and fiduciary activities if calculated on a bank-wide basis, that consists of:

- Annual or administrative fees, including, but not limited to, fees:
  - For personal services, tax preparation, or real estate settlement services; or
  - For disbursing funds from, or for recording receipt of payments to, a trust or fiduciary account; or
  - In connection with securities lending or borrowing transactions; or
  - For custody fees.

Administrative fees also include various fees in connection with investments in mutual funds. The fees do not have to be paid to the bank by the mutual fund, but can be paid by a third-party, such as the fund's distributor, transfer agent, administrator or an advisor to the fund. Such fees include:

- Fees for personal services;
- Fees for the maintenance of shareholder accounts;
- Fees based on a percentage of assets under management for the following services:
  - Transfer or sub-transfer agent services;
  - Aggregating and processing purchase and redemption orders;
  - Providing account statements to beneficial owners;
  - Processing dividend payments;
  - Providing sub-accounting services;
  - Forwarding communications to beneficial owners; and
  - Receiving, tabulating, and transmitting proxies.

12b-1 fees are considered relationship compensation since they comprise fees that are based on a percentage of assets under management. The receipt of 12b-1 fees, like the receipt of all compensation related to securities transactions, must be consistent with the fiduciary principles and standards governing the bank's trust and fiduciary accounts.

Finally, flat or capped per order processing fees that do not exceed the cost incurred in effecting securities transactions qualify as relationship compensation. These fees may include the fee charged by the executing broker dealer and the addition of the fixed or variable cost incurred by the bank in effecting the transaction. Banks, however, may not include a profit margin to the cost charged to the customer and still have the fees qualify as relationship compensation. Banks, therefore, are expected to document any fixed or variable costs allocated to transactions in order to support that such allocations include only the actual cost incurred by the bank in effecting the transaction.

It is important to note that relationship compensation is not limited to compensation received by the bank for securities-related transactions, but include all forms of compensation related to the administration of trust and fiduciary accounts, regardless of whether the amounts are paid by the trust or fiduciary account or by a third party.

Total Compensation

The ratio of relationship compensation to total compensation determines whether a bank satisfies the "chiefly compensated" requirement for the Trust & Fiduciary exception from the definition of broker in the Exchange Act. Total compensation encompasses all compensation attributable to a trust or fiduciary account or to the trust and fiduciary business of a bank if the determination is made on a bank-wide basis. However, as discussed below, some forms of compensation are specifically excluded by Regulation R. Total compensation does not include any revenues that are not derived from the provision of trust or fiduciary services. Examples of compensation that should not be included as either relationship compensation or total compensation are:

- Providing bank-office services to third parties;
- The sale of an office or assets of the trust department;
- Internal credits, such as a credit for deposits of trust funds in the commercial bank; or
- "Soft Dollar" credits.

Excluded Compensation

Regulation R provides for the exclusion of various revenues from both relationship compensation and total compensation. Of particular importance is the exclusion of any compensation that is received in connection with a transaction for which the bank is relying on an exception or exemption other than the Trust & Fiduciary exception. For example, Regulation S provides an exemption for transactions in securities issued in an offshore transaction under SEC Regulation S. A bank purchasing Regulation S securities and relying on the Regulation S exemption could not include compensation from those transactions in calculating the "chiefly compensated" ratio.

Similarly, revenues derived from trust and fiduciary accounts held at a foreign branch are excluded if:

- Held at a non-shell foreign branch; and
- The bank has a reasonable cause to believe that the trust and fiduciary accounts of the foreign branch that are held by or for the benefit of U.S. persons constitute less than 10% of the foreign branch's trust and fiduciary accounts.

A non-shell foreign branch is one that is located outside the U.S.; provides services to residents of the foreign jurisdiction where it is located; and the day-to-day decision-making is not done by an office or branch in the U.S. A bank would have a reasonable cause to believe that an accountholder is not a U.S. person if the person's principal mailing address is outside the U.S. or the foreign branch's records indicate that the accountholder is a non-U.S. person. The exclusion of revenues from accounts held at a foreign branch only applies if the bank utilizes the bank-wide method for calculating the ratio of relationship compensation to total compensation.

Under both the account-by-account and bank-wide methods, compensation from short-term accounts, i.e. those open for less than three months in the relevant year, is not included in total compensation. Compensation from acquired accounts, i.e. accounts that the bank acquired from another entity as part of a merger, consolidation, acquisition, purchase of assets or similar transaction, can be excluded for the first twelve months.

Regulation R also provides for a De Minimis Exclusion where those banks using the account-by-account method can exclude the revenues from the lesser of 1% or 500 accounts in determining compliance with the chiefly compensated requirement. In order to do so, the bank must maintain records demonstrating that the securities transactions by or on behalf of the account were undertaken in the exercise of its trust or fiduciary duties and the bank must not have used the exclusion in the preceding year.

Finally, a transferred account will not cause a bank to fail the chiefly compensated test if the account or its securities are transferred to a registered broker dealer or an unaffiliated entity that is not required to be registered as a broker within three months following the end of the relevant year.

Trade Execution Requirements

The Trust & Fiduciary exception, as well as the other GLBA/Regulation R exceptions and exemptions, require that securities transactions be executed in accordance with the Exchange Act's execution requirements, which generally require securities transactions to be executed by a registered broker-dealer or in a cross trade. Regulation R, however, provides several exemptions from the Exchange Act's trade execution requirement. Regulation R permits banks to effect certain transactions directly through the NSCC, the issuer's transfer agent, or an insurance company, if certain requirements are met.

Regulation R permits transactions in "covered securities" to be effected through the NSCC, directly with the transfer agent, or with an insurance company or separate account that is excluded from the definition of transfer agent in the Exchange Act. A "covered security" is a registered mutual fund or a variable insurance contract funded by a separate account that is registered.

The following two requirements must be satisfied:

- The security is not traded on a national securities exchange or through the facilities of a national securities association or an interdealer quotation system; and
- The security is distributed by a registered broker dealer, or the sales charge is no more than the amount permissible for a security sold by a registered broker dealer under Investment Company Act of 1940 rules.

Regulation R also provides an exemption whereby transactions in employer securities for employee benefit plans can be effected directly with the transfer agent provided that:

- No commission is charged;
- The transaction is solely for the benefit of an employee benefit plan account;
- The security is obtained directly from:
  - The employer; or
  - An employee benefit plan of the employer.
- The security is transferred only to:
  - The employer; or
  - An employee benefit plan of the employer.

Custody & Safekeeping Exception

GLBA provides an exception from the definition of broker for banks that provide custody and safekeeping services. GLBA specifically provides that a bank will not be considered a broker if it engages in the following custodial and safekeeping activities:

- Providing safekeeping and custody services to customers with regard to securities, including the exercise of warrants and other rights on behalf of bank customers;
- Facilitating the transfer of funds or securities as a custodian or clearing agent in connection with the clearance and settlement of its customers' transactions in securities;
- Facilitating lending or financing transactions or investing cash in connection with its safekeeping, custody, and securities transfer services;
- Holding securities pledged by a customer to another person or securities subject to repurchase agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided by law, provided that the bank maintains records separately identifying the securities and the customer; or
- Serving as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

In addition to the statutory exception, Regulation R provides two exemptions whereby a bank can take orders for the purchase or sale of securities from custody account customers. One exemption allows a bank, as part of its customary banking activities, to accept orders for securities transactions from employee benefit plan accounts, individual retirement accounts, and similar accounts. The second exemption allows a bank to accept orders for securities transactions from custody account customers on an accommodation basis.

The exemptions discussed below apply to accounts for which the bank acts as a custodian. Regulation R defines an account for which a bank acts as a custodian as an account that is:

- An employee benefit account;
- An individual retirement account or similar account;

- An account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities; or
- An account for which the bank acts as a directed trustee.

Whether a bank serves as custodian for securities or other assets of an account depends on the services the bank provides to the account, rather than the label used to identify the account. Thus, a bank that acts as an escrow agent or paying agent and that provides custody and safekeeping services to the account is considered an account for which the bank acts as custodian, notwithstanding the fact that the account is not called a custody or safekeeping account.

- Exemption for EB, IRA, and Similar Accounts

  A bank may accept orders for securities transaction from custody accounts for employee benefit plans, individual retirement plans and similar accounts provided that:

  - The bank does not advertise that it accepts orders, except as part of advertising its other custody and safekeeping services;
  - No bank employee is compensated based on whether a securities transaction is executed or on the quantity, price, or type of security involved;
  - The bank is not a trustee or fiduciary, other than a directed trustee;
  - The bank is not acting as a carrying broker; and
  - The bank complies with the trade execution requirements in Exchange Act Section 3(a)(4)(C)(i).

