

# ASSET MANAGEMENT

## Part I: Investment Principles, Policies and Products

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### Section 3

- A. Trust Investment Principles
- B. Suitability
- C. Prudent Investments
- D. Principal and Income
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### A. TRUST INVESTMENT PRINCIPLES

The management of property for others is one of the principal functions of a fiduciary. Fiduciaries administering personal or corporate accounts, either as trustee or agent, are guided by state statutes and the principles embodied in common law. For employee benefit accounts, ERISA, with its implementing Department of Labor (DOL) regulations and opinions, provides statutory and regulatory guidance.

The primary investment guidance given to fiduciaries is found in the terms of each account's governing instrument. There are major differences in the fiduciary's responsibilities under different types of accounts.

- When the fiduciary has discretion to select investments for an account, or makes recommendations for the selection of investments, the investments selected must both follow the terms of the governing instrument and be suitable investments given the needs of the beneficiaries or the purpose of the trust.
- When the trust department has no discretion in choosing investments (such as for self-directed or custodial accounts), the institution's sole responsibility is to follow the provisions of the governing accounting instrument.

Accounts subject to ERISA, diversification standards, parties in interest, and co-fiduciaries and investment managers are presented in Sections 404 through 406. Refer to specific sections of ERISA in Appendix E - Statute 404 through 406 and Section 5 of this Manual for further discussion.

### B. SUITABILITY

In enacting the Prudent Investor Act, states should have repealed legal list statutes, which specified permissible investments types. (However, guardianship and conservatorship accounts generally remain limited by specific state law.) In those states which adopted part or all of the Prudent Investor Act, investments must be chosen based on their suitability for each account's beneficiaries or, as appropriate, the customer. Although specific criteria for determining "suitability" does not exist, it is generally acknowledged that the following items should be considered as they pertain to account beneficiaries:

- financial situation;
- current investment portfolio;
- need for income;
- tax status and bracket;
- investment objective; and
- risk tolerance.

### C. PRUDENT INVESTMENTS

There are two fiduciary standards governing the prudence of the individual investments selected by a fiduciary: the Prudent Investor Act and the Prudent Man Rule. The Prudent Investor Act, which was adopted in 1990 by the American Law Institute's Third Restatement of the Law of Trusts ("Restatement of Trust 3d"), reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investment discretion. This approach allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments. As of May 2004, the Prudent Investor Act has been adopted in 41 States and the District of Columbia. Other states may have adopted parts of the Act, but not the entire Act. According to the National Conference of Commissioners on Uniform State Laws, the most common portion of the Act excluded by states concerns the delegation of investment decisions to qualified and supervised agents.

The Prudent Investor Act differs from the Prudent Man Rule in four major ways:

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- A trust account's entire investment portfolio is considered when determining the prudence of an individual investment. Under the Prudent Investor Act standard, a fiduciary would not be held liable for individual investment losses, so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives of the account.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Instead, suitability to the trust account's purposes and beneficiaries' needs is considered the determinant. As a result, junior lien loans, investments in limited partnerships, derivatives, futures, and similar investment vehicles, are not per se considered imprudent. However, while the fiduciary is now permitted, even encouraged, to develop greater flexibility in overall portfolio management, speculation and outright risk taking is not sanctioned by the rule either, and they remain subject to criticism and possible liability.
- A fiduciary is permitted to delegate investment management and other functions to third parties.

A copy of the model Uniform Prudent Investor Act, together with explanatory notes, is included in Appendix C. A list of states adopting the Uniform Prudent Investor Act is also included. States, however, may and often do, modify uniform model laws when enacting legislation. For states that have adopted a version of the Prudent Investor Rule, this portfolio management approach supersedes the Prudent Man Rule.

The Prudent Man Rule is based on common law, stemming from the 1830 Massachusetts court decision -- *Harvard College v. Armory*, 9 Pick. (26 Mass.)446, 461 (1830). The Prudent Man Rule directs trustees "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. A copy of the Prudent Man Rule, also known as the *Restatement of Trusts 2d*, together with explanatory notes, is included in Appendix C.

Under the Prudent Man Rule, when the governing trust instrument or state law is silent concerning the types of investments permitted, the fiduciary is required to invest trust assets as a "prudent man" would invest his own property, keeping in mind: the needs of the beneficiaries, the need to preserve the estate (or corpus of the trust) and the amount and regularity of income. The application of these general principles depends on the type of account administered. This continues to be the prevailing statute in a small number of states.

The Prudent Man Rule requires that each investment be judged on its own merits. Thus, a fiduciary could be held liable for a loss in one investment, which when viewed in isolation may have been imprudent at the time it was acquired, but as a part of a total investment strategy, was a prudent investment in the context of the investment portfolio taken as a whole. Under the Prudent Man Rule, speculative or risky investments must be avoided. Certain types of investments, such as second mortgages or new business ventures, are viewed as intrinsically speculative, and, therefore, prohibited as fiduciary investments.

Since the Prudent Man Rule was last revised in 1959, numerous investment products have been introduced or have come into the mainstream. For example, in 1959, there were 155 mutual funds with nearly \$16 billion in assets. By year-end 2000, mutual funds had grown to 10,725, with \$6.9 trillion in assets (as reported by CDA/Wiesenberger). In addition, investors have become more sophisticated and more attuned to investments, since the last revision. As these two concepts converged, the Prudent Man Rule became less relevant.

### Prudent Investments in Court-appointed Accounts

State statutes may outline specific permissible investments for certain types of accounts, such as guardianships for minor children or incompetents. Under some state statutes, prudence is more narrowly defined for guardianship accounts, than under the Prudent Man Rule.

Trust departments can be appointed as a conservator for veterans. In general, prudent investments for veteran accounts are defined as an interest or dividend paying account at a Federally-insured institution, or in court-appointed cases, in securities issued or guaranteed by the United States. Under 38 CFR13.103, veteran benefits paid to legal custodians on behalf of a beneficiary may only be invested in U.S. savings bonds, pre-need burials trusts, or interest or dividend paying accounts, which are Federally insured. Department of Veterans Affairs benefits that are paid on behalf of an incompetent veteran to an institution via an institutional award payment arrangement may not be invested in any asset. Pursuant to 38 USC 501, Section 13.106 states that court-appointed fiduciaries must invest income or an estate derived from the Department of Veterans Affairs benefits only in

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legal investments which have safety, assured income, stability of principal, and ready convertibility for the requirements of the beneficiary and his or her dependents.

### Prudent Investments in Employee Benefit Accounts

Employee benefit accounts subject to ERISA are governed by the prudence requirement of ERISA Section 404(a)(1)(B), as well as by DOL Regulation 2550.404a-1. Also see recap of ERISA prudence interpretations and opinions. In implementing ERISA requirements, the Labor Department has generally followed the Prudent Investor approach outlined above.

## D. PRINCIPAL AND INCOME

As discussed more fully in Section 2 - Operations and Internal Controls, there may exist different classes of beneficiaries in a personal trust account that may only be entitled to a trust's principal, or income, but not both. In these situations, it is important that fiduciaries maintain accounting records that clearly distinguish assets as either principal or income.

Principal (corpus) consists of cash and other property transferred to the fiduciary. Income is the return derived from the investment of principal. Income must also be distinguished from capital gains, which are not investment yields or returns on principal, but gains or appreciation of the value of the principal itself. Capital gains are added to the value of principal (capital losses reduce the value of principal) and inure to the benefit of principal beneficiaries. Depending on the terms of the trust, and a variety of other factors including the needs of the beneficiaries, income may be distributed as cash or reinvested and held (for the benefit of income beneficiaries) as invested income. Unless clearly distinguished from other investments, invested income may appear to the observer to be principal. Consequently, it is imperative that fiduciary records distinguish between the two, as failure to do so could result in giving one set of beneficiaries funds that belong to another set of beneficiaries, creating a Contingent Liability. Separate records of principal and income are customary and can be used for the preparation of accountings and tax returns. A further discussion of principal and income may be found in Principal and Income, located in Section 2.

## E. TRUST INVESTMENT POLICIES

The ultimate responsibility for establishing an overall investment policy remains with the board of directors or a trust committee appointed by the board. The basis of any investment policy should be sound fiduciary principles, including "prudence", the preservation of capital, diversification, and a rate of return commensurate with the level of risk assumed. The review of the department's investment policies and practices are of major importance in the trust examination.

Many trust departments have a separate trust investment committee which develops and administers investment policy, although smaller departments may utilize the board of directors or the trust committee for this purpose. The committee reviews and either approves or rejects recommendations made by a research division, an outside investment advisor, or the department's investment officer. Often the committee has the responsibility of reviewing individual account portfolios and determining whether assets are invested in compliance with the trust department's overall investment policy.

Accounts for which the department exercises investment discretion should receive an investment review in accordance with the Statement of Principles of Trust Department Management. An initial asset review should, in most cases, be conducted promptly following acceptance, and should establish an investment program for the account. Reviews should include securities and other types of assets received with the account. The initial review is of great importance, as the fiduciary may be required to act quickly to protect assets from loss or erosion of principal, or to take immediate action to protect tangible assets from creditors, insurable losses or physical damage. *A fiduciary may have to compensate accounts that sustain investment losses due to the fiduciary's negligence such as a failure on the part of the fiduciary to act in a timely manner.*

The department's overall investment policy should be flexible enough to accommodate the types of fiduciary appointments accepted. For example, individual trusts under will or agreement are usually established for the purpose of providing income to the income beneficiary and leaving principal (corpus) to the remainderman at the termination of the trust. By contrast, employee benefit trusts need to generate sufficient growth and income to provide the promised retirement benefits to participants and their beneficiaries. Conversely, investment management agency accounts normally desire capital growth rather than income.

When the governing instrument is silent, investment authority or directions default to state law, which must be followed. When the governing instrument's language concerning investments is unclear, court approval should be obtained.

### Investment Policy Components

Investment policies should clearly set forth a framework for the selection, retention, review, and management of assets over which the department holds investment discretion. The policies should discuss the overall structure of the department's investment management responsibilities. They should provide for: appointing qualified officers to supervise daily investment activities; the monitoring of discretionary transactions, including the reporting of such transactions to the appropriate supervisory officers and committees; procedures for handling exceptions; and, formal procedures for reviewing and revising investment policies and practices. Depending on a department's size, complexity, and the types of appointments accepted, the following elements may also need to be addressed:

- Management's investment philosophy and standards of practice.
- A code of conduct for employees, officers, and directors who by their duties or supervisory roles have knowledge of, or access to: (1) discretionary investment transactions; or (2) the department's approved list of securities, or changes to the approved list of securities. FDIC Part 344 requires that bank officers and employees who make investment recommendations or decisions for accounts of customers file a report with the bank on a quarterly basis.
- Investments and investment practices deemed appropriate, or inappropriate, with regard to the management of discretionary accounts.
- The nature and size of accounts the department is qualified to administer, and the minimum standards required for the acceptance of new accounts.
- Pre-acceptance review of the transferred assets for new accounts.
- The initial review of newly accepted accounts.
- Investment reviews of existing accounts.
- Procedures for documenting investment reviews.
- Whether the department will prepare its own research in-house, or purchase investment research from outside investment advisors.
- Guidelines governing the use of outside investment advisor refer to Section 10.G.6 including:
  - Procedures for adopting and/or amending an approved list of investments recommended by outside advisors, if appropriate,
  - Procedures for diverging from outside advisor recommendations when appropriate, and
  - Procedures for monitoring purchases and sales to ensure compliance with the approved lists.
- Procedures for adopting and amending an approved list of equity investments based on in-house research, including:
  - Criteria for selecting the investments to be included on approved lists,
  - Criteria for monitoring the investments included on approved lists,
  - Description of the approval process for adding or deleting investments from approved lists, including specifying the person(s) having authority to make such additions or deletions, and
  - Monitoring purchases and sales to ensure compliance with the approved lists.
  - Procedures for making exceptions to the approved lists.
- Procedures for adopting and amending an approved list of mutual fund investments (inclusive of proprietary mutual funds, refer to subsection F.4.a, if appropriate) including:
  - Justification for the selection of a load fund over a no-load fund.
  - Criteria for the selection of the mutual funds to be included on approved lists,
  - Criteria for monitoring the mutual funds on the approved lists, and
  - Description of the approval process for adding or deleting mutual funds from the approved lists.
  - Criteria for diverging from the approved lists.

- Establishment of procedures for adopting and amending an approved list of obligors (corporate and municipal) of fixed income debt investments, if applicable, including:
  - Criteria for evaluating the credit risk of the obligors to be included on the approved lists,
  - Criteria for monitoring the credit risk of the obligors on the approved lists,
  - Description of the approval process for adding or deleting obligors from the approved lists, and
  - Monitoring purchases and sales to ensure compliance with the approved lists.
  - Criteria for making exceptions to the approved list.
- Guidelines for the development and use of asset allocation models, including:
  - Criteria or methodology for creating and modifying asset allocation models, and
  - Description of the process for supervisory review and approval of the models.
- Guidelines for the holding, purchasing, and managing of real property, including:
  - The evaluation of environmental risk, initially, and on an ongoing basis, and
  - Initial and periodic reappraisals/inspections of real property.
- Guidelines and procedures for holding closely held businesses, including:
  - Identification of conditions under which the department would administer such assets.
  - Criteria for contracting with a third party to run a closely-held business.
  - Methods and procedures for the initial and periodic evaluation of such assets
  - Whether the trust officer should serve on the board.
- Guidelines and procedures employed in the selection and use of money market mutual funds, including:
  - Periodic reviews of fund performance,
  - Methods for monitoring the use of and reliance on derivative products by such funds, and
  - Guidelines for the selection and use of funds paying 12b-1 fees, including: the appropriateness of such funds for each type of account administered, notification to customers of such fees, the solicitation of customer approvals when appropriate, and the routine disclosure to customers of such fees earned by investment of their accounts in such funds.
- Guidelines governing the use and monitoring of derivative investment products, as outlined in the FDIC Office of Capital Markets Examination Handbook and the FDIC Statement of Policy on Investment Securities and End-User Derivative Activities.
- Guidelines for the evaluation and management of assets deemed worthless.
- Guidelines and procedures for evaluating and monitoring exceptions, such as non-rated, or non-approved list, securities held in accounts. Refer to the following section.
- Guidelines and practices for securities lending. Refer to F.15.
- Guidelines and procedures governing loans from trust accounts (real estate, unsecured promissory notes, etc.).
- Guidelines and procedures regarding lending to, and permitted indebtedness of, managed accounts.
- Guidelines providing for the prompt investment of income and principal cash, unless the governing instrument, local law, or parties properly authorized to direct investments provide otherwise.

### Discretionary Asset Review Policies

It is generally acknowledged that trust departments are liable, to varying degrees, for all assets held, whether or not they possess investment authority. It also follows that greater authority imparts greater risk. Trust departments which are otherwise well managed may sometimes lack appropriate policies with respect to periodic reviews of assets not contained on the approved list. Many departments hold at least some assets in discretionary accounts that were not acquired through the exercise of discretionary authority. These include directed purchases, assets acquired "in-kind," and assets acquired through distributions, corporate re-

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organizations or liquidations. This is especially true with respect to assets acquired as executor, trustee under will, successor to previous fiduciaries, and through guardianship or conservatorship appointments. The value of these assets may represent a significant percentage of the market value of an individual account.

Trust management should institute written policies which affirmatively address the routine evaluation of all discretionary assets (refer to subsection F. Account Review Program, of Section 1). This is true whether or not the assets were acquired by virtue of management's fiduciary authority. At least once during the calendar year, all assets held in discretionary accounts should be reviewed and evaluated in light of governing instruments and individual account circumstances. Departments that adopt a "passive" stance over assets received in-kind increase their exposure to fiduciary risk. Trust management may believe it can eliminate this risk by obtaining "direction letters." Although prudent and necessary, at best, this reduces, but cannot eliminate, fiduciary risk. The beneficiaries may change or may lack the legal capacity to release the fiduciary from liability, as in the case of minors or the unborn. Likewise, account circumstances change and economic factors vary over time, sometimes dramatically and with little or no advance warning.

Also, asset management policies should address the retention process for all discretionary holdings. Investment policies should address minimally acceptable sources for outside research. They should also outline the minimum acceptable standards for documenting and approving the retention of assets and provide guidance for the sale of underperforming assets. Trust departments may fail to include all discretionary assets in their annual review function, thereby increasing fiduciary risk. Trust departments that have adopted an "approved list" approach may be at increased risk if they do not review discretionary assets that are not on their approved list.

