Asset Management Part II: Securities Transactions, Processing, and Administration

Section 3

A. BROKERAGE PLACEMENT

The Board of Director or trust committee should approve policies regarding the selection and retention of securities dealers. The FDIC Supervisory Statement Policy Statement on Investment Securities and End-User Derivative Activities considers the selection of dealers, investment bankers, and brokers particularly important in effectively managing risks. Trust management should have sufficient knowledge about the securities firm and the personnel with whom they are conducting business. At a minimum, trust management should consider the following before selecting a securities firm:

- The ability of the securities dealer, its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength, liquidity, and operating results;
- The dealer's general reputation for financial stability, and fair and honest dealings with customers;
- Information available from State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer, its affiliates or associated personnel;
- In those instances when an institution relies upon the advice of a dealer's sales representative, the background of the sales representative with whom the business will be conducted, in order to determine their experience and expertise.
  - Approved Broker Monitoring
    - Commission rates
    - Net cost or net realization from the trade,
    - Promptness and certainty of execution,
    - Experience and knowledge of the broker with a security, industry, or market,
    - Access to a security's sources of supply,
    - The broker's market making ability, and
    - Financial stability and reputation
  - Internet Trading
    - Fraudulent and unregistered on-line brokers;
    - Fraudulent investment schemes;
    - Fraudulent news stories; and
    - New methods of disseminating erroneous reports on altered "website banners" pirated from legitimate institutions.
- Technological failures brought on by overwhelming internet traffic on finite or outdated systems;
- The inability to effect transactions quickly enough to avoid volatile fluctuations in highly sought after securities,
- The volume of which may be fraudulently induced; failure to use "limit orders" to prevent the purchase of securities at prices inflated by market volatility;
- Failure to understand the meaning of "best execution" broker practices;
- Technological failures induced by the investor's own equipment; and
- The failure to recognize that on-line "real-time" pricing can in actuality be 15 minutes old, or older, which increases the likelihood that "market order" transactions may be executed at prices vastly different than anticipated by the investor in a turbulent market.
- Prior to opening an on-line account, obtain complete information about the alternatives available for buying and selling securities, and how to obtain account information if the broker's website cannot be accessed.
- Recognize that the investor's computer is not directly linked to any market and that orders are not instantaneously executed when entered on the computer screen.
- Obtain information from the firm to substantiate advertised claims concerning the ease and speed of on-line trading.
- Obtain information from the firm about significant website outages, delays, and other interruptions to securities trading and account access.
- Before trading, obtain information about entering and canceling orders (market, limit, and stop loss), and the details and risks of margin accounts.
- Determine whether the computer is displaying delayed or real-time stock quotes, and when the information was last updated.

- Review the firm's privacy and website security policies, and whether the investor's name may be used for mailing lists or other promotional activities.
- Obtain clear information about sales commissions and fees, and any conditions which may apply to advertised discounts.
- Learn how to contact customer service representatives with on-line trading concerns.
- Contact state securities agencies to verify the registration and licensing status, and any disciplinary history of on-line firms and representatives; and file complaints when appropriate.
- Requiring a due diligence investigation of internet brokers.
- Inquiring among peer trust departments about their experience with internet brokers and obtaining other references.
- Performing a due diligence review of the reasons for using internet trading instead of regular brokerage accounts.
- Requiring Board of Director or trust committee authorization of internet trading practices. The Board or trust committee should review trust management's documented justification for using internet brokers, including:

    - projected commission savings by trust customers, and
    - best execution protections.

- Requiring periodic reporting to the trust committee, or other operating committee, of usage of internet trading, including:
    - number and dollar volume of trades,
    - listing of trades which were executed at prices which were different than "real time" price on internet sites,
    - trades which were not executed,
    - problems with internet brokers,
    - delays in order transmission due to hardware problems,
    - slow internet transmissions,
    - discrepancies between trade orders and confirmations,
    - fails, etc.

- Performing the following oversight functions by the Board, trust committee, or other operating committee:

    - Periodic reviews of the quality and execution of internet trading,
    - Approval of the continued use of internet trading brokers,
    - Analysis of whether the use of internet brokers will result in increased research costs, if internet broker does not provide investment advice, and
    - Analysis of the quality and availability of investment research provided by internet brokers.

- Specific controls to limit internet trading risk.
- Prohibiting the use of internet for personal trading by employees.
- Prohibiting officers and employees from trading for accounts off the banking premises (or at home).
- Prohibiting after-hours trading if the department has not established specific controls governing after-hours trading.