  Banks may not advertise that custody accounts are securities brokerage accounts or are a substitute for a brokerage account. While the bank cannot be a trustee or fiduciary and still rely on the custody exemption, there is an exception made for banks that serve as directed trustees. A bank that serves as a directed trustee is eligible for the custody exemption provided it complies with the other requirements of the exemption. A directed trustee is a trustee that does not hold any investment discretion over an account.

  Within common securities industry usage, the terms "carrying broker" and "clearing broker" are virtually identical and often are used interchangeably. In certain instances, the terms mean a broker that, as part of an arrangement with a second broker (an "introducing" or "corresponding" broker), allows the second broker to be subject to lesser regulatory requirements (e.g. under the net capital provisions of Exchange Act Rule 15c3-1 and the customer protection provisions of Exchange Act Rule 15c3-3). Technically, however, a "carrying broker" is a broker that holds funds and securities on behalf of customers, whether its own customers or customers introduced by another broker-dealer, and a "clearing broker" is a member of a registered clearing agency.

  The preamble to the final Regulation R discusses factors that the SEC would consider in determining if a bank were acting as a carrying broker. The SEC indicated that it would consider the existence of shared clients between a broker dealer and bank and the reason why clients of the broker dealer have established custody accounts at a bank. The existence of shared customers where the broker-dealer causes its customers to establish custody accounts at a bank could result in a determination that the bank was acting as a carrying broker for the broker-dealer. If, however, the clients of the broker-dealer independently decide to open a custody account at a bank, then the bank would likely not be viewed as acting as a carrying broker for the broker-dealer. Banks may share systems and platforms with a broker-dealer, for example an affiliated broker-dealer with which a common BSA/AML compliance system is used. Other examples of permissible arrangements include legal and compliance functions, accounting and finance functions (such as payroll and expense account reporting), and administrative functions (such as human resources and internal audit). Moreover, banks may perform limited back office functions for a broker-dealer without being deemed as acting as a carrying broker. A broker-dealer cannot delegate to a bank functions that require registration with a self-regulatory organization (SRO) and the broker-dealer must retain control of its property, cash, and securities.

  In addition to bank custodians, non-custodial, nonfiduciary third-party administrators and record keepers for employee benefit plans may rely on the EB/IRA custody exemption provided that:

  - Both the custodian bank and the third-party administrator/record keeper comply with the requirements of the exemption; and
  - The administrator/record keeper does not execute cross trades other than:

  - Crossing or netting open-end mutual funds not traded on an exchange; or
  - Crossing or netting orders for accounts held at the custodian bank that contracted with the third-party administrator/record keeper.

- Exemption for Accommodation Trades

  For custody accounts that are not maintained by an employee benefit plan, individual retirement accounts, or other similar accounts, a bank may accept orders for securities transactions as an accommodation to the customer provided:

  - Any fee charged or received by the bank does not vary based on:

    - Whether the bank accepted the order; or
    - The quantity or price of the securities bought or sold.

  - Advertisements do not state that the bank accepts orders for securities transactions;
  - Sales literature does not state that the bank accepts orders, except as part of describing other aspects of its custodial and safekeeping services;
  - The bank does not provide investment advice or research, make recommendations, or solicit transactions. However, the bank may:

    - Advertise or provide sales literature as allowed in the exemption;
    - Respond to customer inquiries about custody and safekeeping services by providing:

      - Advertisements and sales literature;
      - Prospectus or sales literature prepared by a registered investment company; or
      - Materials based on the above.

  - The bank complies with the compensation and trade execution requirements of the EB/IRA exemption.

  The requirement that the bank not provide investment advice or research, make recommendations, or solicit transactions does not prohibit a bank from cross marketing its trust and fiduciary services to custody account customers. Banks may cross-market investment advisory services to custody customers by:

  - Providing non-account specific information via newsletters, websites, etc.;
  - Providing examples of research, including stock specific research that the bank provides to other persons for marketing purposes.

  A bank, however, may not provide personalized investment research regarding securities held in a custody account. Lists and menus of securities that can be purchased or sold are not considered investment advice.

  If a customer has both a trust or fiduciary account and a custody account at the bank, the bank may provide investment advice and research to the customer in connection with the trust or fiduciary account. The bank is not responsible for how the trust or fiduciary accountholder uses such advice or research.

- Sub custodians

  A bank that acts as a sub custodian for an account for which another bank acts as custodian may rely on either the EB/IRA exemption or the Accommodation Trade exemption, depending on the type of account at the custodial bank, provided that:

  - Both the sub custodian and the custodian bank comply with the requirements of the respective exemption; and
  - The sub custodian does not execute cross trades, other than:

    - Crossing or netting open-end mutual funds not traded on an exchange; or
    - Crossing or netting orders for accounts of the custodian.

Networking Exception

The networking exception permits non-licensed employees to receive compensation for the referral of a retail customer to a registered broker-dealer without causing the bank to be considered a broker-dealer under the Exchange Act. Regulation R defines "referral" as "an action taken by one or more bank employees to direct a customer of the bank to a broker-dealer for the purchase or sale of securities for the customer's account." Normally, a non-licensed individual is not allowed to receive incentive compensation in connection with a securities transaction. The networking exception allows non-licensed bank employees to receive a referral fee, which will not be considered incentive compensation, provided that the fee received is a nominal, one-time cash fee of a fixed dollar amount and the payment is not contingent on whether the referral results in a transaction. In addition to limiting referral fees to a nominal amount, the regulation also addresses bank bonus plans and the circumstances under which such plans can include securities-related activities without being considered incentive compensation for purposes of the Exchange Act. Referral fees and bonus programs are discussed in detail below.

- Referral Fees
  - Nominal

    Regulation R defines the term nominal referral fee as a payment to a bank employee personally involved in making the referral that does not exceed:

    - Twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee; or
    - 1/1000th of the average of the minimum and maximum annual salary established by the bank for the current or prior year for the job family that includes the employee; or
    - Twice the actual hourly wage established by the bank for the current or prior year for the job family that includes the employee; or
    - 1/1000th of the actual annual salary established by the bank for the current or prior year for the job family that includes the employee; or
    - $25.

      Banks are not limited to using a single definition for determining whether a referral fee is nominal. Banks may use different methodologies for different lines of business or operating units. Banks may also change the methodologies used within a given year. An employee's "job family" means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education, or training, that a bank, ...uses...for purposes of hiring, promotion, and compensation. Examiners should review these job families in order to ensure that they are not being used to evade the "nominal referral fee" requirement.

      The $25 definition of "nominal" will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

  - Non-Contingent

    A fee is non-contingent if it does not depend on whether:

    - The referral results in the purchase or sale of a security; or
    - The referral results in an account being opened with a broker-dealer; or
    - The referral results in multiple transactions.

  A referral fee can, however, be contingent on whether the customer:

    - Keeps an appointment with the broker-dealer; or
    - Meets base-line qualification criteria for referral, such as minimum net worth, etc.

- Bonus Programs

Incentive compensation is compensation intended to encourage a bank employee to refer customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction at a broker dealer. Regulation R provides, however, that incentive compensation does not include a bonus or similar plan that is:

- Paid on a discretionary basis. A bonus plan is discretionary if the amounts paid are not fixed in advanced and employees do not have an enforceable right to the bonus before it is declared by the board;
- Based on multiple factors or variables;
- Include multiple significant factors or variables that are not related to securities transactions at a broker dealer;
- Referrals by employees are not a factor; and
- Referrals by any other person are not a factor.

Bonus programs can also be based on the overall profitability or revenue of:

- The bank, on a stand-alone or consolidated basis;
- An affiliate or operating unit of a bank, if they do not predominately engage in making referrals to a broker dealer; or
- A broker-dealer, if:
    - Overall profitability or revenue is only one of multiple factors or variables used to determine compensation;
    - Referrals are not a factor; and
    - Referrals by other employees is not a factor.

In assessing bonus programs for compliance with Regulation R, examiners will consider the following factors:

- Whether the factors and variables of the bonus plan relate to activities actually being conducted;
- The resources being devoted to the activities being conducted; and
- Whether the business lines or activities materially contribute to the amount of bonus payments.

Over time, it is expected that factors and variables related to securities transactions will not predominate the determination of the amount of bonus payments awarded.