Trust departments may hold assets for which they cannot obtain reliable valuations. Such assets may include limited partnership interests, investments in closely held businesses, the common stock of thinly traded or unlisted companies, partnership agreements, hedge funds, royalties, patents and copyrights, oil and mineral interests, etc. Asset pricing is an integral component of an annual portfolio analysis. It is also necessary for the preparation of estate tax returns (IRS Form 706), gift tax returns (IRS Form 709) and annual IRA account filings (refer to Section 5, F.1.). It is a key factor in the proper calculation of account fees and commissions (department earnings). In these situations, and in situations where management does not have the resources to adequately evaluate certain types of assets, it should seek outside expertise. Management may not, however, be able to pass the cost of these outside services through to the account, particularly when the assets in question were purchased by the department under its discretionary authority. Consequently, examiners should review accounts for inappropriate charges in this context.

## F. TYPES OF INVESTMENTS

Various investment vehicles are available for the investment of trust funds. The more common types of investments and some newer products are discussed below, along with applicable regulations, examination procedures and other related matters.

The Capital Markets Handbook defines products not outlined on the following pages and provides examination guidance. The Capital Markets Branch in the Washington Office can readily provide information concerning most investment products.

### Cash Management

#### *Money Market Funds*

Various money market funds are offered for the short-term investment of idle cash. These funds are mutual funds and have differing portfolios depending on the particular fund. Investments in domestic or foreign certificates of deposits, repurchase agreements, commercial paper, and short-term U.S. Government or agency obligations are some of the more common portfolio components. Although the trustee may have full investment discretion, it should be satisfied that the investment of trust funds in money market funds is permissible under state statutes. When trustees do not have full discretion, sufficient authority should be sought in state statutes or court decisions, the language of the account's governing instrument, or by obtaining binding consents from all beneficiaries or written instructions from the parties authorized to direct investment selection, before utilizing these funds. In general, it would not be considered appropriate to permanently place funds in this type of investment vehicle, as money market funds are considered short-term investments.

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Money market funds are registered under the Investment Company Act of 1940 and as such, are regulated by the Securities and Exchange Commission. Fund companies are required to provide a prospectus to the investor prior to purchase. The funds are required to have external audits. Prior to investing in a money market fund, the prospectus of the fund and portfolio composition should be reviewed to determine that the fund meets the objectives of the trust account. Thereafter, the fund should be reviewed periodically to ensure that the investment objectives continue to be met. In addition, there have been instances where money market funds have "broken the buck", referring to situations where the fund's net asset value falls below \$1 per share. This issue has recently resurfaced and concerns may be found at in Appendix G, Interagency Policy on Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates. Therefore, various risks such as credit, liquidity, concentration, operational, and reputation risks should be assessed by trust department management. Examiners should determine that money market funds have been properly analyzed prior to investment and that the funds are periodically reviewed. Appropriate comments should be included in the Report of Examination if such funds have not been properly analyzed or if such investments are inappropriate for the accounts involved.

### *External Sweep Arrangements*

Money market funds generally accrue interest daily and pay interest at the end of the month. Many trust departments now have services which automatically invest available cash exceeding predetermined dollar limits in a money market fund. These are commonly called "sweep" arrangements.

Fiduciaries are obligated to keep funds productive. Uninvested cash of discretionary appointments should be invested "temporarily" until "permanent" investments are chosen or pending the implementation of an investment program or distribution to beneficiaries. Uninvested principal cash, including cash not awaiting immediate distribution or payment against a draft, are often "swept" at the close of each business day into some form of interest-bearing investment vehicle. Income cash should be treated in a similar manner. Current technology makes possible, and prudent fiduciary investment philosophies advocate, the full employment of all cash in some form of productive investment. Management's failure to invest cash when appropriate and practicable should be considered imprudent and a breach of fiduciary duty subject to criticism. In those cases where the fiduciary is responsible for the investment of cash, it is difficult for a fiduciary to justify permitting cash to remain idle when it is possible to make it productive. It would be unusual, given the current state of investor awareness, for customers to be indifferent to a fiduciary's intentional failure to invest large cash balances.

The investment of nondiscretionary cash is largely governed by the terms of the account agreement. There may be instances, however, when the account agreement lacks specific directions concerning how cash is to be invested, and the customer has not provided any specific instructions. Examiners, in such cases, should be careful when "interpreting" a trust department's investment authority with respect to the investment of cash balances. In such cases, management should be encouraged to modify the governing account agreements in a manner to resolve any ambiguity concerning the department's responsibility to invest cash. In addition, faced with such uncertainty, the fiduciary should contact the account principal and request direction concerning the investment of the cash.

Examiners may encounter situations in which the trust department charges an additional fee ("sweep fee") for performing cash management services. The taking of such fees is customarily governed by state law and examiners should determine the permissibility of assessing additional fees under local statutes. If permissible under state law and not prohibited by the account agreement, the fee charged should be reasonable for the service performed. Additionally, the department should fully disclose the imposition of the fee to interested parties. The amount of fees charged relative to the sweep arrangement should be disclosed periodically in the account statements sent to customers. The charging of sweep fees in **ERISA accounts is not strictly prohibited**. Refer to Section 5, subsection H.7.f.(20). Sweep Fees for additional guidance for ERISA accounts.

### *Deposits*

Deposits, whether time, savings, or demand, are another common form of investment. The deposits could be in another institution or in the commercial department of the bank under examination. Often times, such investments provide the safety and liquidity needed by the account. However, given the availability of numerous other investment vehicles providing similar safety and liquidity, examiners should determine whether deposit holdings result from a lack of management initiative to seek other investment opportunities. Large holdings of non-interest bearing deposits should be scrutinized, since it is a fiduciary's duty to



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make trust assets productive. Discretionary deposits with the commercial bank should also be reviewed, given the conflict of interest and self-dealing aspects of such investments.

Some trust departments sweep cash to the commercial department's deposit accounts on an overnight basis, rather than sweep to an external investment vehicle. In those situations, bank management should have a strategic plan for the activity. Within that plan, management should not view overnight trust funds as a long-term funding source for the commercial department. Management should have calculated the costs, including interest on deposits and the FDIC deposit insurance assessment. More importantly, trust management should be able to demonstrate that the customer is at least as well compensated, as he would have been with an external sweep, usually a money market fund. Care should also be taken to assure the deposit account is appropriately titled in the commercial department's records to insure pass-through deposit insurance coverage. Examiners should be aware that Section 24 of the FDI Act prohibits the pledging of bank securities to secure deposits of trust accounts. However, an irrevocable letter of credit issued by an agency of the U. S. Government or a surety bond, issued on behalf of the bank or trust department, is allowable under the regulation.

Refer to Section 8. E.3. Use of Own Bank or Affiliate Deposits, of this Manual for additional guidance in this area.

Federal deposit insurance coverage of trust account deposits is discussed in Section 10, subsection L. Deposit Insurance of Trust Funds.

### ***Overdrafts***

Overdrafts occur for numerous reasons, including timing differences related to cash receipts and disbursements. Overdrafts should be short term in nature, and rare in occurrence. The department should not be funding securities purchases with overdrafts. Such a practice reflects poor cash management of an account. Likewise, the failure of the department to properly plan for recurring or expected disbursements, resulting in a lack of liquid assets to fund disbursements, reflects poor cash management. These and similar events, if prevalent, should be criticized. The department should have a policy governing overdrafts. The policy should include review procedures, methods for curing overdrafts, and the action(s) that will be taken if an overdraft cannot be cured within a reasonable time period. Overdrafts outstanding for long periods of time should be treated as a loan to the account.

### **Fixed Income Products**

In those states where the Prudent Investor Act has been adopted, the suitability of the entire portfolio should be reviewed as a whole, and individual investments are not considered inherently good or bad based solely on investment type or credit rating.

In states which operate under the Prudent Man Rule, investments are considered prudent or imprudent on an individual basis. Therefore, investments can be considered inherently prudent or imprudent based solely on investment type or credit rating.

The following is a brief overview of the more common investments and some newer products found in trust departments. For particular products and their risks not included on the following pages, examiners should refer to the Capital Markets Examination Handbook and the Manual of Examination Policies, used for safety and soundness examinations.

### ***Corporate Debt Issues***

Marketable debt securities (bonds, debentures, etc.) generally comprise a significant portion of a trust department's assets. The selection of acceptable debt instruments for discretionary accounts should be based on research performed in-house, acquired from outside sources, or a combination of the two. The department may also rely on ratings provided by the nationally recognized rating agencies. The rating bands for three of the rating services are outlined in this section. As seen in recent events, highly rated debt issues can decline into sub investment quality rating bands or go into default. Therefore, management should monitor investments on an on-going basis to determine that the issue remains suitable for the account. As previously stated, the Prudent Investor Act does not preclude the investment in or continued holdings of sub investment quality securities. However, speculation is inappropriate for trust accounts.

InterNotes are investment grade, medium-term notes, offered in minimum denominations of \$1,000 to retail investors. InterNotes represent the debt of each respective issuer and are subject to credit and secondary market risk. The notes are offered via a

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prospectus, and issues are sold at par value. Each week, new offerings from various corporations are made, and include issues with varying maturities, coupons, and interest payment schedules (monthly, quarterly, semi-annually.) InterNotes appear to have a shelf registration, meaning that the amount offered in the prospectus is registered once, and the issuer can offer amounts under that prospectus as needed.

An example of an InterNote may be the following:

- \$6 billion issue from a corporation under a prospectus dated August 2002.
- Separate CUSIP numbers are assigned to specific terms, such as maturities, coupons, and call provisions, which represent amounts used under the registration.
- The offer as stated is valid for a week, and the minimum investment (denomination) and increments are \$1,000.
- The products are rated by nationally recognized rating agencies and the ratings are posted on the InterNotes' website, along with other information concerning terms.
- Some InterNotes are based on floating rates, indexed to short-term rates.
- The products are directed at small, retail investors, in lieu of certificates of deposits and may be received in-kind.

### *Municipal Bond Issues*

The department may invest in debt obligations issued for the benefit of local municipalities, school districts or other small governing authorities. Industrial revenue bonds may be issued for the benefit of corporate entities. Frequently, municipal bonds will be received in-kind rather than purchased by the department. The issues may or may not be rated. The lack of a rating may result from the expectation that the issue will be sold to a limited number of investors in the local community, or the cost of acquiring a rating may be expensive in relation to the size of the issue. However, non-rated, does not necessarily equate with investment quality. Trust management should analyze prior to purchase and periodically thereafter to determine that the issuer is creditworthy. Management should establish policies and procedures including selection criteria and investment review procedures when non-rated investments are purchased for discretionary accounts.

Municipal bond issues may be appropriate for managing the customer's tax position, but normally the investment should not be placed in tax deferred accounts, such as employee benefit accounts, as the accountholder does not gain any additional tax benefit from the exemption. Private activity bonds used for funding football stadiums, basketball arenas, etc., are subject to the Alternative Minimum Tax and may affect the customer's income tax liability. In either of these or other scenarios, management should determine and document the suitability for the accountholder.

### CORPORATE & MUNICIPAL BOND RATINGS

Description	Moody's*	Standard & Poor's**	Fitch**
Highest quality, "gilt-edged"	AAA	AAA	AAA
High quality	Aa	AA	AA
Upper medium grade	A	A	A
Medium grade	Baa	BBB	BBB
Predominantly speculative	Ba	BB	BB
Speculative, low grade	B	B	B
Poor to default	Caa	CCC	CCC
Highest speculation	Ca	CC	CC

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Lowest quality, no interest	C	C	C
In default, in arrears, questionable value		DDD DD D	DDD DD D

\* Moody's uses numerical modifiers 1 (highest), 2 and 3 in the range Aa1 through Ca3.

\*\* Standard and Poor's and Fitch may use + or – to modify some ratings.

### ***Collateralized Mortgage Obligations (CMO)/Real Estate Investment Conduits (REMIC)***

CMOs are a mortgage derivative security consisting of several classes secured by mortgage pass-through securities or whole mortgage loans. Principal and interest payments from the underlying collateral are divided into separate payment streams that repay investors in the various classes at different rates. All collateralized mortgage obligations now issued are in Real Estate Mortgage Investment Conduit (REMIC) form. REMIC classes include sequential pay tranches, planned amortization classes (PAC), and targeted amortization classes (TAC). These tranches are generally more stable than some of the tranches outlined below.

The following tranches are generally more sensitive to changes in interest rates:

- Stripped Mortgage-Backed Securities - The separation of interest or principal cash flows from the underlying mortgage assets give I/Os and P/Os vastly different risk profiles. These products are highly sensitive to changes in interest rates.
- Interest-Only Stripped Mortgage-Backed Securities - A pure I/O consists entirely of a premium. The value of the I/O is the present value of the future interest payments based on the underlying collateral.
- Principal-Only Stripped Mortgage-Backed Securities - P/Os are generally sold at a discount, and the investor realizes a return on investment, as principal is returned at par and the discount is returned as income. (Refer to the Uniform Principal and Income Act for a discussion on determining income.)
- Inverse Floaters - The coupon varies inversely to an index. As the floating rate class of securities within the issue is larger than the inverse floating rate tranche, leverage factors or multipliers are used to balance the inverse tranche with the floating rate tranches. Leverage factors or multipliers can magnify the effect of minor interest rate movements.

Prior to investing in any product, management should perform the appropriate due diligence. A copy of the prospectus and pre-purchase analysis should be retained in the trust files. Subsequent evaluations consisting of total return screens, stress tests, or volatility analyses performed by management should be retained for REMICs. This documentation should support the continued investment in the product.

The trust investment officer should have expertise in managing these instruments. Management should be fully aware of all derivative holdings and be able to explain how these instruments benefit the individual account. During account and investment reviews, management's knowledge of the products should be documented and the use in a particular account should be demonstrated through written comments or exhibits retained in file. Trust departments that cannot adequately demonstrate a reasonable level of knowledge of a derivative investment and its associated risks should be criticized.

For employee benefit accounts, an apparent violation of ERISA Section 404(a)(1)(B) (prudence), which can be found in Section 5.H.5.c r) should be cited. The basis for the apparent violation is detailed in the DOL advisory opinion letter issued to the OCC on March 21, 1996, entitled "Investments in Derivatives." Derivatives are defined in the letter as a financial instrument whose performance is derived in whole or in part from the performance of an underlying asset. Examples include futures, options, options on futures, forward contracts, swaps, structured notes, and collateralized mortgage obligations. In that letter, the DOL opined that the products are permissible. However, trust management is responsible for assessing the inherent risks of derivatives by "securing sufficient information to understand the investment prior to making the investment." The letter discusses the importance of performing stress simulations under normal and abnormal market conditions, the effect of volatility on the plan's portfolio, and the ability to properly analyze the investment. A copy of this letter is contained in Appendix E.

The trust policy should provide guidance, as to when investments in derivatives are appropriate and how investment risks will be managed. Parameters should be established for the dollar volume and interest rate risk that is acceptable for accounts, and formal

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monitoring and reporting mechanisms should be established. Furthermore, management should understand the types of risks involved in each derivative investment and should not rely solely on the statements of the selling broker, as an impartial analysis of such risks. A broker's job is to sell a product, and often the riskier the product being sold, the greater the broker's commission.

Potential risks associated with such derivative investments consist of the following:

- The investment is bought in a large block, and several accounts hold the investment. An individual account's investment may not be liquid. For example, when an individual account needs to liquidate the asset, the question becomes how liquid is that individual account's investment. Also, is the holding in a saleable lot and at what price for a relatively small holding rather than a block transaction? Management may determine that the particular account's portion is not liquid and may sell the asset to another account. When inter-account transactions occur, self-dealing or conflicts of interest are a major concern. Also, management should have documentation supporting the transaction price. However, the pricing used may be matrix pricing, which is a calculated price. While matrix pricing should be reliable under normal circumstances, the pricing does not incorporate every conceivable outside factor which may influence pricing.
- Trust accounting systems should provide for adequate, timely and accurate pricing of derivative investments. Many pricing services do not have sufficient capability in this area. In such cases, trust accounting systems often default to the purchase price or face value of the investment. As products return principal and income, the purchase price may greatly overstate to the value, if the trust accounting system does not accept paydowns. Each CMO tranche has a factor, indicating the amount outstanding as a percent of the original face amount. Normally, these factors are available on the payment of principal and interest ticket or for FNMA issued REMICs, on the agency's website. The Capital Markets Branch in the Washington Office can provide factors and other information regarding these and other products.

### *Asset-Backed Securities (ABS)*

Asset-backed securities are debt instruments secured by installment loans or leases or revolving lines of credit. Common ABS collateral includes credit card receivables, automobile loans, automobile lease, mobile homes, and home equity loans. The ABS can be in the form of a pass-through or in a REMIC. Depending upon the structure, the investor either receives a pro rata share of the principal and interest payment or a structured payment.