Exemption for Referral of High Net Worth/Institutional Customers

Regulation R provides an additional exemption for referrals by non-licensed bank employees of high net worth (HNW) or institutional customers to a third-party broker-dealer. Unlike referrals of retail customers, payments can be more than nominal in amount and may be contingent in nature. To receive payments under this exemption bank employees must meet the following requirements:

- Not be licensed;
- Be predominately engaged in banking activities other than making referrals to broker-dealers;
- Not be subject to any statutory disqualification; and
- Encounter customers in the ordinary course of the employee's duties. Regulation R defines a HNW customer as either:
- A natural person who, either individually or jointly with a spouse, has a net worth of at least $5 million, excluding equity in his/her primary residence; or
- Any revocable, living trust, where the settlor is a natural person meeting the $5 million net worth requirement.

For purposes of determining whether a natural person meets the $5 million net worth test, the assets of a person include: (1) any assets held individually; (2) if the person is acting jointly with his or her spouse, any assets of the person's spouse (whether not such assets are held jointly); and (3) if the person is not acting jointly with his or her spouse, fifty percent of any assets held jointly with such person's spouse and any assets in which such person shares with such person's spouse a community property or similar shared ownership interest.

Regulation R defines an institutional customer as a corporation, partnership, limited liability company, trust, or other non-natural person with at least:

- $10 million in investments; or
- $20 million in revenues; or
- $15 million in revenues if the referral is for investment banking services.

The final rule defines "investment banking services" to include, without limitation, acting as an underwriter in an offering for an issuer, acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction, providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments, serving as placement agent for an issuer, and engaging in similar activities. The phrase "other similar services" would include, for example, acting as an underwriter in a secondary offering of securities and acting as a financial adviser in a divestiture.

The dollar thresholds detailed above will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

When making a referral of an HNW/Institutional customer the bank must disclose the following:

- The name of the broker-dealer; and
- The fact that the bank employee participates in an incentive program where the employee may receive a fee of more than a nominal amount that may be contingent on whether the referral results in a transaction.

The disclosures must be provided either:

- In writing prior to or at the time of the referral; or
- Orally prior to or at the time of referral, provided that the bank provides the required information in writing within 3 days of the referral.

Banks may, however, contract with the broker-dealer to provide the required disclosures, provided the agreement is in writing. When provided by the broker dealer, the disclosures must be provided:

- Prior to or at the time the customer begins the process of opening an account; or
- If the customer already has an account at the broker-dealer, prior to the time the customer places an order.

The bank must have a reasonable basis for believing that the customer is a HNW or institutional customer at the time of the referral for natural persons or before the referral is paid to the employee for a non-natural person.

The exemption imposes the following obligations on the broker-dealer with which the bank contracts for third-party brokerage services:

- Determine whether the referring bank employee is subject to a statutory disqualification;
- Have a reasonable basis to believe that the customer referred is an HNW/institutional customer;
- If the referral fee is contingent, perform a suitability analysis of the transaction before execution;
- If the referral fee is non-contingent, determine that the customer:

    - Has the capability to evaluate investment risk and make independent decisions; and
    - Is exercising independent judgment based on individual assessment; or
    - Perform a suitability analysis of all transactions requested by the customer contemporaneously with the referral.

The broker-dealer is required to determine whether the referring employee is subject to a statutory disqualification prior to paying the first referral and once a year thereafter as long as the employee remains eligible to receive such referral fees. The rule requires that, before a higher-than-nominal referral fee is paid to a bank employee under the HNW/institutional customer exemption, the bank provide the broker-dealer the name of the employee and such other identifying information that the broker-dealer may need to determine whether the employee is subject to statutory disqualification. The bank should provide at least annually its broker-dealer partner any changes to the identifying information initially provided.

A bank or broker-dealer would have a "reasonable basis to believe" that a customer is a high net worth customer or institutional customer if, for example, the bank or broker-dealer obtains a signed acknowledgment from the customer (or, in the case of an institutional customer, from an appropriate representative of the customer) that the customer meets the applicable standards to be considered a high net worth customer or an institutional customer, and the bank employee making the referral or the broker-dealer dealing with the referred customer does not have information that would cause them to believe that the information provided by the customer (or representative) is false.

The broker-dealer is required to inform the customer if the customer does not meet the suitability criteria. The broker-dealer must also notify the bank if it determines that the customer is not a HNW or institutional customer and if it determines that a referring employee is subject to a statutory disqualification.

For purposes of the HNW/Institutional Customer exemption the term "referral fee" is defined as a predetermined dollar amount, or a dollar amount determined by a predetermined formula that does not vary based on:

- The revenue generated by or the profitability of the securities transactions of customers; or
- The quantity, price, or identity of the securities transactions conducted over time by the customer; or
- The number of customer referrals made.

A referral fee, however, can be based on a fixed percentage of the revenues received by a broker-dealer for investment banking services provided to the customer.

The exemption provides that a bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of the exemption will not be considered a “broker” under Section 3(a)(4) of the Exchange Act solely because the bank fails, in a particular instance, to determine that a customer is an institutional or high net worth customer; provide the customer the required disclosures; or provide the broker-dealer the required information concerning the bank employee receiving the referral fee within the time periods prescribed. If the bank is seeking to comply and takes reasonable and prompt steps to remedy the error, such as by promptly making the required determination or promptly providing the broker-dealer the required information, the bank will not lose the exemption from registration in these circumstances. Following any required remedial action, the bank must make reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for a referral that does not, following any required remedial actions, meet the requirements of the exemption and that exceeds the amount the bank otherwise would be permitted to pay.

Sweep Account Exception/Money Market Fund Exemption

The Sweep Account Exception allows a bank to effect transactions as part of a program for the investment or reinvestment of deposit funds in a no-load money market fund. Regulation R defines a no-load fund as a fund that does not charge an upfront sales load or a deferred sales load, and where total charges against the net assets for sales, sales promotion, personal services or the maintenance of shareholder accounts does not exceed 25 basis points. Under the statutory exception, a bank may also sweep deposit funds on behalf of another bank into a no-load money market fund. Regulation R provides an exemption under which a bank may, on behalf of both bank customers or other banks, invest or reinvest funds in a money market fund that is not a no-load fund, as defined in the regulation.

In order to effect transactions in a money market fund that is not a no-load fund the bank must:

- Provide the customer, directly or indirectly, another product or service that would not cause the bank to register as a broker dealer;
- Provide the customer with a prospectus for the fund not later than at the time the customer authorizes the transactions; and
- Not refer to or characterize the fund as a no-load fund.

Exemption for Transactions in Regulation S Securities

Regulation S is an SEC regulation that governs the conditions under which securities offered to investors outside the U.S. are exempt from registration under the Securities Act of 1933. A Regulation S security is an equity security issued by a public company located in the U.S. to non-U.S. persons in an offshore transaction.

Regulation R exempts a bank effecting transactions in Regulation S securities from the definition of broker to the extent that the bank, acting as an agent:

- Effects a sale of an eligible security to a purchaser who is not in the U.S.; or
- Effects, by or on behalf of a person who is not a U.S. person, a resale of an eligible security after its initial sale with a reasonable belief that the security was sold outside the U.S. to a purchaser who is not in the U.S. or a broker dealer. If the resale is made prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of Regulation S; or
- Effects, by or on behalf of a registered broker-dealer, a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside the U.S. to a purchaser who is not in the U.S. If the resale is made prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of Regulation S.

An eligible security is a security that:

- Is not being sold from the inventory of the bank or an affiliate of the bank; and
- Is not being underwritten by the bank or an affiliate of the bank on a firm commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank. A purchaser is a person who purchases an eligible security and who is not a U.S. person.

Exemption for Securities Lending Transactions

Regulation R provides an exemption from the definition of broker for banks that, as an agent, engage in securities lending transactions or securities lending services. A bank may engage in these activities with or on behalf of persons the bank reasonably believes to be:

- A qualified investor as defined in the Securities Exchange Act of 1934; or
- An employee benefit plan that owns or invests on a discretionary basis not less than $25 million in investments.

A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner and has the right to terminate the transaction and recall the loaned securities on terms agreed by the parties.

Regulation R defines "securities lending services" as:

- Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrowers:
- Receiving, delivering, or directing the receipt or delivery of loaned securities;
- Receiving, delivering, or directing the receipt or delivery of collateral;
- Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending activity;
- Investing, or directing the investment of, cash collateral; or
- Indemnifying the lender of securities with respect to various matters.

<u>Other GLBA Exceptions</u>

Permissible Securities Transactions

Permissible securities transactions are transactions in specific types of securities and instruments that banks commonly engage in. The types of transactions covered by this exception are:

- Commercial paper, bankers acceptances, or commercial bills;
- Exempted securities, e.g. U.S. government securities;
- Qualified Canadian government obligations; and
- Any standardized credit enhanced debt security issued by a foreign government pursuant to the March 1989 plan of then Secretary of the Treasury Brady, used by such foreign government to retire outstanding commercial bank loans, i.e. Brady bonds.

For purposes of this exception, municipal securities are not treated as exempted securities. Transactions in municipal securities are covered by a separate exception in GLBA.

Stock Purchase Plans

A bank, acting as transfer agent, may effect transactions in the securities of an issuer as part of any pension, retirement, profit sharing, bonus, thrift, savings, incentive, or other similar benefit plan for the employees of the issuer, or affiliates thereof. The bank, however, may not solicit transactions nor provide investment advice with respect to such securities in connection with the plan.

A bank, acting as transfer agent, may also rely on this exception to effect transactions as part of an issuer's dividend reinvestment plan, if:

- The bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and
- The bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC.

Similarly, a bank, acting as transfer agent may effect transactions in the securities of an issuer as part of a plan or program for the purchase or sale of such issuer's share, if:

- The bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and
- The bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC.

A bank may deliver written or electronic plan materials to the employees of the issuer, shareholders of the issuers, or members of affinity groups of the issuer, provided the materials are comparable in scope or nature to that permitted by the SEC as of the date of enactment of GLBA or are otherwise permitted by the SEC.

Private Securities Offerings

A bank may effect sales of a primary offering of securities not involving a public offering, provided that the bank is not affiliated with a broker or dealer and any one private placement offering in which the bank is involved does not exceed 25% of the bank's capital. Private placements of government and municipal securities are not subject to the 25% of capital limitation.

Municipal Securities

GLBA provides for an exception for a bank acting as a broker in municipal securities transactions.

Affiliate Transactions

A bank may effect transactions for the account of any affiliate of the bank, provided that the affiliate is neither a registered broker-dealer nor engaged in merchant banking activities. For this exception, affiliate is as defined in the Bank Holding Company Act of 1956. Similarly, the term merchant banking is as described in Section 4(k)(4)(H) of the same act.

Identified Banking Products

Banks may effect transactions in "identified banking products." Identified banking products are products that have not traditionally been considered securities and include deposit accounts, certificates of deposit, loans, and loan participations. The loan participation exception, however, is qualified by the requirement that it must be a participation which the bank, or an affiliate of the bank, participates in or owns and that is sold to either qualified investors or persons having the opportunity to review and capability of assessing material information concerning the loan participation. One further requirement governing the sale of loans or loan participations requires that such loans or participations not be deemed securities under the Securities Exchange Act of 1934. Swap agreements, including all credit and equity swaps, other than equity swaps with retail customers, are considered identified banking products.

De Minimis Transactions

GLBA provides for a de minimis exception for banks that effect up to 500 securities transactions a year. The de minimis exception, however, can not be used for transactions effected by dual employees. It should also be noted that the up to 500 transactions threshold pertains to the total of both broker transactions and dealer riskless principal transactions, so that the combined securities transactions governed by the broker De Minimis and dealer Riskless Principal exceptions must total less than 500 per year.

Registered Dealer

Bank Dealer Exceptions to Registration with the SEC for Certain Securities Activities.

Section 202 of the GLBA amended the definition of "dealer" by repealing the Securities Exchange Act exclusion for banks from dealer registration and regulation.

The SEC has issued a final rule concerning the bank dealer exceptions to the Securities Exchange Act of 1934 ("Exchange Act"), as amended in Section 202 of the GLBA. See 68 Federal Register 8686 (February 24, 2003). Also refer to Appendix D, Bank as Dealer. The compliance date of the rule is September 30, 2003. Exchange Act section 3(a)(5) defines a "dealer" as a person that is "engaged in the business of buying and selling securities" for its own account through a broker or otherwise, and exempts persons, whether banks or non-banks, who do not buy or sell securities "as part of a regular business". Banks do not need to register with the SEC and the National Association of Securities Dealers unless they act as dealers and do not qualify under any of the exceptions under Section 202 of GLBA. The SEC has recently issued a Staff Compliance Guide to Bank on Dealer Statutory Exceptions and Rules, which is available on the SEC Division of Market Regulation's website and in Appendix D of this manual.

GLBA replaced the former uniform bank exception for securities dealer registration under the Exchange Act with four specific exceptions. These statutory exceptions are:

- Investment transactions: permits banks to buy and sell securities for investment purposes for the bank and in its customers' trustee and fiduciary accounts.
- Permissible securities transactions: permits banks to buy and sell exempted securities, certain Canadian government obligations, and Brady bonds.
- Identified banking products: permits banks to buy and sell certain "identified banking products," as defined in Section 206 of GLBA.
- Asset-backed transactions: permits banks through a grantor trust or other separate entity to issue and sell to qualified investors certain asset-backed securities representing obligations predominately originated by a bank, an affiliate of a bank other than a broker-dealer, or a syndicate in which the bank is a member for some types of products.
- The SEC's bank dealer rule addresses certain interpretive issues arising from these statutory exceptions for bank dealer activities. In addition, it addresses certain additional exemptions that involve bank dealer activities that also could be covered as broker activities. These additional exemptions provided under the SEC's bank dealer rule include.
- Riskless principal transactions. This exemption permits banks to engage in a limited number (up to 500) of "riskless principal" transactions per calendar year without registering with the SEC as dealers. A "riskless principal" transaction is one in which, after having received an order to buy from a customer, a bank purchases the security from another person to offset that contemporaneous sale. Alternatively, a riskless principal transaction is one in which after having received an order to sell from a customer, a bank sells the security to another person to offset that contemporaneous purchase.

    - How to count transactions for purposes of this exemption: Transactions with two customers where the bank acts as a riskless principal between them count as one transaction. However, if a bank acts as a riskless principal between one counterparty and multiple counterparties by arranging multiple transactions, each of the transactions on the side that involves the largest number of transactions would count as separate transactions against the annual transaction-limit.
    - How counting will be affected by banks' brokerage activities: The Exchange Act also permits banks to engage in certain "broker" activities without registering with the Commission. At the time the "dealer" provisions become effective, however, the "broker" provisions still will be subject to a Commission order delaying their effectiveness. One of the "broker" exceptions - known as the de minimis exception - permits banks to engage in no more than 500 brokerage

transactions per year that are not otherwise exempt without registering with the Commission. When banks utilize this exception after the compliance date is set for the broker rules, banks' riskless principal transactions **and** brokerage transactions effected under the de minimis exception will count toward the same 500-transaction limit. In other words, banks may be able to engage in any combination of brokerage transactions under the de minimis exception and riskless principal transactions under Rule 3a5-1, so long as the total number of these transactions does not exceed 500 per year. Until the broker rules are effective, however, banks may use the entire 500-transaction limit for riskless principal transactions.

Securities lending transactions. This exemption permits banks to engage in, or effect, securities lending transactions with certain counterparties. A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party under a written securities lending agreement. Through this agreement, the lender retains the economic interests of an owner of the securities. Subject to the terms agreed upon by the parties, including an agreement to loan the securities for a fixed term, the lender also has the right to terminate the transaction and to recall the loaned securities.

Investment Advisors

Section 217 of the GLBA amends certain sections of the Investment Advisers Act of 1940 (Advisers Act) to require any bank or bank holding company which serves as an investment adviser to a registered investment company (i.e. open-end mutual fund) to register under the Advisers Act. A bank or bank holding company can also register a separately identifiable department or division (SIDD). Under the GLBA, regulatory agencies and the Commission are required to provide each other with the results of any examinations or inspections conducted with respect to the investment advisory activities. Refer to Appendix D, Bank as Investment Advisor, for additional information.

Privacy Issues Faced by the Fiduciary

Privacy applies to all financial institutions. It is an emerging area of concern, therefore, rules and regulations applicable to financial institutions are continuing to evolve and will for some time. In order to assess privacy issues in the context of fiduciary activity, a few fundamental concepts and terms/definitions are necessary. Part 332 of the FDIC's Rules and Regulations is the privacy regulation applicable to state nonmember banks. The regulation contains extensive definitions of terms, and numerous examples to illustrate the definition. Some of the defined terms include:

- A "financial institution" is any institution the business of which is to engage in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956. Industry publications have stated this, in general terms, means "any institution the business of which is engaged in financial services". The definition includes providing investment advisory services and issuing and selling of interests in pooled assets.
- Privacy rules pertain to "nonpublic personal information" which is defined as personally identifiable financial information. It includes information provided by the consumer to obtain a product or a service and/or information gleaned from transactions with the consumer or performed for the consumer. It excludes "publicly available" information. Information is "publicly available" if a financial institution has a reasonable basis to believe that the information is lawfully made available to the general public from one of the categories of sources listed in Part 332.
- It only covers "personal" information. Therefore, it only applies to consumers, not to business or institutional customers.
- A consumer is defined as an individual, who obtains from a financial institution, financial products or services used primarily for personal, family, or household purposes. The definition also includes the legal representatives of such an individual.