### *Structured Notes*

These are hybrid securities that combine fixed term, fixed or variable rate instruments, and derivative products. Structured notes are debt securities issued by corporations or government-sponsored enterprises, including the Federal Home Loan Bank, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. Most corporate structured notes are issued through shelf-registered medium-term note programs. The shelf-registration allows the issuer to issue up to \$1 billion in debt over a two-year period, without re-registering with the SEC. Structured notes generally contain embedded options and have cash flows that are linked to the indices of various financial variables, such as interest rates, foreign exchange rates, commodity prices, prepayment rates, and other financial variables. Structured notes can be linked to different market sectors or interest rate scenarios, such as the shape of the yield curve, the relationship between two different yield curves, or foreign exchange rates.

### *Trust Preferred Securities (TPS)*

#### Overview

Trust Preferred Securities originated in 1993, with industrial and utility companies being the primary issuers. Since then, both large and small bank holding companies have issued the hybrid investment product: The securities have characteristics that resemble both corporate debt and preferred stock. The debt-like characteristics include the tax deductibility of distributions, a fixed maturity date, a stated coupon or formula for the calculation of the coupon, and the ability of investors to accelerate claims against the company in the event of default. The securities rank behind both senior and subordinated debt in terms of repayment priority. The equity-like characteristics include resembling cumulative preferred stock, subordinating to other obligations, and representing a minority interest in a wholly-owned subsidiary. Currently, TPS issued by bank holding companies are limited to 25 percent of Tier 1 capital. All TPS have an interest deferral feature of up to 5 years. In general, TPS have a 30-year maturity, although TPS can be issued with a maturity of up to 50 years. The securities generally have a par value of \$25 for retail investors, a \$1,000 for institutional investors is the norm. A call provision of 5 or 10 years is common for the institutional class investor.

### TPS Structure and Flow of Funds

#### *Underlying Structure*

First, the parent company establishes a wholly-owned special purpose subsidiary (a grantor trust), whose sole purpose is to issue the securities. The holding company then acquires all of the special purpose trust's common stock. Next, the trust issues preferred stock to the public, representing an undivided interest in the trust's assets. The holding company guarantees, on a subordinated basis, that the trust preferred securities holders will receive interest payments. The trust then lends the proceeds back to the parent company to purchase junior subordinated deferral debenture with identical terms. The interest that the trust receives from the funds lent to the parent company is used to pay the dividend on the trust preferred securities. In general, TPS are considered a variable interest entity and subject to FIN 46 - Special Purpose Entity accounting.

Common structures:

- Monthly income preferred securities (MIPS)
- Quarterly income preferred securities (QUIPS)
- Pooled Trust Preferred Securitization

In a pooled trust preferred offering, an additional trust is added to the structure and is referred to as a business trust. The business trust issues securities to investors and uses the proceeds to purchase all of the trust preferred securities from the grantor trust, as described above. The trust preferred securities are then securitized, as the business trust is the sole investor of the securities. A pooled trust preferred security is a form of a collateralized debt obligation backed by various trust preferred securities. The pooling crosses geographical lines and therefore limits concentration risk.

Eligible trust preferred securities are issued by bank or financial holding companies, whose subsidiaries' deposits are FDIC insured. The individual holding company must have assets of at least \$200MM or deposits of \$100MM. The entity must have been in operation for at least 5 years and have a Tier 1 risk-based capital ratio of 10 percent or more.

#### *Deferral Period*

TPS can defer interest payments for 20 consecutive quarters, unless the deferral would extend beyond the stated maturity. While the deferral period is not considered a default, the reputation of the issuer is harmed. Further, while the interest may be deferred, it still must be paid. Therefore, the deferral period is also an accumulation period for interest. The issuer can enter into a deferral period, pay investors income due, and enter back into another deferral period. As long as there is a cleanup period, successive deferral periods are allowable.

#### *Investment Considerations*

TPS with fixed rate coupons and lives of 30 to 50 years are sensitive to interest-rate fluctuations. Coupons for these products are normally high in relation to market rates for long-term Treasury securities and generally yields are higher than those of corporate bonds or preferred stock issued by the same corporation. While the products contain call provisions, there is usually a lock-out period on the call.

An alternative to the fixed rate TPS is the floating rate TPS. The coupon for the floating rate issues may be based on a short-term rate, such as three-month LIBOR plus a spread. By reducing the interest-rate risk, these products have significantly less attractive coupons than the fixed rate products.

Trust preferred securities are rated by nationally recognized rating firms. For the pooled trust preferred issuance, only the senior notes and mezzanine notes are rated, with the senior notes carrying a higher rating. The income notes are not rated and are similar in concept to a residual.

Payments may be deferred for up to five years, but that action is not considered a default. However, TPS are not immune to default. For example, Enron issued TPS that have since defaulted. In the event of bankruptcy, the TPS are below all senior and subordinated debt, but above equity securities in priority.

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While the previously mentioned deferral period may harm the issuer's reputation, from an investor's point of view, the deferral period can be significant, also. During the deferral period, the investor is liable for including the deferred income in gross income for federal income tax purposes, where it is considered original-issue discount. To collect the accrued but unpaid income, the investor must own the security on the date dividends are finally paid.

### Employee Benefit Account Considerations

Investments in affiliated holding company trust preferred securities should be carefully reviewed. The transactions may be considered a "party in interest" under ERISA or a "disqualified person" within the meaning of Section 4975 of the Internal Revenue Code with respect to employee benefit plans and individual retirement accounts. The purchase of trust preferred securities by an employee benefit plan or IRA that is subject to the fiduciary responsibility provisions under ERISA or prohibited transaction provisions under Section 4975(e)(1) of the Internal Revenue Code may constitute a prohibited transaction. Prior to investing in trust preferred securities issued by the parent company, management should consult with legal counsel knowledgeable of ERISA and the Internal Revenue Code.

A prohibited transaction may occur when employee benefit accounts or IRAs are transferred from one institution to another. If the account held a TPS of the second holding company and transferred the asset into an account at a subsidiary of the second holding company, a prohibited transaction may occur.

### **Church Bonds**

Church bonds are certificates of indebtedness issued by churches, and proceeds from the sale are used primarily to fund acquisition or expansion of the church property. Churches use the funding when conventional borrowing is not available; the bonds are secured by mortgages. In general, the bonds are held by members of a particular church. Maturities range from 6 months to 15 years, with interest paid or compounded every 6 months. The bonds are promoted as acceptable investments for Individual Retirement Accounts, although the ability to accurately value the bonds is questioned. Furthermore, the bonds most likely will not be rated, due to the nationally recognized rating agencies not analyzing this type of investment, nor are the churches willing to pay for a rating, especially when the rating may be less than investment quality.

### **Equity Securities**

Marketable equity securities may comprise a significant portion of a trust department's assets. Equity investments selected for accounts where the trust department exercises investment discretion should be based on research that is either performed in-house, acquired from outside sources, or a combination of the two.

The department may also consider equity ratings assigned by rating agencies and services. In recent months, various financial service organizations, such as Charles Schwab, have established proprietary equity ratings, in addition to those established by the better known national rating agencies. While the rating scales used by either the rating agencies or the financial service organizations appear similar to the bond rating scales, equity ratings do not have the same purpose as bond ratings. The stock rating represents the expected performance of the stock and/or its risk level, while a bond's rating is based on perceived creditworthiness. Therefore, a "C" rated equity may be considered as a hold, whereas a debt rated "C" is indicative of a security at or nearing default. Given the numerous entities issuing equity ratings, trust management should maintain a copy (paper or electronic) of the rating criteria and definitions used by the particular rating service.

The department may develop its own "approved list" based on in-house research; it may adopt the approved list of an outside investment research firm; or it may modify the "approved list" provided by an outside research firm. If the department uses in-house research or adopts its own version of an outside research firm's "approved list," there should be policies describing the criteria used to include investments on the "approved list," as well as procedures for reviewing such selections. Investments in equity securities should be suitable for the purpose and investment objectives of the account.

Restricted equity securities are not subject to registration under Federal securities laws. The securities certificates usually contain a "legend" stating that they are transferable only upon certain conditions, such as after a certain date or after "x" years. The securities must have been obtained in a transaction not involving a public offering. Normally a trust department acquires such securities in-kind rather than by purchase. To sell such securities, the trust department must comply with the requirements of SEC

Rule 144, issued under the Securities Act of 1933 (refer to SEC regulations at 17 C.F.R. Section 230.144). For additional information, refer to Section 3.k.2. Restricted Equity Securities.

### *Financial Derivatives*

The following are the four types of Interest Rate Derivative Instruments: interest rate options; interest rate futures and forwards; interest rate swaps; and, interest rate caps, floors, and collars. These instruments are principally designed to transfer price, interest rate, and other market risks without involving the actual holding or conveyance of balance sheet assets or liabilities. Examiners are unlikely to find these types of instruments in a trust department unless the investment portfolio is exposed to some risk that can be mitigated by the use of one of these instruments. Some examples of how these vehicles could be used include: using foreign currency swaps to reduce foreign exchange risk, purchasing a call option to lock in the price of a security which the department expects to purchase in the future, purchasing a put option to establish a future selling price, and writing covered call options to enhance the yield of a portfolio.

Some trust departments use over-the-counter put and call options for accounts as a means of increasing trust account revenue. The writer of put and call options is paid a fee for selling these contracts. The purpose of using exchange traded options would be to take advantage of price fluctuations. Whether engaging in options transactions is legally permissible for trust accounts depends upon the terms of the agreement, and the applicable state law governing the investments permitted for specific types of accounts. Employee benefit trusts are governed by the prudent investment standards in Section 404(a)(1)(B) of ERISA and in DOL regulations at 20 C.F.R. Section 2550.404a-1.

Many departments have restricted option writing activity to covered call options. However, it is recognized that under certain conditions, the writing of put options, within clearly defined policy parameters, may be an acceptable and appropriate investment strategy for some accounts. Prior to approving the utilization of options as an investment strategy, the board of directors, or an appropriately designated committee thereof, should ensure that adequate policies and procedures are established to measure, monitor and control the risks involved. The policies should: address the propriety of option writing for different types of fiduciary accounts; define the permissible option strategies that may be employed; define the dollar volume of options that may be written by individual accounts; establish procedures for reporting and approving such transactions; and prescribe control and record keeping practices. The policies should be reviewed on a regular basis, no less frequently than annually. The trust department should also obtain an opinion from bank counsel as to the legality of these activities.

When a department writes a covered call option on stock held in its trust accounts, it sells to a third party the right (option) to purchase that stock (call) at a specified price until a specific date. Possession of the stock by the trust account makes the written option "covered."

Receipt of cash (fee) paid by the third party for the option provides an additional return on the stock if the market price remains the same and cushions the potential loss if the market value declines. An element of risk is involved if the market value of the stock rises above the strike price, in which case the holder of the option will exercise the right to purchase the stock at the previously agreed upon price. In such instances, by granting of the option, the trust account foregoes any price appreciation over the strike price of the option. If the option contract is written and exercised on a bond, the trust account will receive the cash proceeds resulting from the sale, but reinvestment of these funds in a rising market will likely result in a reduced yield (income) to the account.

The following guidelines should be followed by examiners in reviewing investments in call options: (1) Sufficient authority must exist to make such investments. Such authority might consist of specific authority in the governing instrument, specific or express authority in applicable state law, the written and binding consent of all account beneficiaries, an order from a court of competent jurisdiction, or in those cases where the governing instruments and state law are silent, applicable Prudent Man or Prudent Investor Rules; (2) Such an investment must be prudent for each trust account involved, coupled with a determination that employment of an option writing strategy is consistent with the needs and investment objectives of the account; and (3) The trust department should have the necessary technical expertise to monitor and execute such transactions, which should be documented in accordance with approved policy by appropriate records, reviews and approvals.

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### *Variable Annuities*

#### Overview

The Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) regulate the sale of variable annuities, as the products are registered with the SEC as securities. The variable annuity is a contract between a purchaser and an insurance company, where the latter makes periodic payments to the purchaser beginning either immediately or at some future time. The purchase can be made by a single, lump-sum payment, or by multiple payments. All investments in variable annuities should be viewed as a long-term investment.

A range of investment options are offered, although investments in mutual funds are the most common. The underlying assets are generally invested in stocks, bonds, or money market funds. The rate of return varies with the investments selected. While the investment options may consist of mutual funds, variable annuities differ significantly from mutual funds, by the following:

- Variable annuities provide periodic payments and protect the owner from outliving his assets.
- The beneficiary is guaranteed a specified amount if the purchaser dies before receiving payments.
- The income and gains are tax-deferred until withdrawn.
- When withdrawing funds, income is taxed at the ordinary rate, and not the lower capital gains rate.

Variable annuities should not be used in lieu of 401(k)s or other similar plans, as the contributions are not excluded from current income. Once a 401(k) or similar plan is funded to the legal maximum contribution, variable annuities may be an investment option. Generally, variable annuities should not be held in retirement accounts, such as 401(k) or IRA, as those accounts are already tax deferred. There is no additional advantage to owning tax deferred products in such accounts (this would be the same for municipal bonds.) However, examiners should determine if there are any other reasons to hold such products.

#### Phases

The product has two phases. The first phase is the accumulation phase. During that time, the purchaser allocates investments amongst various investment options. Just like a mutual fund, the investment selected will increase or decrease in value based on the fund's performance. During this phase, funds can be transferred between investment options, without a tax consequence. However, withdrawing funds during this time may result in "surrender charges." Withdrawals prior to age 59 ½ are also subject to a 10 percent federal tax penalty.

The second phase is the payout phase. The payout may be a lump-sum payment or multiple payments, usually monthly. The purchaser, not the insurance company, selects the number of payments under the multiple payment option. Some annuity contracts are structured as immediate annuities, which provide protection against market downturn, and which, upon purchase, provide payments that are guaranteed for life. In this form, there is no accumulation. Since 2001, sales of the immediate annuities have experienced substantial growth, while variable annuities in general were on the decline. Several financial service providers have entered the immediate annuity market. Finally, the payout phase may be structured as a deferred annuity, where payments are delayed into the future.

#### Cost and Fee Structure

The cost and fee structure of variable annuities can be high. First, a surrender charge is assessed when funds are withdrawn (surrendered) prior to the end of a set period of time. This period may be as long as ten years. The sales charge is used to pay a commission to the representative who sold the product. Each year the surrender charge percent decreases. In addition, a mortality and expense risk charge is assessed annually. This charge covers the guaranteed death benefit, payout options that are guaranteed for life, or administrative charges. Administrative fees are charged to cover recordkeeping and other expenses. Other fees, known as underlying fund expenses, such as an initial sales load, transfer fees, and fees for stepped-up death benefits, may also be charged. Fees should be fully disclosed in the prospectus. The annual fees can reach two percent of the annuity's value.

Individuals can exchange their current variable annuity for a different variable annuity without paying tax on the income or gains under Section 1035 of the US Tax Code. While this allows a tax-free exchange, other fees such as surrender charges may still apply.



### *Insurance Company Ratings*

The guarantee provided by the insurance company is only as good as the insurance company that offers the product. Insurance companies are rated by nationally recognized rating services, such as A. M. Best Company, Moody's Investor Service, Fitch Ratings, Standard & Poor's Insurance Rating Services, and Weiss Ratings. Each service provides ratings, but ratings from one rating service to another are not comparable, without knowing the rating agency's definitions. The following are the ratings and definitions from A. M. Best Company.

#### Definitions of Best's Ratings and Not Rated Categories (NR)

##### Secure Best's Ratings

###### A++ and A+ (Superior)

Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders.

###### A and A- (Excellent)

Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders.

###### B++ and B+ (Very Good)

Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.

##### Vulnerable Best's Ratings

###### B and B- (Fair)

Assigned to companies that have, in our opinion, a fair ability to meet their current obligations to policyholders but are financially vulnerable to adverse changes in underwriting and economic conditions.

###### C++ and C+ (Marginal)

Assigned to companies that have, in our opinion, a marginal ability to meet their current obligations to policyholders but are financially vulnerable to adverse changes in underwriting and economic conditions.

###### C and C- (Weak)

Assigned to companies that have, in our opinion, a weak ability to meet their current obligations to policyholders but are financially very vulnerable to adverse changes in underwriting and economic conditions.

###### D (Poor)

Assigned to companies that, in our opinion, may not have an ability to meet their current obligations to policyholders and are extremely vulnerable to adverse changes in underwriting and economic conditions.

###### E (Under Regulatory Supervision)

Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control or restraint, whereby they are no longer allowed to conduct normal ongoing insurance operations. This would include conservatorship or rehabilitation but does not include liquidation. It may also be assigned to companies issued cease and desist orders by regulators outside their home state or country.

###### F (In Liquidation)

Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

###### S (Rating Suspended)

Assigned to rated companies that have experienced sudden and significant events affecting their balance sheet strength or operating performance whose rating implications cannot be evaluated due to a lack of timely or adequate information.