  - Federal banking authorities have excluded beneficiaries of trusts and participants of employee benefit plans that the bank either sponsors, or for which it acts as trustee or fiduciary. The rationale is that the trust/plan itself is the customer and not an individual, and therefore the rules do not apply.
  - An investment management agency relationship with a business or a trust would not fall under this regulation.
  - However, in the case of an individual who selects a financial institution as custodian of securities or assets, as in an IRA, the individual is viewed as a consumer. Another example is an investment management agency with an individual(s).
  - Refer to Section 332.3(e) for the complete definition of "consumer" and Section 332.3(i) for the complete definition of "customer relationship."

- A financial institution is prohibited from disclosing "nonpublic personal information" about a consumer to nonaffiliated third parties unless the institution satisfies various notice and opt-out requirements, and the consumer has not elected to opt-out.

A nonaffiliated third party means any person except: (i) a bank affiliate; or (ii) a person employed jointly by the bank and any company that is not a bank affiliate. The company the person works for is considered a nonaffiliated third party. Also, an affiliate that is an affiliate solely by virtue of its direct or indirect ownership in an entity conducting merchant banking or insurance company activities (as defined in Section 4(k) of the Bank Holding Company Act of 1956) is considered a nonaffiliated third party.

- A financial institution is required to disclose to all of its customers the institution's privacy policies and practices with respect to information sharing with both affiliates and nonaffiliated third parties. This is discussed below in item F.2.b.
- Federal privacy guidelines do not supersede more stringent State regulations. Nor do they preempt the Fair Credit Reporting Act.

Applicability to Trust Operations

A financial institution is required to develop guidelines for the safeguarding of customer information. The guidelines are applicable to trust operations. These guidelines pertain to the administration and physical safeguarding of customer records and information. There are three elements to consider when establishing policies and procedures with regard to privacy. First, the fiduciary is to insure the security and confidentiality of customer records. Second, the fiduciary is to protect against any anticipated threats or hazards to the security or integrity of such records. Third, the fiduciary is to protect against unauthorized access to, or use of, such records or information that could result in substantial harm or inconvenience to any customer. This includes: the fiduciary's use of information; the re-disclosure and reuse of information (Section 332.11); and the use of information by contractually obligated third party service providers (Section 332.13). The guidelines will be unique to each institution and dependent upon the size and complexity of the operation. To develop an effective risk management program to govern privacy, the following will be required:

- Identification and assessment of risk;
- Development of written plans and procedures to manage the risk;
- Implementation and testing of compliance with established policies; and
- Adjustments to the policies, as needed, based upon findings and changes in the operating environment.

The Board of Directors should approve the written policies and periodically receive reports on the implementation and effectiveness of the policies. Management should continually evaluate the operating environment to determine needed changes to, and monitor compliance with, the policies.

Applicability to Fiduciary Customers/Consumers

The privacy regulation contains customer and consumer disclosure requirements. There is no preset method for disclosure. However, alternative methods are available to satisfy disclosure requirements, including the use of short-form initial disclosures; toll-free telephone numbers, hand-delivered disclosures, etc. The disclosures may be provided in paper or electronic format. The only requirement is that "each consumer should reasonably be expected to receive the notice" Verbal notification is prohibited. However, regardless of the method used, detailed guidelines govern the type of information to be contained in disclosures, as summarized below:

- Typically, a fiduciary must disclose the privacy policy at the initiation of the relationship and annually thereafter. However, Sections 332.14 and 332.15 identify exceptions to this rule. Annually has been defined to mean at least once in any 12 consecutive months during which the relationship exists. A fiduciary may define any 12-consecutive-month period so long as it is applied consistently.
- Disclosures are to be "clear and conspicuous." Section 332.3(b) provides a detailed definition of "clear and conspicuous". There is also guidance for web site notices. There is no predefined disclosure language or form.
- There are minimum requirements (Section 332.6) governing the content of annual and periodic disclosure statements. In general, the disclosure statement includes the following information: categories of nonpublic information that are collected; the categories of information that are disclosed; the categories of affiliated and nonaffiliated third parties to whom the information is disclosed; and the categories of information disclosed about former customers. A statement of the categories of information disclosed, and to whom it is disclosed, is also required if "nonpublic personal information" is disclosed to nonaffiliated third parties. At this point, the consumer's right to "optout" must also be disclosed. Finally, all statements must also include the fiduciary's policy and practices with respect to protecting the confidentiality and security of "nonpublic personal information."

- The "opt-out" information must also be "clear and conspicuous". In general, the notice must include language to the effect that the fiduciary reserves the right to disclose nonpublic personal information to nonaffiliated third parties, that the consumer has the right to opt-out of the disclosure, and a "reasonable" means by which the customer may opt-out. Significantly, the "opt-out" requirement typically does not pertain to the disclosure of nonpublic personal information to a nonaffiliated third party that performs services or functions on behalf of the fiduciary. Instead, at a minimum, the contractual agreement with the third party should prohibit the third party from disclosing, or using the information, other than to carry out its duties.

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G. OUTSIDE CONTRACTING FOR FIDUCIARY SERVICES

Increasingly, financial institutions are contracting with affiliates and third parties to facilitate the offering of trust services to their customers. These contracts can be for services ranging from trust data processing, custody, investment management, and complete fiduciary services. Many small trust departments have historically outsourced data processing, tax preparation, and certain specialized asset management tasks.

Outsourcing is one method for obtaining expertise not internally available, improving services, and managing costs. However, outsourcing may also expose the department to additional risk. This includes security of customer information, and the availability of information and management reporting systems. Management should identify the key risks associated with outsourcing arrangements, and implement appropriate oversight programs to monitor each service provider's controls, performance, and financial condition on a continuing basis.

Today, it may be possible for banks to delegate virtually the entire process of providing and administering trust services, while retaining the appearance of, and some of the income from, providing such services. The Corporation neither endorses nor prohibits an institution's full delegation of services and duties to outside service providers. Rather, this practice is considered a business risk decision. In doing so, bank management is expected to *fully investigate and document beforehand* the inherent challenges and legal obstacles to providing fiduciary services in this manner. Bank management is also expected to *demonstrate its continuous monitoring* of service provider activities, the quality of services provided its customers, and any associated business or legal risk. The Corporation's approach in evaluating business plans to extend trust services in this manner is to consider the merits of each business plan on a case-by-case basis.

Once a decision has been made to employ an outside service provider, the selection process itself must be prudent. Before selecting an agent, the board and senior management should first investigate and acquire a suitable working knowledge of the business or service to be contracted. Management should then perform and document its due diligence review of prospective agents. These activities may later aid the bank in demonstrating that care and prudence were exercised in selecting an agent to assist in, or perform, fiduciary duties. Significantly, although fiduciaries may be permitted under law to delegate duties to agents, they retain responsibility for the *careful selection* of such agents (refer to section 9 of the Uniform Prudent Investor Act). And while the initial selection process is important, management has a continuing responsibility to ensure the service provider's suitability after the relationship has been established.

States still operating under the Prudent Man Rule may prohibit the out-outsourcing of account administrations, fiduciary and/or investment management responsibilities. Refer to Prudent Man Rule in Appendix C.

Applicable Regulations

When establishing a relationship with a third party or affiliate, management must be conversant with all applicable regulations. For relationships with affiliates, Section 23A and 23B of the Federal Reserve Act may apply. Section 23B requires all transactions between a financial institution and a non-bank affiliate to be conducted on a basis comparable to that of similar transactions between nonaffiliated entities. Management must also ensure that state law permits the delegation of services to third parties. For those states that have enacted the Prudent Investor Act, management is typically granted broad delegation power. This power is further addressed below. In all instances, contracts between the bank and third parties should meet the requirements of Section 30 of the FDI Act; namely, that the contract does not adversely affect the safety and soundness of the institution.

Due Diligence Reviews

Prior to designating a servicing agent for its fiduciary activities, the serviced institution should document its exercise of reasonable caution in selecting agents. Compatibility and performance should be considered in conjunction with the cost of the services to be provided. The scope of the due diligence may depend upon the type and significance of outsourcing activity. However, detailed below are common considerations in any due diligence review. The listing does not supersede provisions of law or regulation, nor does it preclude additional concerns which may occur in some situations.