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#### Not Rated Categories (NR)

##### NR-1 (Insufficient Data)

Assigned predominately to small companies for which A.M. Best does not have sufficient financial information required to assign rating opinions. The information contained in these limited reports is obtained from several sources, which include the individual companies, the National Association of Insurance Commissioners (NAIC) and other data providers. Data received from the NAIC, in some cases, is prior to the completion of the cross-checking and validation process.

##### NR-2 (Insufficient Size and/or Operating Experience)

Assigned to companies that do not meet A.M. Best's minimum size and/or operating experience requirements. To be eligible for a letter rating, a company must generally have a minimum of \$2 million in policyholder's surplus to assure reasonable financial stability and have sufficient operating experience to adequately evaluate its financial performance, usually two to five years. General exceptions to these requirements include: companies that have financial or strategic affiliations with Best's rated companies; companies that have demonstrated long histories of financial performance; companies that have achieved significant market positions; and newly formed companies with experienced management that have acquired seasoned books of business and/or developed credible business plans.

##### NR-3 (Rating Procedure Inapplicable)

Assigned to companies that are not rated by A.M. Best, because our normal rating procedures do not apply due to a company's unique or unusual business features. This category includes companies that are in run-off with no active business writings, are effectively dormant, underwrite financial or mortgage guaranty insurance, or retain only a small portion of their gross premiums written. Exceptions to the assignment of the NR-3 category to run-off companies relate to those that commenced runoff plans in the current year or are inactive companies that have been structurally separated from active affiliates within group structures that pose potential credit, legal or market risks to the group's active companies.

##### NR-4 (Company Request)

Assigned to companies that were assigned a Best's Rating but request that their ratings not be published because the companies disagree with Best's rating conclusion. The NR-4 will be assigned at the request of the company following the dissemination by A.M. Best of the latest letter rating assignment.

##### NR-5 (Not Formally Followed)

Assigned to insurers that request not to be formally evaluated for the purposes of assigning a rating opinion. It is also assigned retroactively to the rating history of traditional U.S. insurers when they provide prior year(s) financial information to A.M. Best and receive a Best's Rating or another NR designation in more recent years. Finally, it is assigned currently to those companies that historically had been rated but no longer provide financial information to A.M. Best because they have been liquidated, dissolved, or merged out of existence.

#### Rating Modifiers and Affiliation Codes

Under Review (u) Rating Modifiers are assigned to Best's Ratings to identify companies whose rating opinions are Under Review and may be subject to near-term change. Best's Public Data (pd) Rating Modifiers may be assigned to Health Maintenance Organizations (HMOs), Canadian, UK and other European insurers that do not subscribe to our interactive rating process. Best's Public Data Ratings reflect both qualitative and quantitative analysis using publicly available data and other public information. Syndicate (s) Rating Modifiers are assigned to syndicates operating at Lloyd's. Affiliation Codes are based on a Group (g), Pooling (p) or Reinsurance (r) affiliation with other insurers.

Rating Modifiers	Affiliation Codes
u – Under Review	g – Group
s – Syndicate	p – Pooled
pd – Public Data	r - Reinsured

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For a complete definition of Best's Ratings, please refer to the Preface of Best's Insurance Reports or Best's Key Rating Guide. Best's Ratings reflect our independent opinion but are not a warranty of a company's financial strength and ability to meet obligations to policyholders.

For the latest Best's Ratings, visit <https://web.ambest.com/home>.

#### Financial Size Categories (FSC)

Assigned to all companies and reflects their size based on their capital, surplus and conditional reserve funds in millions of U.S. dollars, using the scale below.

To enhance the usefulness of our ratings, A.M. Best assigns each company a Financial Size Category (FSC). The FSC is designed to provide the subscriber with a convenient indicator of the size of a company in terms of its statutory surplus and related accounts. Many insurance buyers only want to consider buying insurance coverage from companies that they believe have sufficient financial capacity to provide the necessary policy limits to insure their risks. Although companies utilize reinsurance to reduce their net retention on the policy limits they underwrite, many buyers still feel more comfortable buying from companies perceived to have greater financial capacity.

FSC I	less	than	1
FSC II	1	to	2
FSC III	2	to	5
FSC IV	5	to	10
FSC V	10	to	25
FSC VI	25	to	50
FSC VII	50	to	100
FSC VIII	100	to	250
FSC IX	250	to	500
FSC X	500	to	750
FSC XI	750	to	1,000
FSC XII	1,000	to	1,250
FSC XIII	1,250	to	1,500
FSC XIV	1,500	to	2,000
FSC XV	greater	than	2,000

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### *Exchange Traded Funds*

An Exchange Traded Fund (ETF) is an index-linked portfolio of securities. ETF portfolios are purposely structured to replicate as nearly as possible the performance of a specific index. Precise replication is not possible due to expense factors in operating the trusts which hold the securities and other factors. This form of investing is sometimes referred to as "passive," since the portfolio of an EFT is not actively managed by any investment manager. Their composition is dictated by securities comprising the index itself, and they typically do not change unless the composition of the index changes. As with all investments, the inclusion of ETFs in any portfolio should conform with the requirements of local law, the governing instruments, the needs and requirements of both current beneficiaries and remainder interests, and the overall investment strategy and investment objectives of the particular accounts. Individual account records and trust management's investment records should document the basis for investing in an ETF, both initially, and on a continuing basis.

Most ETFs are structured as unit investment trusts and listed on the American Stock Exchange. ETFs can be purchased and sold like stocks. They are similar to mutual funds in that they consist of a diversified portfolio of stocks but are dissimilar in that they are typically concentrated in a single industry, market, or based on some economic benchmark. Consequently, the performance of some ETFs may be more volatile than those which are based on broader indices. They are also dissimilar to mutual fund operated index funds in that they can be traded throughout the day. ETFs are traded on an exchange, and prices are available continuously throughout the trading day. Investors must also pay broker commissions on ETF purchases and sales. Most mutual funds can only be purchased and sold at the end of a trading day at the fund's Net Asset Value.

The more common of the Exchange Traded Funds are:

The NASDAQ-100 Index Tracking Stock (ticker symbol QQQ) is designed to track the performance of the 100 largest non-financial U.S. and non U.S. companies listed on the National Market tier of NASDAQ. It was created March 10, 1999. NASDAQ-100 Index Tracking Stock Options are standardized put and call options on the underlying index. These options are also available for covered call writing.

The NASDAQ-100 Index Tracking Stock is structured as a regulated investment company trust. It is an index based unit investment trust and is sponsored by NASDAQ Investment Product Services, Inc., a wholly owned subsidiary of The NASDAQ Stock Market, Inc. ALPS Mutual Funds Services, Inc. is the Distributor of the trust. The Bank of New York is its Trustee.

The Standard & Poor's Depository Receipts (referred to as SPDRs, with a ticker symbol of SPY) is designed to track the performance of the Standard & Poor's 500 Index. SPDRs are listed and traded on the American Stock Exchange. Trading began on January 29, 1993.

The Standard & Poor's MidCap 400 Depository Receipts (referred to as MidCap SPDRs, with a ticker symbol of MDY) is designed to track the performance of the Standard & Poors MidCap 400 Index. MidCap SPDRs are listed and traded on the American Stock Exchange. Trading began on May 4, 1995.

SPDRs and MidCap SPDRs are structured as regulated investment company trusts. They are index based unit investment trusts. PDR Services Corporation, a wholly owned subsidiary of the American Stock Exchange, sponsors these trusts. ALPS Mutual Funds Services, Inc. is the Distributor of the trusts. State Street Bank and Trust Company is Trustee of the SPDR trust, and The Bank of New York is Trustee of the MidCap SPDR trust.

Select Sector SPDRs are nine individual sector SPDR funds which comprise all of the companies in the Standard & Poors 500 Index. They are listed on the American Stock Exchange and began trading on December 22, 1998. Their trading symbols are:

XLB Basic Industries Sector XLF Financial Sector XLV Consumer Services Sector

XLI Industrial Sector XLP Consumer Staples Sector XLK Technology Sector

XLY Cyclical/Transportation Sector XLU Utilities Sector XLE Energy Sector

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Select SPDR Funds are structured as a regulated investment company trust. The funds are index based unit investment trusts. State Street Bank and Trust Company is Adviser, Administrator, and Custodian of the Select SPDR Trust. ALPS Mutual Funds Services, Inc. is its Distributor.

DIAMONDS (ticker symbol DIA) tracks the performance of the 30 stocks comprising the Dow Jones Industrial Average. The DIAMONDS trust is listed on the American Stock Exchange and began trading on January 20, 1998.

DIAMONDS is structured as a regulated investment company trust. It is an index based unit investment trust. Its Sponsor is PDR Services LLC, a Delaware limited liability company whose sole member is the American Stock Exchange, LLC. ALPS Mutual Funds Services, Inc. is the Distributor of the trust.

Most investors who purchase and sell ETFs do so in the secondary market. Purchasers of ETFs acquire an investment in a unit investment trust holding shares of the companies comprising a specific index. Initial units in the investment trust are generated by large or institutional investors through "creation units." These "creation units" consist of large blocks (generally 50,000 shares) of securities of the companies comprising the index. Each "creation unit" can only be created and redeemed in aggregates of these blocks of securities. Only investors who have executed a participating agreement with the trust's distributor and trustee, and who deposit the requisite number of shares of the securities making up the index, plus cash for accumulated dividends and transaction costs, are eligible to create "creation units." These investors act as arbitrageurs who trade "creation units," keep the trust's net asset value close to index target levels, and attempt to profit from differences between "creation unit" prices and index levels.

WEBS Index Fund, Inc. consists of funds trading on the American Stock Exchange. WEBS index funds consist of 17 country-specific stock portfolios structured to replicate as closely as possible the performance a specific Morgan Stanley Capital International index. Trading began in March 1996. The trading symbols are:

EWA Australia EWQ France EWJ Japan EWS Singapore EWO Austria EWG Germany  
EWM Malaysia EWP Spain EWK Belgium EWH Hong Kong EWW Mexico EWD Sweden  
EWC Canada EWI Italy EWN Netherlands EWL Switzerland EWU United Kingdom

WEBS Index Fund, Inc. is an investment company registered under the Investment Company Act of 1940 and is organized as a series fund. Barclays Global Fund Advisors is the investment manager of each WEBS Index series. Morgan Stanley Trust Company is the fund's global custodian. Portfolio securities are held by various sub-custodians throughout the world.

Most investors who purchase and sell WEBS do so in the secondary market. These index based funds hold shares of the companies comprising one of the 17 foreign equity securities sectors tracked by the Morgan Stanley Capital International indices. Initial units in the funds are generated by certain investors through "creation units." These "creation units" consist of a large number of shares of the companies comprising each WEBS sector. Only investors who deposit the requisite number of shares of the securities of the companies that make up a sector, plus cash for accumulated dividends and transaction costs, are eligible to create "creation units."

### ***Economically Targeted Investments (referred to as ETIs or Social/Ethical Investing)***

Social investing is an investment approach whereby the investor considers non-investment criteria in the investment decision making process. Normally, the investment manager desires to either promote or endorse a non-investment criterion or attempts to avoid investing in companies with certain negative criteria. The screening process may deal with individual companies or entire countries or industries. A potential investment may be reviewed through multiple criteria to determine whether the non-investment goals can be achieved.

Social investing is known by any number of other terms. Sometimes it is referred to as ethical investing. The Labor Department's term is "Economically Targeted Investments", or ETIs.

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Examples of such criteria are:

Positive Criteria	Negative Criteria
Energy producers	Oil companies or large users of energy
Environmentally friendly	Polluters
Food production	Tobacco firms
Unionized companies or industries	Non-unionized companies
Companies providing employees with certain types of desirable benefits (company-paid health benefits, non-contributing pension plans day care facilities, etc.)	Companies with records of repeated labor strife, those with large amounts of unfunded pension liabilities, etc.
Health/pharmaceutical firms	Nuclear energy
Companies with high quality products	Companies whose products are shoddy, subject to forced recalls, lawsuits
US-owned companies, those which manufacture and/or sell products made locally or in certain countries	Companies which do business in countries engaging in human-rights abuses, or sell products made by forced-labor or prison inmates
Multiple-Family (or Low Cost) Housing	Luxury Hotels or Resorts

The concept behind ETI investing is that the investment manager can identify investments that meet the desirable attributes (or screen out the undesirable investments) without sacrificing investment quality or returns. This is often difficult. Companies that meet one or more desirable criteria may also contain negative criteria.

The social investing approach became fairly well-known in the early 1980's. There are now several mutual funds which have as their basic premise social investing. Results of social investing portfolios have been mixed to date. Refer to Section 5.H.5.c.(3) for additional information on this form of investment philosophy with respect to ERISA accounts.

### Mutual Funds

Mutual funds are open-end funds registered under the Investment Company Act of 1940 and regulated by the Securities and Exchange Commission. (A closed-end fund is often referred to as a mutual fund but is an investment trust.) The mutual fund raises money from investors, and, in return, investors receive an equity position in the fund. The proceeds from the shareholders are invested in a group of assets. The primary benefit of investing in mutual funds is diversification. Funds offer choice, liquidity, and convenience, but for a fee and for a minimum investment. The price of a share of an open-end fund is determined by the net asset value (NAV), which is the total value of the securities owned divided by the number of shares outstanding. The NAV is the price at which you buy or sell shares when commissions and loads are not involved.

There are many types of mutual funds, but most are a variation on the following general types:

- Bond Funds

U. S. Government and Agency issued bonds - These funds primarily invest in notes and bonds issued by the U. S. Treasury or Federal Government or Government Sponsored Agencies. Credit risk is not an issue, although returns are usually below those of other bond funds. These funds do have interest rate risk, especially those investing in long-term bonds.

Corporate bonds - Most corporate bond funds invest in highly rated bonds issued by corporations.

High-yield or junk bonds - These funds invest in the debt of corporations which are in weakened financial condition or in unproven small firms. The potential that any individual corporation will default is much higher compared to corporate bond funds, but due to a large number of bonds held, the fund does not have a concentration that would impact the overall fund.

Municipal bonds - These funds invest in tax-exempt bond issued by state, county, or municipal governments. The advantage of these funds is the income earned is exempt from Federal taxation and, in some instances, state and local taxation.

Trust management should consider the expense ratios based on the type of fund, the length of maturities, and yields. However, management should not be solely focused on the yield, but the composition of the fund. To boost yields, many funds invest in bonds other than those expected in the fund.

- Stock funds

Value funds - These funds invest in stock, that the fund manager believes are undervalued based on their low price/earnings ratios or the value of the underlying assets. The large-cap versions look toward corporations whose stocks are selling at discounted prices, while small-cap fund managers look for stocks which have the potential to increase in value.

Growth Funds - The managers of these funds may have vastly different approaches to managing the funds. Some are rather conservative, while others are aggressive. In general, growth funds do not generate the highest returns in bull markets but maintain their position better in a downturn. This type of fund generally focuses on appreciation rather than income.

Growth and income, Equity-Income, and Balanced Funds - These funds provide steady long-term growth while generating an income stream. All invest in dividend or income-producing securities, such as bonds or convertible securities. Growth and income funds normally have lower yields, as the funds are more focused on growth. Each fund maintains its NAV better during a downturn but lag the market in a bull market. These funds are suitable for investors who are risk-averse or need a constant level of income.

Specialty or Sector Funds - These funds invest in particular market segments. By diversifying with the numerous stocks held in the funds, the investor reduces the risk of holding an individual stock, but still subject to the sector risk.

Before investing in any mutual fund, trust management should consider the expense ratios for the type of fund, the investment style and consistency therewith, risk profile, past performance, and tax consequences for the account. To generate higher returns, some fund managers will make trades in fund assets, especially at year-end. If the asset is sold at a sizeable gain, that may affect the trust account's tax position.

### *Investing in Proprietary Mutual Funds*

Banks and their holding companies have increasingly become more involved in sponsoring their own mutual funds, known as proprietary mutual funds. Characteristically, the funds' names include the name of the institution. In general, trust department investment in proprietary mutual funds is permitted only when certain requirements are met. The applicable requirements depend on the type of trust account and whether the trust department holds investment discretion. As with all trust investing, the use of a proprietary mutual fund must be: (1) authorized by the governing instrument, (2) suitable for an account's investment objectives, and (3) authorized under state law.

Banks engage in a prohibited transaction in violation of ERISA Section 406 if they invest employee benefit accounts in proprietary mutual funds at their discretion. The prohibited transaction may be avoided, however, if the conditions of the Labor Department's

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ERISA Prohibited Transaction Class Exemption (PTE) 77-4 are followed. Refer to Section 5, H.7.f(11) Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised, for additional guidance for ERISA accounts.

Although investments in proprietary mutual funds are permissible, such investments pose conflict of interest and self-dealing issues. Therefore, these investments should also be reviewed with these concerns in mind. Refer to Section 8, Investment in Proprietary Mutual Funds for additional discussion of this topic.

Investments in proprietary mutual funds by nondiscretionary accounts are not restricted by the above requirements.