- An assessment should be made of the servicing organization's ability to handle the volume and nature of trust accounts and assets to be serviced. Obtaining a list of servicer references and contact names is a common practice.
- The financial strength and viability of the servicing organization should be considered. In this regard, the strength provided by a parent holding company or similar organization may also be considered. This would entail a review of financial statements and audit reports, and a search of pending or threatened financial or legal claims.
- If investment management is being outsourced, then a review of the servicer’s investment performance (over a minimum of 5 to 10 years, or several investment cycles) should be reviewed. SEC advisers Form ADV, if required, may provide some insight on the registered investment advisers investment philosophy.
- Audit or supervisory evaluations of the servicing organization, if available. Depending upon the outsourced function, management may obtain AICPA Statement of Auditing Standards SAS 70 Reports, if conducted, or other available reports.
- A review of certain policies, procedures, and controls of the servicing organization should be made. Knowledge of a service provider's business strategies, privacy policies, service philosophies, and quality control initiatives may be beneficial in choosing a firm whose standards correspond to the bank's standards.
- Evidence supporting the maintenance of fidelity insurance coverage by the servicing organization should be obtained.

Written Agreements With Agents

Once a service provider is chosen, a written agreement should be drafted that governs the arrangement. The institution's legal counsel should be involved in the drafting and/or review of the contract when critical functions are being outsourced. The contract should be flexible, yet clearly outline the expectations and responsibilities of all parties. The contract should specify the scope and risks of the outsourced activity, all relevant terms, conditions and responsibilities, and the liabilities of each party. The minimum provisions which should be included are:

- the duties and responsibilities of each party; and
- compensation and any cost sharing arrangements.

Institutions should be strongly encouraged to include the following in written servicing agreements:

- Minimum service levels, dispute resolution procedures, termination clauses - It is prudent for the contract to include bankruptcy clauses, and warranties allowing for termination for cause without penalty by the serviced institution. Examiners should be alert for contracts with extended termination dates between the bank and affiliated entities which may be used to create "value" on the books of the affiliate. Contracts should be reasonable in length, given services performed.
- Documentation Standards - The files and computer records relating to the serviced bank should be identified as accounts of the serviced bank, and not that of the servicer, to facilitate audits, examinations, preparation required regulatory reports (e.g. Call Report Schedule RC-T), and any similar reporting requirements. Additionally, the confidentiality of shared information and client data should be addressed.
- Audit Provisions - The contract should include the right of the serviced entity to obtain SAS 70 Reports, or other third-party reviews and audits. Or, the contract may allow for the serviced entity to conduct audits of the service provider's operations. Some contracts may also allow for receipt of the servicing entities audit reports, or those sections of audits which apply to the serviced institution.
- Supervisory Access - The rights of the institution's supervisory authorities to access information of the institution and the operations of the servicer.
- File Recovery at Termination - Clauses in the contract should address the return of hardcopy and electronic files to the serviced institution, or its designee.
- Liability Clauses - An indemnity provision in the agreement should set forth the liability of each party.

- Insurance Coverage - There should be a provision requiring sufficient fidelity and liability insurance coverage on the activity by both parties.

In all instances, contracts between the bank and third parties should meet the requirements of Section 30 of the Federal Deposit Insurance Act; namely, contracts must not adversely affect the safety and soundness of the institution.

Periodic Monitoring of Agent's Condition and Performance

In addition to performing an initial review of the servicing agent, management has a responsibility to monitor and periodically update its documentation on the condition and activities of the servicing organization, while ensuring that the provisions of the agreement are being met. At a minimum, the institution's monitoring program should incorporate:

- Conducting, or reviewing results of, independent audits of the service provider's operation;
- Verifying and reviewing the adequacy of the service provider's contingency plans; and
- Developing contingency plans in the event of deteriorating performance or other problems encountered with the service provider.
- Monitoring the investment performance of the servicer, if the servicer provides investment management services.

Client Disclosures

Since it is possible for an institution to delegate virtually the entire process of providing and administering trust services, the question arises as to how much disclosure should be made to clients regarding such arrangements. An institution that delegates virtually all of its responsibilities would be expected to disclose more than those which only outsource ancillary services. Regardless, disclosures should provide clients with sufficient information to make informed decisions, and to maintain a rapport commensurate with the fiduciary relationship itself. State laws may also dictate the extent of disclosures made to clients.

Delegation of Investment Management Services

Some departments do not have the expertise or staffing resources to provide investment management services. These institutions either do not offer investment management services to their clients, or have delegated this function to a third party. To some degree, the legality of delegating fiduciary investment management authority is dependent on state law. FDIC-supervised financial institutions located in states in which fiduciary investments are governed by the Prudent Man Rule or by a Legal List, may not delegate the servicing of their fiduciary accounts to another institution, unless state law explicitly provides for such a delegation. FDIC-supervised financial institutions located in states in which fiduciary investments are governed by the Prudent Investor Act, may delegate the servicing of their fiduciary accounts to another trust department or other entity.

Those firms that have delegated investment management responsibilities to others may use Registered Investment Advisers as defined under the Investment Advisers Act of 1940. Registered Investment Advisers are paid to provide investment advice, and generally must register with the SEC or the state securities agency where their principal place of business is located. Generally, those who manage client assets of $25 million or more must register with the SEC, while all others register with their respective state agency.

The SEC adopted a rule amendment under the Investment Advisors Act of 1940 to exempt certain investment advisers that provide advisory services through the Internet from the prohibition on Commission registration. The rule amendments permit these advisers, whose businesses are not connected to any particular state, to register with the Commission instead of with state securities authorities. The final rule (Release No. IA-2091 www.sec.gov) became effective January 20, 2003.

All registered advisers are required to file a "Form ADV," which is an application to apply for registration or amend registration. Form ADV consists of two parts. Part I contains general and personal information about the applicant. Part II contains information on the nature of the applicant's business, including: operations, services offered, fees charged, type of clients advised, educational and business backgrounds of associated persons, and other business activities of the applicant. The ADV is a public document, and registered investment advisers should provide a copy of the form to their clients. Therefore, if the department utilizes the services of a registered adviser, management should have a copy of the most recent Form ADV on hand. Additionally, management should have a contract with the adviser outlining the responsibilities of both parties. The receipt and periodic review of such documents is an integral task of the due diligence process.

Use of a Registered Securities Broker as Custodian

Increasingly, departments are utilizing the services of registered securities brokers as custodian for the assets of trust department accounts. While this practice was previously prohibited under Corporation guidelines and long-standing precedents of the OCC, he revised OCC Regulation 9 no longer contains such prohibitions. As such, other regulatory agencies have reportedly permitted institutions to utilize similar arrangements. If such an arrangement is encountered, the examiner should expect to see an appropriate due diligence program to manage associated risks. Bank management has the responsibility to ensure that the legal agreement with the broker offers sufficient protections to the bank and its trust beneficiaries. Please refer to Section 2.J. Use of Broker Dealer for Securities Safekeeping for more information.

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H. SERVICING CONTRACT ACCOUNTS

The trust department may engage in contracts to provide services for outside companies, such as accepting a role (agent, custodian, trustee, etc.) from outside organizations marketing employee benefit plans, IRAs, investment plans, trusteeship of prototype trusts, and other similar products. Since these types of arrangements inherently contain additional risk exposure, management should ensure that they are fulfilling all their responsibilities under written agreements and fiduciary laws. Many of the same due diligence efforts discussed above would be applicable to the institution providing such services.

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I. ENFORCEMENT ACTIONS

Trust department activities are subject to supervisory enforcement actions just as any other activity or department of the bank. The underlying rationale for all "enforcement actions" or supervisory initiatives is to obtain correction or improvement of a perceived problem, condition, or weakness. The examiner's careful selection and judicious recommendation for the use of such actions continues to be paramount in preserving the effectiveness of these tools.

Types of Enforcement Actions

Informal Actions

Informal actions include: memorandums of understanding, board resolutions, written agreements, and capital directives. Examiners should consider an informal action for those departments exhibiting supervisory concern, but where the problems do not pose a threat to trust beneficiaries or the safety and soundness of the institution. An informal administrative action should be considered, but is not mandatory, for any department rated a composite "3". The relative significance of weaknesses, management's recognition of the weaknesses and its willingness to take corrective measures, together with the extent of corrections made during the course of an examination, should be all evaluated when considering an informal action. However, at a minimum, an informal action may be necessary where significant weaknesses remain uncorrected from prior examinations.

Formal Actions

Section 8 of the FDI Act gives the FDIC Board of Directors broad enforcement powers including: Termination of Insurance Actions (Section 8(a)), Cease and Desist Actions (Sections 8(b) and 8(c)), and Suspension and Removal procedures (Section 8(e)). Problem trust departments are those which are assigned a composite rating of "4" or "5" under the Uniform Interagency Trust Rating System. It is expected that such departments will normally be subject to some type of formal enforcement action designed to return the department to an acceptable condition. If a formal action is not undertaken, examiner comments should describe alternative actions taken and justify their reasonableness.