### *Due Diligence Standards*

Prior to investing trust account assets in proprietary or affiliated mutual funds, or mutual funds which are advised by the bank or its affiliates, trust management should:

- Conduct and document a due diligence review of the legality of investing fiduciary accounts under Federal and state law.
- Establish written investment policies outlining acceptable standards for investments in such funds. These standards should be consistent with the minimum acceptable standards adopted by management for the investment of trust account assets in non-proprietary funds.
- Establish procedures for the periodic review, including the documentation thereof, of the fund's performance in comparison to indexes or other available funds. The analysis should employ performance criteria published by independent companies and include a comparison of mutual fund expense ratios.
- Establish an arms-length process for evaluating the prudence of investing trust accounts in proprietary or bank advised mutual funds rather than in non-proprietary alternative investments.

Minimum acceptable criteria for investment in mutual funds (whether proprietary, affiliated, advised, or non-proprietary) should be adopted by the Board of Directors. Acceptable performance criteria may include provisions addressing the following:

- An investment record with well-defined and discipline investment styles
- A comparison of the fund to peer group performance and peer group fees
- An investment performance which tracks the peer group; the peer group used should be adequately defined, since there are different performance measurements for the same class of funds. For example, the performance of a small-cap fund may be compared to the Russell 2000, the S & P Small Cap 600 index, or to the Morgan Stanley U. S. Small Cap 1750. Depending on which benchmark is used, the small cap fund performance may be above one benchmark and below another, since each were designed differently.
- An expense ratio which is consistent with the peer group

All funds appearing on the approved list should also be periodically reviewed for the following criteria:

- Investment performance
- Investment objective changes
- Investment drift
- Fund management
- Fund structure

The inclusion of any mutual fund in the trust department's investment mix should be documented by the trust investment, or similar, committee. The performance of proprietary, affiliated, or bank advised mutual funds should be reasonable in comparison to other available funds. If the proprietary funds' performance is significantly below benchmark indicators (poorly performing funds), management's decision to retain the investments should be reviewed regularly and supported by appropriate documentation. The Board of Directors or a committee thereof, which reports to the Board of Directors, should review and approve the decision to retain poorly performing proprietary funds.



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#### *Other Mutual Fund Considerations*

In addition to typical investment considerations, including the needs of beneficiaries, the account's investment objectives, and the potential for capital appreciation, etc., trust management should consider other investment criteria that are unique to mutual fund investing.

#### Mutual Fund Fees

The fees associated with all mutual fund operations pose fiduciary concerns for both overall investment performance and potential conflict of interest, with respect to proprietary funds. Investment in proprietary mutual funds poses a conflict of interest, since investment in these funds is linked to increased bank fees and profitability through fund fees. Nevertheless, investment in any mutual fund imposes additional fees on trust accounts, unless trust management reduces trust fees for assets invested in mutual funds on a dollar for dollar basis. The resolution of these issues, and justification for passive investment management (mutual fund investing) vs. active investment management, should be articulated in trust policies and at the account level itself.

All mutual funds charge fees in one form or another. Mutual fund fees affect a shareholder's overall investment performance, because they are deducted from the investor's return. Some of the fees represent investment management fees, while others represent marketing expenses. Mutual funds are required to disclose fees in a standardized fee table, which is divided into two sections: (1) shareholder fees and (2) annual operating expenses. The table is required to be placed in the front of the fund prospectus. Transaction commissions are not included in the disclosed expense ratio but can materially impact the investor.

According to <http://www.fundexpenses.com> for the year 2002, investors paid \$35.2 billion in mutual fund fees. Of that amount, \$9.2 billion or 26.1 percent represents 12b-1 fees; \$6.1 billion or 17.3 percent represents administrative fees; and \$19.9 billion or 56.5 percent represents advisory/management fees.

#### Shareholder Fees

Approximately 38 percent of all funds, excluding money market funds, are "no load" funds sold directly to the investor. The remaining 62 percent are sold through financial advisors, brokers, or insurance agents, who may have a vested interest in generating fee income for themselves. Shareholder fees may consist of purchase charges (frontend load fees), sales charges (back-end load fees), redemption fees, exchange fees, etc. Shareholder fees may also include "class" fees, depending on which "class" of shares the investor buys. For example, Class A shares may include front-end sales or "load" charges and may include 12b-1 fees, but at a lower rate than those of Class B and C shares. The front-end load potentially can be reduced or eliminated by breakpoint discounts, which are based on the size of the investment. The larger the investment, the lower the sale load. Class B shares may include an annual 12b-1 fee and/or deferred "back-end load" sales charges. Usually, contingent deferred sales charges decline each year the investor remains in the fund. Furthermore, most Class B shares convert into Class A shares after a certain number of years. At that point, the fund begins charging the same annual fund operating expenses as Class A shares. Class C shares may charge higher 12b-1 fees, but no front-end or back-end sales charges. Class C shares may be less expensive than either Class A or Class B shares, if the investment time horizon is short-term. However, if the investment is long-term, Class C shares can be more expensive. Purchasing different classes of a mutual fund may be optional for the buyer, or dependent on the "class" the buyer falls into as defined by the mutual fund's plan of operation (such as institutional, individual, etc.).

In June 2003, the NASD censured a brokerage firm, suspended its chairman, and directed restitution be paid to customers for recommending the purchase of large positions in Class B shares, when the customers would have qualified for lower sales charges through the Class A shares.

Short-term redemption fees are assessed against those who move in and out of funds in under 90 days. These fees are intended to hinder those who attempt to time the market, resulting in increasing investor costs and decreasing returns. Short-term redemption fees can represent up to 2 percent of assets.

#### Annual Operating Expenses

Annual operating expenses include all on-going fees paid by shareholders as long as they hold shares in the fund, including: investment management fees, 12b-1 fees, oversight fees paid to a fund's board of directors, custodial fees, transfer agent fees, and

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other administrative expenses. "Distribution expenses" up to 0.75 percent of a fund's net average assets per year may be paid in the form of 12b-1 fees. Even "no-load" mutual funds may pay up to (but no more than) 0.25 percent of average net assets each year in 12b-1 fees.

In general, the annual operating expenses increase with the fund's risk profile. For example, funds consisting of investment-grade bonds or large or mid-size U. S. stocks will have lower expense than funds invested in small-cap stocks or foreign stocks. Index funds will have lower annual operating expense than managed funds. However, some managed funds fairly closely track index funds, yet assess much higher fees. [The degree of mirroring the index funds is called "R-squared". Funds with an R-squared over 90 fairly closely track an index fund.]

#### Other Considerations

During 2003 and 2004, mutual funds came under scrutiny for a variety of potential abuses, including hidden fees. The following are three major types of hidden fees that may be used by a mutual fund:

**Directed Brokerage** - Fund advisers direct brokerage commissions from fund portfolio securities transactions to selling brokers. A mutual fund company agrees to do a certain volume of trades with a brokerage firm, if that firm agrees to distribute the funds. In essence, the mutual fund company pays commissions to brokers to distribute the funds. This should have been accounted for in the 12b-1 fee but may not be included. At the August 18, 2004, the SEC unanimously agreed to end the practice of directed brokerage, as the arrangements create conflicts of interest, and potentially increase fees mutual fund investors pay.

**Revenue Sharing** - A mutual fund company pays brokers part of its own profits to push the funds, usually to smaller, non-institutional investors. Currently, this is not disclosed in the prospectus or by the broker.

**Soft-Dollars Embedded in Commissions** - A mutual fund company pays a brokerage firm, reportedly for research, but may also cover costs such as subscriptions to magazines, computer software and hardware, and attorney fees. The commissions are not included in the disclosed expense ratio (discussed below) but are deducted from the fund's assets. Commissions are higher, as significantly lower cost trades may be done on electronic trading exchanges. The research provided may be very little or useless but can be maintained to justify their usage. As long as the mutual fund achieves "best execution," the practice is allowable.

#### Mutual Fund Expense Ratio

A mutual fund's "expense ratio" is its total annual operating expenses as a percentage of the fund's assets. The expense ratio must be disclosed in the mutual fund prospectus. Although it is a good gauge of a mutual fund's ongoing fees, there is no link between high or low expense ratios and a mutual fund's performance. Consequently, neither trust management nor examiners should evaluate the "prudence" of investing in one mutual fund versus another upon a fund's expense ratio alone.

#### Mutual Fund Tax Considerations

Mutual funds generally make both ordinary dividends and capital gains distributions each year. Ordinary dividends are reported as dividend income. Capital gains distributions are reported as capital gains, regardless of how long the investor owns shares in a mutual fund. Both dividend and capital gains distributions affect a fund's net asset value (NAV), which declines by the amount distributed. Despite any lower post-distribution NAV to the investor, the investor's investment basis remains unchanged. (NAV is the per share value of a mutual fund. It is equal to fund assets less liabilities, divided by the number of shares outstanding. The NAV calculation is a daily regulatory requirement.) Investors are also liable for any taxable capital gains on the sale of mutual fund shares. An investor's gain or loss on the sale of mutual fund shares is computed as the difference between a share's "cost basis" and its sales price.

Although mutual funds generally make capital gains distributions during the last calendar quarter, attempting to "time" purchases to avoid capital gains treatment, or capture a lower NAV after capital gains distributions, also subjects the investor to the uncertainties of market. Increases in a fund's NAV may be greater than the potential tax liability incurred by purchasing a fund before its capital gains distribution.

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While the tax-efficiency of a mutual fund is not relevant to investors in tax-deferred accounts, the tax consequences may be significant to the investor in a taxable account. Effective April 16, 2001, the SEC adopted rules and amendments under the Securities Act of 1933 and the Investment Company Act of 1940 requiring the disclosure to investors of the effect of taxes on the performance of mutual funds. The rules and amendments require mutual funds to disclose in the prospectus after-tax returns based on standardized formulas comparable to the formula used to calculate before-tax average annual total returns. The standardized presentation requires after-tax returns for the 1-, 5-, and 10-year periods, and will accompany before-tax returns in fund prospectuses. The disclosure must be presented in two formats: (1) after taxes on fund distributions only and (2) after taxes on fund distributions and a redemption of fund shares. While the after-tax returns generally will not be required in fund advertisements and sales literature, any fund that either includes after-tax returns in these materials or include other performance information or that represents that the fund is managed to limit taxes, is required to include after-tax returns in the literature. Money market funds are exempt from this disclosure, as are fund shares used exclusively by defined contribution plans (i.e., qualified under Section 401(k), 403(b), 457 of the IRC) or similar arrangements (i.e., Section 817(d) of the IRC concerning variable contracts; entities that are not subject to the individual federal income tax, such as tax-exempt foundations, colleges, and corporations; or, a similar plan or arrangement for which an investor does not pay tax on the investment until sold.)

### Mutual Funds: Receipt of 12b-1 Fees

SEC Rule 12b-1, promulgated under the Investment Company Act of 1940, permits mutual funds to adopt a plan which uses fund assets to finance, or promote, a fund's sales. The expenses associated with this plan are referred to as "distribution costs." These costs may take the form of commission-like payments (termed "12b-1 fees") to organizations which generate a high volume of transactions in the mutual fund. Distribution activities include: advertising; the compensation of underwriters, dealers, and sales personnel; the printing and mailing of prospectuses to other than current shareholders; and the printing and mailing of sales literature. The rule is contained in 17 C.F.R. Section 270.12b-1(a)(2).

Approximately 7% of all funds assess 12b-1 fees, including some funds that are closed to new customers. According to an industry survey, approximately 63 percent of the fees go to brokers, while 32 percent covers administrative costs, and 5 percent is used for advertising. Another recent survey found that 19 percent of no-load funds charge 12b-1 fees, compared with 92 percent of load funds.

Whether a fiduciary may accept and retain 12b-1 fees for its own benefit depends upon the type of account, together with certain characteristics of the account, such as the fiduciary's investment authority, and the nature of customer disclosures. The following provides general guidance regarding the retention of 12b-1 fees for ERISA covered employee benefit accounts, non-ERISA employee benefit accounts, and personal accounts.

### *ERISA Accounts*

Retention by an ERISA fiduciary of 12b-1 fees paid by mutual funds may be a form of a prohibited transaction, in violation of ERISA Section 406(b). Different treatment is appropriate for discretionary accounts, as opposed to nondiscretionary or custodial accounts. Refer to Section 5.H.7.f.13 Mutual Funds, Receipt of 12b-1 Fees for further guidance.

### *Personal and non-ERISA Employee Benefit Accounts*

(EBs) Guidelines governing the receipt and retention of 12b-1 fees associated with the administration of personal and employee benefit accounts depend on the level of discretionary investment authority exercised by the fiduciary, together with the nature of the disclosures provided to the customer.

- **Discretionary Accounts**

A standard fiduciary principle under state law and ERISA is that all decisions to place fiduciary assets in particular investments must be in the best interest of the trust beneficiaries. This fiduciary principle reflects the trustee's duty of loyalty under state law. All such investments must also be consistent with the provisions of an account's governing documents. An institution may fail to act in the best interests of its beneficiaries in certain situations in which it receives duplicate fees for identical investment management services from a trust account and from the mutual fund provider in which it invests on

behalf of the trust account. As a result, an institution may face increased legal risk due to potential litigation on behalf of account beneficiaries claiming that the institution placed its interest ahead of the interest of beneficiaries.

In certain situations, the receipt by a fiduciary of 12b-1 fees from a mutual fund provider for distribution services regarding trust accounts may be a potential violation of state law or regulation. However, nearly every state legislature has now modified its laws to explicitly permit fiduciaries, under certain conditions, to accept such fees. The conditions imposed typically require investments to be prudent and permitted by the governing documents. The fees that the institution receives must also be "reasonable".

Even when permitted by state law and the governing trust documents, institutions are still expected to identify measure and control the additional legal and compliance risk that such conflicts of interest present. In particular, institutions must continue to adhere to proper fiduciary standards when exercising investment discretion, including adequate documentation supporting the institution's decisions. Therefore, prior to entering into fee arrangements, senior management and the board, or a duly appointed committee thereof, should conduct and document an appropriate due diligence process. The due diligence process should include the following procedures (These procedures also are contained in Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation SR99-7, "Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest", March 26, 1999.)

- Reasoned Legal Opinion - The institution should obtain a reasoned legal opinion of counsel that addresses the conflict of interest in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.
  - Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
  - Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.
- Agency and Non-discretionary Accounts

Even in the case where the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, the institution should implement due diligence processes appropriate for the duties and responsibilities performed. Due diligence procedures should include a reasoned legal opinion in order to ensure compliance with applicable state and federal laws and regulations, as well as sound fiduciary principles. As part of the due diligence process, management and the board should establish adequate policies and procedures governing such fee arrangements for non-discretionary accounts. The institution, in addition, should document the "reasonableness" of the fees collected.

Except as noted in the following paragraph, a violation of general fiduciary duties resulting from the receipt of 12b-1 fees by a fiduciary from a mutual fund can be cured if the fiduciary rebates the 12b-1 fees back to the trust accounts that generated the transactions. Where the bank has retained 12b-1 fees without the authorizations or directions noted above, examiners should recommend that the fees be returned to the accounts that generated them. If there is a difference over the interpretation of state law, a general criticism of the matter should be presented together with a request for a legal opinion.

Financial institutions that operate proprietary mutual funds may attempt to resolve the conflict of interest and self-dealing concerns that result when a proprietary mutual fund collects 12b-1 fees from trust accounts that the institution administers in a discretionary capacity by rebating or waiving such fees for trust account shareholders. The proprietary fund, however, collects 12b-1 fees from non-trust account shareholders. The SEC has indicated that the waiving or rebating of 12b-1 fees for some shareholders, but not others, may violate the proprietary mutual fund's obligation to treat all shareholders impartially. See Southeastern Growth Fund, Inc.'s 1986 request for a No-action letter.

### Hedge Funds

#### *Product Overview*

Although the term has not been formally defined, hedge funds refer to an entity that holds pools of securities or that does not register those securities under either the Securities Act of 1933 or the Investment Company Act of 1940.

The funds are exempt from the Investment Company Act due to the sales of the funds being limited to 100 or fewer investors. Also, the funds are only sold to highly sophisticated investors. To qualify for either exclusion, the funds must restrict the offerings, and by not selling to the general public. As a result, solicitation and advertising of hedge funds is prohibited. This includes advertising in written or verbal form, articles or other notices published in a newspaper or magazine, information on the Internet or via email, or at any meeting or seminar where the participants were invited by general solicitation or advertising.

Hedge funds may be sold to an unlimited number of "accredited investors." (In determining compliance with Rule 501(a) of Regulation D under the Securities Act of 1933, accredited investors are not included in the 35 limit.) To qualify as an accredited investor, the individual must have a minimum annual income of \$200,000 (\$300,000 when combined with spouse), or \$1,000,000 in net worth. Most hedge funds require \$5,000,000 in assets as a minimum. In order to avoid Investment Company Act registration, the fund may only be sold to "qualified purchasers," which is a standard with significantly higher financial requirements than "accredited investors." Hedge fund investment advisors avoid registering under the Investment Advisors Act by relying on the de minimis exemption for registration, which is limited to 14 or fewer clients. Under SEC rules, each hedge fund counts as one client.

In recent years, hedge funds have grown significantly both by the number of hedge funds and the dollar amount invested in the funds. Much of the growth is associated with institutional investing by large plans, such as state teacher retirement plans, endowments, foundations, and other charitable organizations. Although the amount of media attention given to the funds gives the impression that hedge funds are a new investment product, the funds have actually been available for quite some time. The first hedge fund was established over 50 years ago.

Until recently, the funds actively avoided registration under the above Acts. Now, some hedge funds have registered under the Investment Company Act as closed-end investment companies, while others registered under the Securities Act of 1933. Registration makes the funds available to a larger number of potential investors, including trust and employee benefit accounts.

Hedge funds, whether registered or unregistered, invest in various financial instruments to achieve a positive return, and may take on speculative trading positions. Ironically, hedge funds may or may not engage in hedging or arbitrage activities. Some hedge funds adopt strategies similar to mutual funds, while others are extremely flexible in their approach. Hedge funds may or may not be as risky as other available investment options. However, hedge funds are constantly changing.

A substantial volume of hedge funds use leverage to increase an investment's value, without increasing the amount of funds invested. In many instances, the leverage factor is greater than 2:1. The ratio equals total absolute dollars invested divided by total dollars of equity. Therefore, leverage magnifies a position, so gains or losses are greater than they would otherwise have been without leverage. In addition, leverage may increase the risk of owning assets that are illiquid or those that are saleable, but at a price less than expected. In the end, leverage is only limited by margin or collateral requirements imposed by lenders and the willingness of lenders to provide credit to the funds.

#### *Common traits of hedge funds*

- The fee structure usually pays the adviser based upon a percentage applied to the fund's capital gains and appreciation.

- One or more brokers may be involved in providing trade clearance and settlement, financing, or custody services.
- The funds do not have specific time horizons, although the life may be shorter than other investment products.
- Investors cannot liquidate their assets during lock-up periods; redemption frequently allowed only quarterly.
- Hedge funds repurchase their own interests from investors on a limited, periodic basis.
- Fund managers provide potential investors with a private placement memorandum that discloses information about the investment strategies and operations.
- The funds may have the legal structure of a limited partnership, a limited liability company, or business trust. All three forms limit taxes and liability.
- If the fund is a limited partnership, the investment adviser normally serves as the general partner. If the fund is a limited liability company, the investment adviser normally serves as the managing member.
- Offshore hedge funds are originated outside of the United States but are affiliated with United States-based funds.
- Hedge funds are not subject to any law or provision requiring financial statement audits.
- Fund advisers often invest heavily in their own fund.

### *Legal Structures*

There are two different legal structures, depending on whether the funds are "Domestic" or "Offshore." The manager of a domestic fund may also operate an affiliated offshore fund, either as a separate fund, or through a master fund, which is a non-US corporation. Domestic hedge funds typically do not have a board of directors or any comparable corporate body.

Offshore hedge funds are typically organized in countries considered tax havens. These funds attract investment by pension funds, as well as charities and foundations. While the fund may employ the same US entity to serve the offshore as well as domestic fund, most operational activities are performed at the offshore location. These funds generally have a board of directors. Offshore hedge funds may have over 100 investors, although Section 3(c)(1) of the Investment Company Act of 1940 limits investors to 100. The statute was interpreted to exclude non-US investors in determining the number of investors.

### *Supervision and Regulation*

In general, the SEC does not examine or supervise hedge funds, as the funds can be exempt from the three SEC Acts previously described. While hedge fund regulations and supervision are under consideration, there is no definitive action in that direction at this time.

The most significant reason for establishing supervision is the manner in which hedge funds are valued. There is no independent oversight of the valuation and performance results are not required to follow a standardized format and calculation. This may directly or indirectly affect the investor. First, the manner of presenting performance results may be inconsistent or inaccurate. With registered funds possibly investing in hedge funds, the net asset value of the mutual funds may be inaccurate and may result in violations for the registered mutual fund.

While the funds are not subject to supervision by the SEC, the funds are subject to the antifraud provisions of the federal securities laws. The identified frauds have been similar in nature to those fraudulent acts, such as misappropriation of assets or misrepresentation of performance, committed by other types of investment advisers. However, the frequency of outright theft, or misappropriation of investors' funds is greater.

### *ERISA Considerations*

An investment advisor to a hedge fund is a plan fiduciary, if it exercises discretionary authority over the management of plan assets. The hedge fund is considered a plan asset, when the plan's investment in a particular hedge fund is significant. This is defined to be more than 25 percent of the value of any class of equity interests in the hedge fund is held collectively by the employee benefit plan investors. Some hedge funds disclose in the private placement memorandum that a subscription may be denied, or a redemption may be forced, to maintain ownership at less than the 25 percent limitation. Once the ownership by an employee benefit plan exceeds 25 percent, the hedge fund is subject to regulation as an ERISA fiduciary. Conversely, some hedge funds accept regulation under ERISA to make their funds more attractive to investors.

### *Fund of Hedge Funds (FOHF)*

Typically, FOHFs invest in 15 to 25 hedge funds to diversify the risks associated with an individual hedge fund. The minimum investment may be as low as \$25,000. In concept, it is similar to a mutual fund investing in numerous stock or bond issues. FOHFs are generally not registered as investment companies under the Investment Company Act and use private placement to sell the funds. Some FOHFs are registered but are not listed or traded on any exchange or NASDAQ.

On September 29, 2003, the SEC issued a paper entitled "Implications of the Growth of Hedge Funds." The paper provides a detailed explanation of the products, their usage, and the SEC's concerns that the product remains unregulated. To read this paper, go to <https://www.sec.gov/files/implications-growth-hedge-funds-09292003.pdf>.

### **Notes and Mortgages**

Notes and mortgages can be acquired in many ways, including: received in kind, from the sale of real estate from a trust account in return for a mortgage, and the outright purchase of notes and mortgages. There are three basic types of notes and mortgages: unsecured loans, loans secured by real estate, and loans secured by assets other than real estate.

The repayment of an unsecured note depends solely on the willingness and ability of the borrower to repay. Unsecured loans are, therefore, rarely seen in trust departments as they may be considered inappropriate.

Real estate loans are appropriate fiduciary investments for an account when the loans are secured. Prior to investing in loans, trust management should consider the liquidity needs of the account and how illiquid the loan may be. A trust department should not purchase loans or participations from the commercial department of the bank. Nevertheless, the trust department may participate in the origination of a loan, using the expertise of commercial loan officers to finalize the terms of the loan. Under the Prudent Man Rule, it is ordinarily improper to invest in second or junior mortgages unless the same account holds all senior mortgages. Although a sufficient margin of safety exists, a junior lienholder cannot control the foreclosure of collateral in the case of default.

Obtaining an appraisal is a common and prudent real estate lending practice. Examiners should be aware that the Corporation's appraisal regulation, Part 323 of FDIC's Rules and Regulations, does not generally apply to mortgages made by or to fiduciary accounts. Part 323 does apply, however, if an appraisal is required through the action of another law.

All mortgages should be held in some form of trust capacity unless otherwise permitted by the terms of the trust instrument or state statute. In addition, the mortgage should be accompanied by all the documentation necessary to establish the priority of the lien, an appraisal, and evidence of adequate insurance payable to the corporate fiduciary. The ratio of loan to appraised value should provide an adequate margin of collateral protection. Adequate credit information should be obtained to substantiate the borrower's ability to pay. Ticklers or checklists may be used by the bank to monitor payment of taxes, assessments, and insurance.

For notes secured by assets other than real estate, the bank should have a perfected security interest in the collateral. All states and the US Virgin Islands have adopted the requirements for secured transactions under Article 9 of the Uniform Commercial Code. For negotiable property, the key to security is physical possession. For physical property which is titled, such as automobiles and some machinery, filing is the key to perfecting security.

Procedures should be established to determine payment status and collect delinquent loans. Delinquencies should be reported on a regular basis to the board of directors, the trust committee, or another appropriate committee.

Notes and mortgages, like other investments, should be analyzed periodically to determine whether they should be retained. Collateral should be evaluated periodically to ensure it continues to exceed the balance due. Reappraisal reports should be obtained in limited circumstances, when it is in the best interest of the account. Also, if the security is real estate, it should be inspected periodically to ensure that it is being adequately maintained. Inspections should be standardized and documented.

Privately negotiated loans between the trust department and a potential borrower, sometimes referred to as "private placements", are also potential trust department investments. Since the loan is privately negotiated, the instrument may be highly illiquid. Therefore, the highest degree of confidence should be placed on the financial strength of the borrower. Private placements, like other banking activities, should be subject to adequate safeguards and policy considerations. Special care should be exercised to

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ensure that self-serving practices or conflicts of interest are avoided. Policy constraints should prohibit placing private issues with funds the bank manages in a fiduciary capacity, especially when the issuer is a bank loan customer. A serious conflict of interest could result if the bank were to use or permit the use of proceeds from a placement to reduce criticized loans or accommodate borrowers who are not creditworthy.

### Real Estate

Real estate is generally acquired as a trust account asset as a result of the personal activities of the grantor or testator. Real estate holdings may include personal residences, residential income properties, commercial properties, unimproved lots, and acreage. The real estate may be added to the trust as part of an overall estate plan or left to a beneficiary under the will. In some instances, real estate may be added to trust accounts as an investment vehicle. However, in the absence of special circumstances or specific authority granted in the trust instrument, management should be cautious when investing trust funds in real estate. Under common law, the purchase of property for resale is not considered prudent unless specific provision has been made in the terms of the trust. The Prudent Investor Rule, however, does not consider such an investment inherently imprudent.

In considering the purchase or retention of real estate, management should first determine whether such investments are authorized in the governing instrument. Other factors to consider include: the types of accounts for which real estate may be appropriate; the current or planned use of the property; the geographic location; the size of the parcel and its future marketability; the risks involved in any planned construction or development of the property; the risks and liabilities from any potential environmental pollution or hazards; price comparisons with similar properties; the net yield from investing in the property; and the potential cash flow from and appreciation in the real estate investment.

Decisions to retain real estate should be governed by the requirements of the trust instrument. Appropriate consideration should be given to the current yield and the ease of marketability, if funds are needed to terminate the account or provide for principal withdrawals. Appropriate guidelines should also be in place for selling real estate, including appraisals by competent and impartial appraisers. It should be remembered that trustees have a duty of impartiality in dealing with beneficiaries and that capital gains generally accrue to remaindermen.

Investments in real property can sometimes be speculative in nature, especially when the assumption of risk and the hope of gain are much greater than the investment returns available from other investment vehicles. Real estate of all kinds is burdened with poor liquidity. Raw land generally bears an even higher degree of risk. Although long-term growth potential and possible tax benefits may be positive factors, the illiquid nature of real estate investments has limited their use to large or special purpose accounts (e.g., pension trusts).

The variety of real property investments requires different degrees of management knowledge and expertise. For example, farms are not managed in the same manner as a commercial income property. Every property held by the trust department should be reviewed at least annually, to determine whether the investment meets the needs and objectives of the account and its beneficiaries. When a property is received in kind, it should be physically inspected as soon as possible to determine its condition, verify leases and renters, and to ensure that adequate insurance is in force. In addition, the bank should have a program for reviewing the condition of the real estate through annual inspections, or through personal knowledge of the property obtained by bank personnel or agents, where inspections are not feasible. Each property should be evaluated periodically to ensure that adequate insurance is maintained, and to enable the department to decide whether the property should be retained or sold. The nature and estimated value of the property should be taken into consideration when deciding between an inhouse or outside appraisal. For example, property of nominal value may not require an outside appraisal, whereas, a large shopping center would require an in-depth appraisal by a qualified appraiser. Appraisal review procedures should be established to evaluate the reasonableness of the overall conclusions and the assumptions employed by appraiser. At a minimum, most properties should have a current outside appraisal made prior to sale.

As noted under the previous section related to Notes and Mortgages, Part 323 of the FDIC's Rules and Regulations does not generally apply to real estate investments which are made by or for fiduciary accounts. The regulation would apply if an appraisal is required through the action of another law.

All parcels of real estate should appear on the books at some value, preferably market value, but the institution may, if reasonable, use historical cost or some other value. The bank should maintain appropriate documents for each parcel of real estate.



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Instruments, or copies of instruments, that should be on file are: deeds; mortgages (deeds of trust); liens and/or releases; owner's title policy or title opinion; leases; contract of sale and closing statements; receipted tax bills; fire and liability insurance policies; contracts for improvements; and instruments conveying interests to the bank.

Procedures should be established to provide for the maintenance of adequate income and expense records covering the properties held. Ticklers or other methods should be used to monitor timely payment of insurance premiums, mortgages, and real estate taxes. Procedures should also be established to monitor payments and collect delinquent rent.

When property is managed by others, a management agency agreement should establish the agent's duties and responsibilities, the frequency of reporting, and the commission paid. Management contracts or leases of farms should include guidelines governing the authority for the sale of crops or livestock, the payment of operating expenses, basic repairs and maintenance of buildings, the fees charged by the bank, etc. In addition, procedures should be established for verifying the amount of farm commodities stored in elevators or warehouses.

### ***1031 Exchanges***

This product is named for the Internal Revenue Code Section which authorizes the exchange of qualifying property and is commonly referred to as "Starker", "Exchange", or "Like-Kind Exchange." The most common examples of qualifying property are commercial, industrial, or residential investment property or heavy equipment or collectibles. Personal residences, partnership interests, and financial assets held for sale or resale are generally non-qualifying property, although exchanging one variable annuity product for another may qualify. A bank may serve in one of three capacities but cannot serve in more than one capacity for any one transaction. The three capacities are lender, qualified intermediary (custodian), or property buyer/exchanger. The latter two may be found in trust department activities. When a trust department serves as a qualified intermediary, the trust department is responsible for holding the funds until the transaction is complete or the time limits expire. These accounts should be reflected as a non-managed personal agency account. From an asset viewpoint, these exchanges may be used for personal accounts, where there is a desire to exchange one form of income-producing property for another, without incurring a tax liability. For example, a personal account may hold farmland and exchange it for a strip-shopping center. The shopping center may provide a level of cashflow that the farmland does not provide. However, if the farm was sold outright, there may be a substantial tax liability to the beneficiary. The goal of these transactions is to shield the owner from incurring a large tax liability. Section 4, Personal and Charitable Trust Accounts provides a detailed explanation of the exchange itself.

### ***Environmental Liability***

General when a trust department account invests in real estate or operates a business, compliance with Federal and State environmental protection laws must be considered.

#### Resource Conservation and Recovery Act

Congress passed the Resource Conservation and Recovery Act (RCRA) in 1976 to complement laws governing other forms of pollution and environmental hazards. RCRA addresses solid waste disposal (superseding a 1965 Act which dealt with the issue) and encourages recycling and the use of alternative energy sources. The primary focus, however, is the control of hazardous waste disposal. Amendments added in 1984 regulate underground storage tanks (USTs, or LUSTs, if the tank was leaking).

In September 1995, the Environmental Protection Agency (EPA) issued regulations effective December 6, 1995, clarifying the liability of secured creditors holding as collateral properties with USTs. The EPA considered the question of trustee and fiduciary liability, as requested by commenters on the proposed regulation, but declined to include exemptions similar to those provided secured creditors. The EPA concluded that the 1959 *Restatement of Trusts 2d* adequately addresses the issue of fiduciary liability and affords the trustee indemnification from the trust estate for the expenses properly incurred during the administration of the trust.

#### Comprehensive Environmental Response, Compensation and Liability Act of 1980

Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986, to govern the financial responsibility for cleaning up toxic

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waste. CERCLA is generally considered to be the primary environmental cleanup and liability law. The Environmental Protection Agency administers the Act and has issued numerous implementing regulations. Many states have also issued similar toxic waste cleanup regulations. CERCLA does not address liability for petroleum wastes. Petroleum wastes include the wastes generated by oil or gas production, refining, storage and retailing. However, there are other Federal and State laws which may apply to petroleum products.

In 1996, Congress amended CERCLA, under an amendment known as the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act (Asset Conservation Act). In short, under the amendment, a fiduciary's liability is limited to the assets held by that fiduciary in trust. However, this does not apply to the extent that a person is liable under the Act independently of the person's ownership of a facility as a fiduciary or actions taken in a fiduciary capacity. Also, if negligence of a fiduciary causes or contributes to the release or threatened release of hazardous substance, there is no limitation.