Enforcement Action Resources

There are various resources available to the examiner if the examination findings indicate some type of enforcement action may be necessary. Examiners are reminded that they should be in contact with the Regional Office when considering such action. Detailed below are some resources available for review.

- Manual of Examination Policies (Manual) - Section 13 provides expanded guidance on the use of informal and formal enforcement actions.
- Formal and Informal Action Procedures Manual (FIAP Manual) - Contains procedural guidance when departmental conditions indicate some type of enforcement action is warranted.
- Case Manager Procedures Manual (CM Manual) - For use at the Regional Office; it contains procedures to guide in the review and processing of enforcement actions.

Civil Money Penalties

In connection with examinations of fiduciary activities, infractions of certain laws may be detected for which the assessment of civil money penalties (CMPs) is authorized. A full discussion of criteria and procedures for recommending such penalties is provided in Section 14 of the Manual. In addition, further guidance, as well as the scoring matrix to be used in CMP decisions, is provided in the Formal and Informal Action Procedures Manual (FIAP Manual).

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J. CRIMINAL ACTIVITIES

The examination of trust activities within a financial institution may disclose apparent violations of criminal law, or suspicious activities related to money laundering and the Bank Secrecy Act. When such conduct involves the institution, either as a victim or potential victim, or where the bank is used to facilitate criminal activity, it is the examiner's responsibility to ensure that proper action is taken and that reporting procedures are followed. The prescribed action and reporting procedures are set forth in Section 9.2 of the Manual of Examination Policies. In addition, FDIC Part 353: Suspicious Activity Reports sets forth reporting procedures for FDIC-supervised banks with respect to known, attempted, or suspected crimes.

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K. INSURANCE OF FIDUCIARY ACTIVITIES

Insurance is a fundamental part of a department's risk management program. Once management has identified and analyzed potential risk areas, and reviewed its internal control structure, it may determine the appropriate method to deal with particular risks. The transfer of risk through insurance is one method commonly used. The specific needs of a department will dictate the type of coverage that should be obtained, as well as the level of such coverage. Examiners should refer to Section 4.4 of the Manual of Examination Policies for a general discussion of insurance management. In addition to coverage of trust activities under the bank's blanket bond and excess coverage, the following types of insurance are sometimes obtained by trust departments:

Errors and Omissions (Trust Department Surcharge Liability)

This form of coverage usually covers four types of losses:

- Loss from a claim made against the insured by reason of any alleged negligent act, error, or omission while discharging duties enumerated in the policy. These duties generally consist of administering estates or trusts; managing real and personal property; acting as a custodian; rendering investment advice; or acting as stock transfer agent, registrar, dividend disbursing agent, escrow agent, or trustee under a bond indenture.
- Loss from any claim made against the insured arising out of any alleged failure to act prudently under the Employee Retirement Income Security Act of 1974, or in an insured capacity as a fiduciary for any employee benefit account. It is important to note that for employee benefit accounts to be covered, specific language indicating their inclusion must be present in either the policy or a rider.
- Expenses incurred in the defense of any claim, as long as the coverage for that claim exists under the policy.

- Payments made to reimburse any officer, director, or employee for reasonable expenses and attorney fees incurred defending any claims as an individual. Insurance policies normally will provide for bank reimbursement only if the bank has indemnified the individual. In cases where the bank does not indemnify the director, officer, or employee, there is generally no coverage for the costs incurred by that individual.

Real Estate and Mortgages

Blanket real estate insurance covers all real estate owned by trust accounts, and real estate pledged on mortgages held by the department. This coverage can be less expensive than purchasing individual policies when numerous parcels are held. The blanket policy covering mortgaged real estate usually provides coverage where the mortgagee fails to keep the property insured. During the examination, there is no need to check individual insurance policies for mortgaged real estate loans where a blanket policy covering losses arising out of mortgaged real estate is in force in an adequate amount. However, examiners should check compliance with any covenants of the policy requiring the bank to perform duties to keep the protection effective.

Other Desirable Insurance

Although insurance is not the only consideration, thought should be given to exposure arising from employment of agents by the department. In dealing with a variety of assets and accounts, the department often employs others to perform tasks critical to proper account administration. These agents may not be covered by the bank's insurance policies. Therefore, the department should be certain that both account beneficiaries and itself are properly protected by appropriate third party bonding.

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L. DEPOSIT INSURANCE OF TRUST FUNDS

Deposit insurance regulations are contained in Part 330 of FDIC Rules and Regulations. The publication "The Financial Institution Employee's Guide to Deposit Insurance", provides another reference source. Questions arising during examinations regarding specific circumstances, may be referred to the FDIC Call Center at 1-877-ASKFDIC (877-275-3342). For TDD the toll free phone number is 1-800-925-4618. The hours of operation of the FDIC Call Center are Monday thru Friday from 8 a.m. to 8 p.m. Eastern Time.

From the examiner's perspective, questions concerning deposit insurance generally arise in connection with deposits held as trust account assets. It is generally accepted that, to the extent trust monies are invested in bank deposits, they should be kept within insurance limits. Fundamental principles of deposit insurance for certain types of accounts are provided below, but examiners are cautioned that the complexities of the subject preclude exhaustive coverage here. Bank management and clients should consult with their attorneys, tax advisers, or other private professional advisers, as appropriate, to determine the coverage of their trust accounts under the deposit insurance regulations.

Deposit insurance is based on ownership rights and capacities, as disclosed in the records of the insured depository institution. The precise documentation of account ownership in the records of the depository institution is critical. Deposit records include, but are not limited to, signature cards, passbooks, and account ledgers and computer records that relate to the bank's deposit taking function. With the exception of deposit accounts in the certain retirement accounts ownership category, the maximum coverage is $100,000 per depositor. For those employee benefit accounts and trust accounts that qualify for pass-through deposit insurance, $100,000 per employee benefit plan participant or trust beneficiary. The maximum coverage for deposit accounts of certain retirement accounts is $250,000. Coverage is per institution: the deposits in each individually-insured bank or savings institution are separately insured, even if the institutions are affiliated through common ownership by a bank holding company. However, deposits at separate branch offices operated under a single charter are not separately insured.

Various types of deposits are eligible for coverage, such as savings accounts, certificates of deposit, checking accounts, money market accounts, retirement accounts, official checks, outstanding drafts, etc. For purposes of deposit insurance coverage, deposits are categorized according to eight ownership categories: Single Ownership Accounts; Joint Ownership Accounts; Revocable Trust Accounts; Irrevocable Trust Accounts; Accounts of a Corporation, Partnership, or Unincorporated Association; Certain Retirement Accounts and Employee Benefit Plan Accounts; and Government Accounts. The discussion below centers on those account ownership categories typically encountered in a trust examination.

Deposits of Revocable Trusts

On January 13, 2004, the FDIC adopted new rules for the insurance coverage of revocable trust accounts, also referred to as living trusts. (See FDIC Rules and Regulations Section 330.10, "Revocable Accounts.") The new rules took effect on April 1, 2004. The owner, i.e. the grantor, of a revocable trust will be insured up to $100,000 per beneficiary if all the following requirements are met:

- The beneficiary is the grantor's spouse, child, grandchild, parent, or sibling. Stepparents, stepchildren, adopted children and similar relationships also qualify. Beneficiaries that are in-laws, cousins, nieces and nephews, and charitable organizations do not qualify;
- The beneficiary's interest in the trust vests upon the death of the grantor of the trust; and
- The deposit account must be titled at the bank in a manner that indicates that the deposit account is held by a trust.

The amount of coverage is based on the actual interest of each qualifying beneficiary. Unless the trust states otherwise, the FDIC will assume that each beneficiary, including beneficiaries with a life estate, has an equal interest in the trust.

The new rules differ from the old rules in that the FDIC will ignore conditions that may limit a beneficiary's right to his/her interest in the trust. Prior to the new rule, beneficiaries with contingent interests in a trust were not eligible for per-beneficiary coverage. Also, the new rule eliminated the requirement that the bank maintain account records of the names of the trust beneficiaries. Now, the bank need only indicate in the title of the deposit account that it is held by a trust. The rule for payable on death (POD) accounts, however, still requires that the names of the beneficiaries of a POD account be identified in the bank 's records.

If the trust has more than one grantor, deposit insurance coverage would be up to $100,000 for each qualifying beneficiary for each grantor, provided that the beneficiary's interest in the trust vests upon the death of the last surviving grantor.

The trust interest of a non-qualifying beneficiary is insured as the grantor's single ownership funds. In the case of single ownership funds, the grantor's funds would be added to any other single ownership funds of the grantor, with the total amount of single ownership funds insured up to $100,000.