The Asset Conservation Act defines fiduciary as trustees; executors; administrators; custodians; guardians of estates or guardians ad litem; receivers, conservators, committee of estates of incapacitated persons, personal representatives, trustee (including successor trustees) under an indenture agreement; trust agreement; lease or similar financing agreement for debt securities or other forms of indebtedness as to which the trustee is not acting in the capacity of trustee, the lender or, representative in any other capacity that the administrator, after providing public notice, determines to be similar to the capacities previously described.

The Asset Conservation Act states that a fiduciary shall not be held liable for the following:

- Undertaking or directing another person to cleanup a site
- Terminating the fiduciary relationship
- Including in the terms of the fiduciary agreement a covenant, warranty, or other term or condition that relates to compliance with an environmental law, or monitoring, modifying or enforcing the terms or condition
- Monitoring or undertaking one or more inspections of the facility
- Providing financial or other advice or counseling to other parties to the fiduciary relationship, including the settler or beneficiary
- Restructuring, renegotiating, or otherwise altering the terms and conditions of the fiduciary relationship
- Administering, as fiduciary, a facility that was contaminated before the fiduciary relationship began; or
- Declining to take any of the above actions

This amendment was tested in the courts by Canadyne-Georgia Corporation. In 1996, the corporation sued a bank for its fiduciary capacity seeking damages for clean-up costs. After a lengthy legal process, in 2001, the district court held for the bank on the final issue.

### Protections

Fiduciaries should have adequate written policies and procedures covering environmental risks and such policies should include:

- Pre-acceptance review of potential CERCLA and any state liability by identifying assets which could contain hazardous waste. If possible, the specific asset should not be accepted as part of the account. Potential accounts where the risks are too great or where the risks cannot be managed properly should not be accepted;
- For existing accounts, a written evaluation of the potential environmental hazards for land and businesses held in trust accounts;
- Corrective action to clean up any hazardous wastes identified;
- Periodic inspection and appraisal practices should be amended to include coverage for hazardous and toxic wastes; and
- Required reporting to EPA and/or state pollution control agencies.

Trust counsel should review the department's policies to ensure that they provide adequate guidance for and oversight of the management of potential environmental risk.

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#### *Land Trusts*

A land trust is a grantor-directed type of trust, where the title to real estate is held by the trustee on the customer's behalf, while all rights and benefits of ownership are retained by the grantor/beneficiary. The trustee only holds title to the property and has no responsibility for its care and maintenance. Several states recognize land trusts, including Illinois, Indiana, Florida, Virginia, North Dakota, and Arizona. In some states, the land trust is treated as personal property rather than real estate, during legal judgments. The benefits of a land trust are the following:

- Elimination of probate expenses and delays.
- The ownership of the property is recorded in the trustee's name and provides privacy to the actual owner.
- Elimination of administrative difficulties related to multiple ownership and multiple beneficiaries.
- Land trusts can be pledged as collateral.
- Land trusts can be terminated at any time by either party.

While the trustees duties are extremely limited, there are several areas of potential exposure, including the following:

- Forgeries - Internal policies should require the verification of signatures and identities.
- Tax Bills - Internal procedures should include the prompt forwarding of special assessments, reassessments, delinquency and/or redemption notices.
- Conflicts of Interest - The bank can be both a lender and a trustee for these transactions. Case law has generally permitted serving in two capacities, as long as the bank acts fairly and reasonably.
- Litigation - The bank may become a party to lawsuits involving foreclosure proceedings, building code violations, IRS tax liens, and environmental liability issues. It appears that the more active and discretionary the trustees' powers are, the more likely the trustee is considered an "owner or operator" or "responsible party."

To mitigate these concerns, trust management should review title searches and other public records to determine if the person representing ownership actually has ownership of the property and the current and prior uses of the property.

#### ***Real Estate Investment Trust (REIT)***

##### Overview

The Real Estate Investment Trust Act of 1960 allows companies dedicated to owning and, in most cases, operating income-producing real estate to operate as a real estate investment trust. The REIT structure qualifies as a pass-through entity under IRC and is exempt from corporate taxes, as long as its activities are restricted to certain commercial and real estate activities. Most states also exempt REITs from state income taxes. The underlying real estate may be concentrated in a specific geographic region or in a certain type of property. Some REITs are more diversified and own property nationwide and/or in a wider variety of property types. The majority of the underlying real estate consists of retail, residential, and industrial/office. REITs provide current income, as they are required to pay out 90 percent of their income to investors. There is also the potential for long-term appreciation. The majority of REIT shares can be bought through brokers and can be purchased in small lots; the shares of REITs are traded on stock exchanges. The unsecured debt of a REIT is also rated by nationally recognized rating agencies. Some mutual funds invest entirely in REITs.

The three major types of REITs are described as follows:

**Equity REIT** - The vast majority of the REITs are Equity REITs, which invest in and owns properties through a corporation or trust that uses the invested funds to purchase and manage the properties. The rent from those properties is the income. Equity REITs are traded on major exchanges, which provide liquidity. The underlying property usually consists of commercial property, such as shopping centers and hotels. There is no minimum investment amount.

**Mortgage REIT** - These REITs loan funds to the owners of real estate (and obtain a mortgage) or invest in or purchase mortgages or mortgage backed securities. Interest income on the mortgage loans serves as the source of income.

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Hybrid REIT - This form is a combination of the above two forms. Therefore, both properties and mortgages are held.

In general, the evaluation of a REIT should include an assessment of those who manage the real estate held by the REIT; the perceived access to debt or equity financing sources; and the REIT's earnings potential. To determine the latter, the industry adopted the methodology of "Funds from Operations (FFO)" to address valuation problems and performance. FFO excludes the following from the net income figure: depreciation and amortization costs; gains and losses from extraordinary items; gains or losses from debt restructuring; and gains or losses from sales of real estate. The allocable portions of funds from operations of unconsolidated joint ventures based on ownership interest are added back to net income under FFO. While this should be more accurate, the figure can be somewhat misleading in the analysis of older properties with high required maintenance expenditures.

### Terms Associated with REITs

Payout Ratio - The ratio of a REIT's current annual dividend rate per share divided by its annual FFO per share.

REIT Purgatory - This is an unofficial industry term that means the REIT is shut-off from capital sources. This may occur due to reputation or growth. The most common reasons that a REIT is so designated are for providing misleading financial information; increasing leverage for growth, if the acquisitions would otherwise be unjustified under the REIT's strategy or portfolio composition; or taking actions that public companies would not make. REIT Purgatory is reserved for companies that have long-term structural, systemic, or managerial problems.

Taxable Rent Subsidiary (TRS) - Created by the REIT Modernization Act of 1999, a TRS is a subsidiary of a REIT that provides services to the REIT's tenants and others and is required to pay Federal Income Tax, without disqualifying the tax-exempt status of the REIT. These are similar in concept to the affiliated relationships in mutual fund companies.

Umbrella Partnership REIT (UPREIT) - Generally, the partners of one or more existing partnerships and a newly formed REIT become partners in a new partnership termed the Operating Partnership. For their interest in the Operating Partnership (OP Units), the partners contribute the properties from existing partnerships, and the REIT contributes the cash proceeds from its public offerings. The REIT typically is the general partner and majority owner of the Operating Partnership. Partners may sell their OP Units, usually in convertible format, for shares of the common stock of the REIT. When an OP Unit partner dies, the estate tax rules permit the beneficiaries to tender the Units for cash or REIT shares without paying income taxes.

### ***Mineral Interests***

Investments in natural resources such as oil, gas, and mineral interests, may be found in some trust departments. Such investments require special expertise. Policies for the management of these assets should be established. The authority for acquiring and/or retaining these assets should be evidenced either by specific language in the governing document, or by the consent of all interested parties. Holdings of this type should be reviewed regularly in terms of performance and appropriateness. Evidence of title, such as copies of deeds and title opinions should be maintained. Usually, title to land is a surface right and does not include mineral rights. Therefore, two or more different parties may have an interest in a parcel of real estate, with one having surface rights and the other mineral or subsurface rights. A review of the title should clearly show which interest is held. The status of the property, whether leased or unleased, and producing or nonproducing, should be determined by the trust management immediately upon accepting an account. When properties are placed in trust, the instrument conveying the property to the trustees should be recorded in the county or parish of the state in which the property is located. Copies of any leases should also be maintained. If working interests are involved, the trust department should have a copy of the operating agreement. If necessary, adequate property and liability insurance should be obtained. Proper bookkeeping and information systems should be established, including: ticklers covering delayed rentals on nonproducing interests, expiration of all leases and royalties, and income and expense records. Appropriate checks should be established to identify omitted or significant changes in regular lease income payments. In order to hold title to mineral interests in another state, the bank may have to qualify to do business as a fiduciary in that state or arrange for the appointment of an ancillary trustee.

### **Limited Partnerships**

Limited partnerships usually consist of a general partner, who manages the project, and limited partners, who invest funds in the project. The limited partners are not normally involved in the day-to-day management and usually cannot lose more than their

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capital contribution. Limited partners normally receive income, capital gains and tax benefits, while the general partner collects fees and a percentage of capital gains and income.

Public limited partnerships are sold through brokerage firms, typically for relatively small investments. Private limited partnerships are generally comprised of fewer than 35 limited partners and require much more substantial investments than public limited partnerships. Both types of limited partnerships may have limited marketability. Limited partnerships may be difficult to value, which has led to the emergence of companies specializing in valuing limited partnership interests.

Limited partnerships are involved in real estate management and development, oil and gas exploration and recovery, and equipment leasing. They also finance movies and research and development projects. The limited partnership form of ownership is used extensively for venture capital and leveraged buyout funds. All types of investors participate in such investments.

In the early to mid-1980's, when real estate was booming and oil and gas prices were strong, \$130 billion in limited partnerships were sold to an estimated 10 million investors. Tax laws initially allowed deductions of limited partnership losses from ordinary income, but this was eliminated by the Tax Reform Act of 1986.

One major advantage of limited partnerships is that they are excluded from corporate taxation by, as its name suggests, qualifying for taxation as a partnership. The principal disadvantages are that partnership tax accounting must be used and that the sponsor must provide a corporate general partner to hold 1 percent of the aggregate assets. General partners must make significant cash investments, and they retain unlimited liability for the partnership's obligations.

Many limited partnerships have little or no market value. In 1995, one source estimated that fair market prices were only 20 percent to 60 percent of a partnership's net asset value. The same source concluded that of approximately 2,000 limited partnerships, only an estimated 300 traded with regularity -- and then only by independent dealers using their own clearinghouses for such transactions. These conditions do not contribute to high or competitive selling prices.

The proper valuation of such investments is especially important. Examiners should ascertain that the institution has the ability to obtain reasonably current fair market values for such investments and that customer statements reflect market values. The failure to properly value limited partnerships may lead to overcharging accounts if management or account fees are based on the market value of assets and, as noted in the following paragraphs, can cause difficulties for ERISA plans.

Limited partnership investments of employee benefit plans subject to ERISA must be reported by the plan administrator as a plan asset on the plan's Annual Report IRS Form 5500 found in Section 5.J. Form 5500 requires plan assets to be valued at a reasonable market value. If the bank acts as plan administrator or is responsible for furnishing market values of plan assets to a plan administrator, it must have appropriate procedures for valuing limited partnerships. Since limited partnerships are not traded on a regular basis, it may be difficult for the plan administrator to arrive at a reasonable market value. Since many limited partnerships reportedly have little value, it is particularly important for plans to obtain accurate market values for these assets.

Formal annual appraisals are not required, but the plan administrator must be able to demonstrate that a reasonable approach was taken in valuing the asset. IRS Revenue Ruling 59-60 provides general guidance on valuing non-traded assets. It outlines the general factors that must be taken into consideration and requires a written report detailing the valuation. It indicates that the assets must be more than simply valued. The valuation should also reflect any "lack of control" or "lack of marketability." While the Revenue Ruling is specifically directed toward valuing estate assets, it is widely acknowledged as a general standard for valuing non-traded assets.

IRS Announcement 92-182, "Employee Plans Examination Guidelines," provides the following guidance in valuing limited partnership interests and applying IRS Revenue Ruling 59-60:

- "An accurate assessment of fair market value is essential to a plan's ability to comply with the requirements set forth in the [Internal Revenue] Code and in Title I of ERISA."
- "Plans must value their trust investments at least once a year, on a specified date, in accordance with a method consistently followed and uniformly applied."

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- "Revenue Ruling 59-60 provides guidance for determining the value of plan assets. Although 59-60 provides methods for valuing shares of stock for closely-held corporations for estate and gift tax purposes, the factors may be used to determine values of assets in qualified plans ..."
- "The detail of the plan's valuation should be examined in light of the plan assets involved. For example, the valuation should contain substantial detail if it values a limited partnership or a closely held corporation."

Under IRC Section 408)(i), IRA trustees/custodians are required to report the fair market value of assets to the IRS and IRA owners on an annual basis on Form 5498.

In an information letter dated February 24, 1993, the IRS provided guidance on how limited partnerships in IRA accounts should be treated. In addition to generally affirming the above points, it indicated that the IRA trustee "or issuer" is responsible for proper valuations, and that the trustee or issuer cannot waive, or be released or indemnified by the participant, from such valuation responsibility.

As a result, original cost or an amortized original cost would not normally be considered a reasonable valuation. Since most limited partnerships are not readily traded, the Net Asset Value (NAV) of each partnership unit may be available only on request of the general partner. Since the general partner may have a financial interest in the partnership, either as an investor or as a sponsor, the NAV obtained from the general partner should not automatically be considered the market value.

The plan administrator should attempt to evaluate the reasonableness of the NAV by, for instance, comparing it against other recent trades of the limited partnership's units, consulting a limited partnership valuation service or some equivalent approach.

### Family Limited Partnerships (FLP) or Limited Liability Companies

FLP are a form of limited partnerships, formed to manage and control family property. All of the requirements for a limited liability partnership must be followed. In general, there are two types. One is the discounted technique, where assets are "discounted" in value, which ultimately reduces estate taxes. In order to receive this treatment, the principal must relinquish control, prohibit partners from withdrawing from the entity, and place severe limitations on transfers. Collectively, these restrictions allow the discounted limited partnerships to leverage wealth. The second form freezes the value of an individual's estate and shifts future appreciation to the next generation.

### Master Notes

Master note arrangements, also known as "variable amount notes", are borrowing arrangements whereby trust accounts provide short-term cash to large companies. These types of investments may be operated in place of, or in addition to, a bank's Short Term Investment Fund. With the increased use of commercial paper and other sources of capital, this form of borrowing has lost much of its popularity.

The documentation of the borrowing arrangement includes the note evidencing the maximum amount of the loan, which may be on a demand basis or have a fixed maturity. Either the note or a separate loan agreement will detail the terms of the credit. The interest rate is usually adjusted monthly based on commercial paper rates. The note is payable to the bank or a nominee and may be repaid by the borrower(s) in whole or in part at any time. The amount of the loan may fluctuate daily as increases or decreases are made in the participation. If an account acquires (increases) a participation, a buy order is executed; if the account withdraws (reduces) a participation, a sell order is executed. Buy and sell orders are combined at the end of the day, resulting in a net adjustment to the loan. This is communicated to the borrower on the following business day and may be accepted or rejected. Interest, at an agreed upon rate, must be paid monthly on the daily amount of the loan outstanding during the preceding month.

A separate investment control is maintained for each master note. A participant record for each account should be maintained and appropriate accounting entries made by the bank each time the loan balance changes in order to ensure that participant records reconcile to the amount outstanding. Asset records for each participating account must reflect the investment in the master note.

Broad investment powers in the governing instrument are sufficient authority for such investments. However, investments by accounts for which the bank does not have full investment responsibility must have letters of direction from parties authorized to

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direct each purchase or sale. Custodial and agency accounts may invest in master notes if the terms of the governing instrument permit.

All master notes should be issued by companies classified as "prime credits", i.e., an issuer rated in one of the two highest rating categories by at least two nationally recognized investment rating organizations. The bank should have full information on the capital, debt structure, and financial condition of the issuer, including: total amounts borrowed on master notes, total long and short-term borrowings, and the most current financial statement. Additionally, the bank should obtain quarterly certifications that the notes are: not subordinated to any other debt of the company, there is no litigation pending or threatened which would affect such notes, and the issuer is not in default on any of its outstanding obligations.

As a guideline, if the total amount of variable or master notes exceeds 10 percent of the market value of the assets held by the trust department, the examiner should question the prudence of such investments. A bank which has notes issued by any one company in excess of 5 percent of the market value of the department's total assets should be requested to justify the prudence of such investments. Where a note has both a demand and fixed term component, the examiner should comment upon the arrangement when the fixed term is in excess of 50 percent of the principal amount of the note. As with other types of investments, the bank should have appropriate written policies and procedures governing the use of master notes, including the maximum amount of funds to be extended, the submission of current financial information, periodic credit reviews of the borrower and the submission of corporate borrowing resolutions.