Deposits of Estates

Deposits of an estate (made by an executor or administrator) are considered to fall in the "single ownership" category of deposits. (See FDIC Rules and Regulations Section 330.6, "Single Ownership Accounts.") These deposits are separately insured to the decedent, but would be added to any other deposits denominated in the name of the deceased which have not yet been marshaled by the executor. The decedent's funds are, of course, separately insured from any funds owned and deposited in the same insured institution by the estate's executors or administrators, or the estate's beneficiaries. The fiduciary capacity of the executor or administrator must be disclosed on the institution's records.

Deposits of Irrevocable Trust Accounts

The interests of a beneficiary in all deposit accounts established by the same grantor and held at the same insured bank under an irrevocable trust are added together and insured up to $100,000, if all of the following requirements are met:

- The insured bank's deposit account records disclose the existence of the trust relationship;
- The beneficiaries and their interests in the trust must be identifiable from the bank deposit account records or from the trust's records;
- Each beneficiary's interest in the trust must be non-contingent, as defined in Section 330.1 of the FDIC's Rules and Regulations; and
- The trust must be valid under state law.

Section 330.1 defines a noncontingent trust interest as a trust interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031--7 of the Federal Estate Tax Regulations (26 CFR 20.2031-7) or any similar present worth or life expectancy tables which may be adopted by the

Internal Revenue Service. Note that, unlike the rules covering revocable trusts, the beneficiary of an irrevocable trust does not have to be related to the grantor.

If the grantor retains an interest in the trust, the amount of the grantor's retained interest would be added to any single ownership accounts owned by the grantor at the same bank and the total insured up to $100,000. For such a situation to exist, the grantor of the trust must still be alive.

The following are situations where an irrevocable trust would not be insured on a per beneficiary basis, in which case the deposits of the trust as a whole would only be insured up to $100,000.

- The trust agreement does not name the beneficiaries or provide any means of identifying the beneficiaries;
- The trust agreement provides that a beneficiary will receive no assets unless certain conditions are satisfied;
- The trust agreement provides that a trustee may invade the principal of the trust, with the result that the assets available for other beneficiaries may be reduced or eliminated; or
- The trust agreement provides that the trustee or a particular beneficiary may exercise discretion in allocating assets among the beneficiaries, with the result that the future distribution to each beneficiary is impossible to determine.

Deposits of Accounts Held by an Agent, Nominee, Guardian, Custodian, or Conservator

Funds held in the name of an agent, nominee, custodian, guardian or conservator on behalf of a principal are insured as the funds of the principal. The funds are added together with any other funds the principal owns in the same right and capacity at the insured institution, either directly or through an agent, and insured to the same extent as if the funds had been deposited directly by the principal.

Funds held by an agent, nominee, guardian, custodian, conservator or loan servicer on behalf of two or more persons jointly, shall be treated as a joint ownership accounts. See Section 330.9, "Joint Ownership Accounts," for details on coverage of joint ownership accounts.

Deposits of Employee Benefit Accounts

Employee benefit plan account deposits are deposits of a pension plan, profit sharing plan or other employee benefit plan described in Section 3(3) of the Employee Retirement Income Security Act (ERISA). Deposits of employee benefit plans are insured to a maximum of $100,000 for each participant's non-contingent interest in the plan, provided that the recognition of deposit ownership requirements of Section 330.5 are satisfied. (See FDIC Rules and Regulations Section 330.14 , "Retirement and Other Employee Benefit Plan Accounts") This coverage is known as "pass-through" insurance because the insurance coverage passes through the plan administrator, who for purposes of Section 330.14 is the "depositor" with respect to these accounts, to each participant's interest. Coverage for a plan's deposits is not based on the number of participants, but rather on each participant's share of the plan.

The value of a participant's non-contingent interest in the deposit of a defined contribution employee benefit plan is the employee's account balance as of the date of default of the insured depository institution, regardless of whether the amount was derived, in whole or in part, from contributions of the employee and/or the employer to the account. The value of a participant's non-contingent interest in a defined benefit employee benefit plan is the present value of the employee's interest in the plan, evaluated in accordance with the method of calculation ordinarily used under such plan, as of the date of default of the insured depository institution. In the case of an overfunded plan, an employee benefit plan's deposits that can not be attributed to the interests of the plan's participants will be aggregated and insured up to a maximum of $100,000. Similarly, deposits of an employee benefit plan that represent contingent interests will be aggregated and insured to a maximum of $100,000. A non-contingent interest is an interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031--7 of the Federal Estate Tax Regulations (26 CFR 20.2031--7) or any similar present worth or life expectancy tables which may be adopted by the Internal Revenue Service.

Deposits of Certain Retirement Accounts

Deposits of certain retirement accounts are deposits owned by one person and titled in the name of that person's retirement account. See Section 330.14, "Retirement and Other Employee Benefit Plan Accounts." The following types of retirement plan deposits qualify for coverage as certain retirement accounts:

- All types of IRAs including traditional IRAs, Roth IRAs, Simplified Employee Pension (SEP) IRAs, and Savings Incentive Match Plans for Employees (SIMPLE) IRAs;
- All Section 457 deferred compensation plan accounts, such as eligible deferred compensation plans of state and local governments, regardless of whether they are self-directed;
- Self-directed defined contribution plan accounts, such as self-directed 401(k) plans, self-directed SIMPLE IRAs held in the form of 401(k) plans, self-directed defined contribution money purchase plans, and self-directed defined contribution profit-sharing plans; and
- Self-directed Keogh plan accounts (or H.R. 10 plan accounts) designed for self-employed individuals.

The above listed retirement accounts owned by the same person in the same FDIC-insured bank are added together and the total is insured up to a maximum of $250,000.

For deposit insurance purposes, a "self-directed" account means that plan participants have the right to direct how the assets of their account are invested, including the right to invest funds in deposits of an FDIC-insured bank. If a plan has as its default investment option deposit accounts at a particular FDIC-insured institution, the FDIC considers such a plan to be self-directed for deposit insurance purposes. If a plan's only investment vehicle is a deposit account(s) of a particular bank so that the participants have no choice as to how to invest the assets in their account, such a plan would not be considered self-directed. However, if a plan is a single employer/employee plan, then the fact that there is only a single investment option, e.g. a deposit in an FDIC insured institution, would not cause the deposits on such a plan to not be insured.

Coverdell Education Savings Accounts (formerly known as Education IRAs), Health Savings Accounts, and Medical Savings Accounts are not included in the Certain Retirement Accounts ownership category. Nor are 403(b) plans (annuity contracts for certain employees of public Schools, tax-exempt organizations and ministers) included in the Certain Retirement Accounts ownership category.

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M. APPLICABILITY OF CONSUMER REGULATIONS TO FIDUCIARY ACTIVITIES

Unless specifically exempted, the activities of trust accounts are subject to compliance with applicable laws. Consumer law is one category of such laws. Thus, a particular trust account which engages in a regulated activity, such as lending, may be required to comply with consumer lending laws. Responsibility for compliance will generally rest with the financial institution, or other party, acting in the capacity of trustee.

Primary regulatory responsibility for reviewing the institution's compliance with these laws (both for its own account, as well as in its role as trustee) rests with Division of Supervision and Consumer Protection (DSC). Examiners may review the activity to determine: (a) if particular statutes are applicable to specific accounts under review and, (b) if so, that basic procedures are in place to effect compliance. If performed, the scope of the review should allow an assessment of whether any contingent liability attaches. Where significant activity or problems are encountered, the matter should also be referred to DSC - Consumer Protection and Compliance.

Foremost among these regulations will be the Federal Reserve Board's Regulation Z (Truth in Lending) at 12 CFR 226. The regulation may apply if a trust account meets the definition of a creditor, as noted at Section 226.2(a)(17) of the regulation. The fundamental provisions of the definition require that the creditor regularly (more than 25 times per year, or five times if secured by dwellings) extends consumer credit (for personal, family, or household purposes) that is subject to a finance charge, and payable in more than four installments. As noted in the Official Staff Commentary for Section 226.2(a)(17)(i), item 7, each trust is considered a separate entity for purposes of applying criteria in the definition.

Activities of trusts can also fall within the purview of other consumer regulations, such as Equal Credit Opportunity, FRB Regulation B. For an overview of compliance regulations and statutes, refer to the Compliance Examination Manual.

In some instances, personal, charitable, or corporate trust accounts may be found to be subject to the above regulations. More frequently, applicability will occur with employee benefit plans. A discussion of compliance issues in employee benefit plans may also be found in subsection H.9.g.(4). Consumer Protection Laws and Loans to Plan Participants, located in Section 5.