A conflict of interest may exist if the commercial department of the bank also has loans outstanding to the master note obligor.

### Business Interests

The primary types of business interests encountered in a trust department are: (1) Stocks or other securities of closely held corporations, i.e., a corporate entity whose stock is not actively traded, (2) Partnership interests, either general or limited, (3) Sole proprietorships, and (4) Joint ventures. The management of business interests is often demanding, time consuming and requires expertise.

Family business interests can pose administrative problems to the trust department. One of the greatest problems in holding the securities of a closely-held business is the limited marketability due to concentrated ownership. This is particularly true if an accounts holds a minority interest. The illiquid nature of a minority interest, when combined with a lack of investment diversification, may cause concern. When the bank as fiduciary holds a minority business interest, it may attempt to identify other shareholders with whom it can jointly control or influence the management of the closely-held business. The surcharge potential is perhaps the most important concern with fiduciary appointments involving family business interests.

The purpose of reviewing the administration of closely-held business interests is to evaluate both the institution's expertise and its actual management of such business interests. Due to the relatively high surcharge potential, the bank should, prior to accepting such an appointment, thoroughly review all the potential risks and disadvantages associated with administering a closely-held business. If bank policy permits, it may be desirable for the fiduciary to represent the account by having a bank officer serve as an officer or director of the company. However, a directorship involves a certain degree of potential liability to the bank and the individual serving as a director. Therefore, consideration should be given to obtaining appropriate indemnity insurance to cover these situations.

Occasionally banks are appointed executor or administrator of an estate which includes a sole proprietorship or a partnership interest. As a general rule, such businesses terminate upon the death of the proprietor or partner, but it usually takes considerable time to settle outstanding business matters. The bank should work closely with estate counsel and others interested in the business, as conveyance of such business property is complicated and may be disruptive to the beneficiaries. It is important to determine that the bank has limited its liability in administering such property.

Conflicts of interest may be present when the bank is lending to the business. The bank should approach this area cautiously and seek outside financing sources first. Additionally, the bank should prohibit its personnel from acquiring an interest, financial or otherwise, in the company, other than representing the beneficiaries and the bank.

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The examiner should review and evaluate the adequacy of the department policies governing the administration of business interests. The expertise of the bank in administering such interests should be evaluated through a review of board minutes, trust committee minutes, account files, and the qualifications of its personnel. Compliance with laws, governing instruments and standards of prudence should be determined, the possibility of conflicts of interest ascertained and the potential for liability to the bank assessed. Trust departments that actively manage business interests should be familiar with Federal Statutes that could impact the operation of the business. An example would be the Americans with Disabilities Act, which prohibits discrimination in private employment, transportation, telecommunications, and public accommodations.

Examiners should determine the extent to which the trust department monitors these investments. The department should periodically request financial information from the business, develop a method of evaluating the business' financial condition and document its findings. Additionally, these assets should be carried on the books of the trust department at some value that is supportable based on the available documentation.

### Worthless Securities

On occasion, the trust department will receive securities which are or become worthless, particularly in estates and guardianship accounts. In determining if securities are indeed worthless, the department should obtain documentation, from the corporation commission or the secretary of state of the state in which the corporation that issued the security was chartered, evidencing that the corporation is no longer in business. Frequently, this documentation will state that the securities are worthless. Once such a determination has been made, the information should be presented to the trust committee with a request for approval to write-down the carrying value and identify the securities as worthless on the department's records.

Whenever possible, worthless securities should be returned to the trustor or distributed to the account beneficiary. Those securities remaining in the trust department's control can be listed among the account's assets or carried in a house account with a reference to the account holding the asset. For control purposes, the department should continue to carry the securities on its records at a nominal value.

A complete list of worthless securities should be maintained and the securities kept in the trust securities vault under dual control. Periodically, the list should be reviewed to determine if any of the issues have become marketable, since they occasionally regain value. Protective measures are recommended to guard against neglect or misappropriation of any securities that regain value.

### Tangible Assets and "Collectibles"

Tangible assets include works of art, antiques, stamps, coins and bullion, and diamonds and gemstones. Such assets often appeal to individuals who do not need current income from all their investments, and, therefore, can allocate a portion of their assets to tangibles in an effort to provide long-term capital gains with no current income tax consequences. Assets of this type are often viewed as an inflation hedge.

An examiner has several objectives in reviewing the management of tangibles. First, the examiner needs to determine that the department has adequate control over the assets and has made provisions for proper storage and adequate insurance. Management should attempt to verify ownership of the assets, as the grantor can't acquire good title to stolen property. Stolen artwork has resurfaced years later and has been returned to the rightful owner. However, discovery and demand for the return of stolen art must be made. The recovery period can extend well beyond the statute of limitations. In one case, the court ruled that the statute of limitations didn't begin until a museum demanded the item be returned. That was 30 years after discovery.

Rare stamps and coins should be authenticated by an expert (such as the Philatelic Foundation of New York for stamps and the American Numismatic Association for coins). For diamonds and other gemstones, a certificate should always be obtained. It is essential that such assets be maintained under dual control. Separate storage of tangible assets that might suffer significant damage, such as stamps, should be considered.

The purchase and retention of tangible assets should be permitted in the governing instruments. Appraisals should be obtained periodically. With some notable exceptions, tangible investments may be difficult to liquidate. A national auction market exists for investment grade stamps. Gemstones are usually sold by consignment through a major dealer. Some risks can be minimized by permitting such investments only in directed, i.e. nondiscretionary, accounts, and by using reliable dealers and auction houses.



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The Economic Recovery Tax Act of 1981 essentially eliminated the option of investing in tangibles for self-directed employee benefit accounts (IRA, Keogh, Pension and Profit Sharing) after December 31, 1981. Under the law, any funds of a self-directed retirement plan used to purchase tangible assets must be treated as a taxable distribution of the plan's assets to the participant(s). Refer to Section 5 for further discussion of this topic. However, if an independent trustee or qualified investment manager, vested with investment discretion, selects tangibles as an investment, the participants of the plan would not be similarly penalized.

### Repurchase Agreements

A repurchase agreement is an acquisition of funds through the sale of securities, with a simultaneous agreement (commitment) by the seller to repurchase the securities at a later date. The owner of a U. S. Government or agency security transfers possession of the obligation for a percentage of its market value but retains ownership and the inherent rights to receive the interest and principal of the obligation. At an agreed upon future date, the owner (seller) repurchases the obligation to repay the amount borrowed plus the agreed upon interest. A repurchase agreement, regardless of the terminology used, is a secured borrowing by which an owner (seller) leverages existing positions in securities by pledging these holdings against the repurchase liability.

Some trust departments engage in repurchase agreement transactions as a temporary investment vehicle for cash balances awaiting permanent investment or distribution. In this context, a trust account becomes the lender of funds to a financial institution or a broker/dealer. Although the trust account acquires an asset, it will generally be identified on the trust department's records as a repurchase agreement. Repurchase agreements are collateralized by U. S. Government or agency securities, bear a fixed or variable rate of interest, are payable at a fixed maturity (one day or longer) and may be subject to other terms and conditions.

Repurchase agreements bought from the bank's commercial department or from bank affiliates represent loans by trust account(s) to the fiduciary bank and involve a conflict of interest and self-dealing. The purchase of repurchase agreements from the bank's commercial department, affiliates of the bank or other organizations, where there exists an interest which might affect the best judgment of a fiduciary, should not be made unless specifically authorized either in the instrument creating the trust relationship, by court order, by local law or unless prior written approval is obtained from all interested parties. If appropriate authorization is contained in the instrument or local law, or obtained from a court or all interested parties, the examiner should review the investment in light of normal investment considerations, e.g., rate of return, diversification, adequacy of pledged securities (collateral margin), maturities, etc. The bank must pay a competitive rate of interest, and the terms must be no less favorable than those granted to others purchasing the same types of repurchase agreement.

In those cases where such investments are not authorized, the examiner should fully discuss the matter with management, obtain a commitment to take corrective measures, and detail the situation in the Report of Examination.

The Department of Labor, in Prohibited Transaction Class Exemption 81-8 dated January 23, 1981, "Short-Term Investments", allows employee benefit plans to acquire repurchase agreements with maturities of one year or less from parties-in interest. However, the obligor financial institution or its affiliate(s) cannot hold discretionary authority or control over the investment of assets of the plan purchasing its obligation. If the department has purchased own-bank or affiliate bank repurchase agreements for discretionary accounts, or directed employee benefit plans subject to ERISA prohibited transaction provisions without obtaining proper written direction, the examiner should fully discuss the matter with management and schedule the investment(s) as an apparent violation(s) of ERISA Section 406 (prohibited transactions with a party-in interest) and/or ERISA Section 404 (fiduciary standards).

Repurchase agreements bought from other financial institutions or broker/dealers may be an acceptable short-term investment provided this type of investment is authorized by the governing instrument and/or state law and is appropriate to the investment needs of an account's beneficiaries. Repurchase transactions represent a form of lending. Consequently, the considerations normally associated with granting secured credit should be made by the trust department. Repayment of repurchases by the selling institution or broker/dealer is a major consideration. The trust department should satisfy itself that the seller will be able to generate the funds necessary to repurchase the securities on the maturity date of the contract. In assessing the propriety of these transactions, the examiner must determine if the trust department has considered the ability of the seller to meet its commitment to repurchase on the prescribed date.

Because repurchase agreement transactions are considered a form of secured lending, the bank should have written policies governing their use as trust investments and a written agreement for each transaction outlining specific provisions pertaining to

collateral margins. Acceptable margins, the percentage by which collateral securing the loan exceeds the credit, should be determined by considering the maturity and the volatility of the securities pledged, along with the maturity of the repurchase agreement. The collateral should be priced on a regular basis to assure maintenance of the required margin. Monies should not be lent until acceptable types of securities are delivered into the bank's custody or to an independent safekeeping agent designated by the bank. Trust department management should not make such investments without the account(s) acquiring a perfected security interest in the collateral securities. Registered securities should be endorsed in such a manner to ensure negotiability. In other respects, collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. The examiner should determine that proper procedures have been established for the control of collateral and the maintenance of collateral margins.

Other areas that should be addressed in policies governing repurchase transactions include: setting a maximum amount to be extended to a single firm by any one account and by all accounts in the aggregate; requiring borrowing firms to supply corporate borrowing authorizations; requiring the submission of current financial information; and obtaining periodic credit reviews of the borrowing entities.

Additional guidance is also provided in: the February 17, 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products (FIL-9-94) and the Government Securities Act of 1986. The FDIC adopted the FFIEC Supervisory Policy on Repurchase Agreements on February 10, 1998. This policy statement appears in Appendix C. The discussion of ERISA requirements is located in Section 5.H.7.f.16 Repurchase Agreements.

### Securities Lending

A number of financial institutions and their trust departments are involved in securities lending activities in the capacity of either principal or agent. This is a fee-based service whereby the trust department lends customers' securities held in custodial, safekeeping, personal trust or employee benefit accounts. Collective investment funds and mutual funds whose investments are managed by the trust department may also engage in securities lending.

Securities lending primarily involves loans of large blocks of U.S. government and Federal agency securities held in corporate employee benefit plans. Corporate trust accounts, personal trust and agency accounts are involved to a lesser degree. The primary borrowers of securities are brokers and commercial banks. The primary reasons for borrowing securities are to cover securities fails (securities sold but not delivered), short sales, and option and arbitrage positions. On occasion, securities may be borrowed to meet pledging requirements. Securities lending is conducted through open-ended agreements which may be terminated on short notice by either the lender or borrower. The objective of such lending is to increase a portfolio's yield by receiving fee-based income in addition to interest or dividends.

Securities loans are generally collateralized by U.S. government or Federal agency securities, cash or letters of credit. Each loan is initially collateralized at a predetermined margin. When the loan is terminated, the securities are returned to the lender and the collateral is returned to the borrower. Fees received are divided between the institution as lender/agent and the customer account that owns the securities.

While securities lending is similar to a repurchase agreement program, repurchase agreements have the following distinguishing characteristics:

- The sale and repurchase of U. S. Government or Federal agency securities,
- Cash is received by the seller and the party supplying the funds receives the collateral margin,
- The agreement is for a fixed period of time,
- The fee is negotiated and established for the transaction at the outset and no rebate is given to the borrower for interest earned on the cash collateral, and
- The confirmation received classifies the transaction as a repurchase agreement.

Traditionally, securities lending has been viewed as a low-risk activity which enhances a trust account's investment return. This has changed in more recent years, as a number of major losses have occurred due to securities lending activities. Previously, collateral was generally invested in very short-term investments. When interest rates were low, the returns on short-term

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investments were not attractive. To boost investment results further, high grade but longer-term collateral was accepted. When interest rates suddenly rose, the value of this collateral dropped sharply.

To address those concerns, the FFIEC adopted a Supervisory Policy concerning Securities Lending in 1997. The Policy Statement includes the following guidelines for participation in a securities lending program.

- Develop and implement written policies, procedures, and a system of controls which enables the department to comply with applicable laws and regulations, and minimizes the potential risks associated with securities lending.
- Have a knowledgeable and experienced staff before engaging in any securities lending activity.
- Recordkeeping - Management should be able to readily determine which securities are lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account.
- Administrative procedures - All securities lent and all securities used as collateral must be marked to market daily.
- Credit analysis of the borrower - Securities lending activities involve risk of loss, normally from malfeasance or failure of the borrowing firm or institution. Therefore, the lender should approve transactions with the borrower in advance of lending securities. The review should include at a minimum: an analysis of the borrower's financial statements, management, and any other material evidence of the borrower's creditworthiness.
- Credit and limit approvals should be based on a credit analysis of the borrower. This analysis should be performed by individuals who normally perform credit analyses of borrowers, not the individual responsible for the securities lending program.
- Credit and concentration limits - A credit line should be established for specific borrowers and should be based on the market value of the securities to be borrowed. This does not violate material inside information. Lending concentrations with any one borrower should be avoided.
- Conduct a due diligence analysis and review of the borrower. Enter into a securities lending arrangement only pursuant to a written agreement delineating the duties and responsibilities of each participant. The agreement should specifically address: the types of and the minimum margins acceptable for collateral, procedures to maintain adequate margin levels, custody of collateral, procedures for the collection of dividend and interest payments on securities lent, and procedures in the event of default. If securities are used as collateral, the trust department should review regulations for applicable requirements relating to the pledging, the perfection of the security interest, and the custody of the securities.
- Collateral management - Securities borrowers pledge and maintain collateral at least 100 percent of the value of the securities borrowed. However, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus any accrued interest for debt securities. Collateral must be maintained at the agreed upon margin. A daily "mark-to-market" or valuation procedures must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities. Securities should not be lent unless collateral has been received or will be received simultaneously with the loan.
- Cash as collateral - When cash is used, the lender is responsible for making it productive, by investing in repurchase agreements, master notes, short-term investment fund, certificates of deposit, commercial paper or some other money market instrument. For fiduciaries lending securities, the governing customer agreement should outline how cash collateral is to be invested. Investing in own-bank deposits or repurchase agreements, or investments in the bank's parent company would be a conflict of interest, unless specifically authorized in writing by the owner of the lent securities.
- Letters of credit as collateral - Letters of credit are allowable as collateral for certain securities lending transactions.

Since trust departments are not investing for their own accounts, but rather for the beneficiaries of trust or agency accounts, any securities lending must also take into consideration:

- Authorization by the governing account instrument. Any discretionary management of the cash collateral should be subject to clearly delineated risk tolerance guidelines between the lending account and the trust institution.
- For accounts over which the bank exercises investment discretion, the decision to lend securities represents an investment decision. This decision should be subject to normal fiduciary standards of lending. The following considerations should be documented:
  - The appropriateness of the transaction with respect to account objectives and beneficiary needs;
  - Diversification;
  - The prudence of the investment.

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The Department of Labor has issued two class exemptions which address securities lending programs for employee benefit plans covered by ERISA. Prohibited Transaction Exemption 81-6 (46 FR7527) issued January 23, 1981, supplemented by (52 FR 19754) issued May 19, 1987, and Prohibited Transaction Exemption 82-63 (47FR 14804) issued April 6, 1982, and corrected by 47 FR 16437 on April 16, 1982. The exemptions authorize transactions which might otherwise constitute prohibited transaction under ERISA. Prohibited exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be a "party in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities. Prohibited Transaction Exemption 82-63 permits a fiduciary to receive compensation for service rendered in connection with loans of plan assets that are securities.

Examiners should also refer to Section 5.H.7.f.17 Securities Lending for additional information and guidance with regard to ERISA account securities lending activities.

The FDIC adopted the FFIEC Supervisory Policy on Securities Lending on July 22, 1997. The policy statement is located in Appendix C.