←

B. SECURITIES TRADING

Trust department investment policies and procedures should prohibit research analysts, traders and/or portfolio managers from trading for their own account through brokerage accounts maintained by the trust department. Examiners should verify that the trust department's accounts with brokerage firms are used only to effect transactions for trust accounts or approved outside clients. If the bank has not established policies or control procedures, the examiner should discuss the potential hazards with management and recommend adoption of policies and procedures. The audit program should include procedures to detect misuse of brokerage accounts.

In general, borrowing for the purpose of investment is an improper activity for a trustee, except when purchasing improved real estate. The bank as fiduciary should not maintain a margin account with a broker unless specifically authorized by the terms of the governing instrument and directed by a party having appropriate authority.

Examiners should be alert for any involvement in speculative securities trading activities. Any speculative transaction ordinarily evidences contravention of "prudent man" doctrines.

Churning is a term for excessive trading in an account for the purpose of generating and maximizing broker commissions and can occur in both discretionary and nondiscretionary accounts. The practice is illegal and is among the most common claims made against stockbrokers, investment advisers, and financial planners. In determining whether churning has occurred, consideration should be given to the following:

- the number and frequency of trades;
- the amount of "in-and-out" trading; the amount of commissions generated;
- the investor's objectives and level of business sophistication; and
- the degree of control the broker has over the account.

To be considered churning, the broker:

- must have either explicit (discretionary accounts) or implied control (nondiscretionary accounts) over the account;
- trading must be excessive in relation to the customer's objectives; and,
- the broker must have acted with the intent to defraud or with behavior that was reckless.

The broker's lack of or poor judgment does not demonstrate intent to defraud or reckless behavior. Furthermore, accounts with investment objectives of growth or speculation are likely to have more frequent transactions than accounts with investment objectives of long-term growth or income. Therefore, what may appear to be churning in accounts should be reviewed in light of the investment objectives of each account.

For a more detailed discussion on broker selection, internet trading, and due diligence policies and practices, refer to A. Brokerage Placement.

←

C. BROKERAGE SELECTION SOFT DOLLARS BASIS - SEC § 28(E)(1)

Section 28(e) was added to the Securities Exchange Act of 1934 by the Securities Acts Amendments of 1975. This section provides "safe harbor" protection to the fiduciary exercising investment discretion, provided certain conditions are met. Under Section 28(e)(1), "No person ... shall be deemed to have acted unlawfully or to have breached a fiduciary duty ... solely by reason of his having caused the account to pay ...an amount of commission ... in excess of the amount of commission another ... dealer would have charged ... if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided ... in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion." Section 28(e)(3) defines research and brokerage services. in order to qualify as research or brokerage services, the services provided must:

- Furnish advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in purchasing, or selling securities, and the availability of securities;
- Furnish analyses and reports concerning the issuer, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or,
- Effect securities transactions and perform functions incidental thereto, such as clearance, such as settlement and custody, or required in connection therewith by the SEC, or a self-regulatory organization.

Note that transactions in futures or for transactions done on a principal basis are not covered by the safe harbor.

Four requirements must generally be satisfied to obtain "safe harbor" protection under Section 28(e):

- The soft dollar goods and services must be provided by the broker-dealer effecting the securities transaction,
- The soft dollar goods and services must be provided to the party holding investment discretion over the account,

- The recipient of soft dollar goods and services must make a good faith determination that the commissions paid are reasonable in relation to the value of brokerage and research services provided, and
- The goods and services provided for the soft dollars must qualify as "brokerage and research" services.

Section 28(e) is a "safe harbor" which affords "protection." It is not a regulation, and, therefore, cannot in itself be violated. Any "violations" connected with transactions not afforded the protections under Section 28(e), would be of the antifraud provisions of federal securities laws. Also, while not specifically addressed within Section 28(e), there exists a general fiduciary duty to seek "best execution." Best execution implies the best net price to the customer, together with accuracy and speed of execution. It is not intrinsically linked with, nor does it imply, the lowest brokerage commission.

Trust institutions which engage in soft-dollar trading are required to disclose the research products and services it obtains to the trust accounts paying soft-dollar commissions. In an inspection report on soft-dollar practices released September 22, 1998, the SEC stated that Section 28(e) "does not shield a person who exercises investment discretion from violations of anti-fraud provisions of federal securities laws arising from churning an account, failing to obtain the best price or best execution, or failing to make required disclosure." Regarding full disclosure, the report provided, "Disclosure is required whether the product or service acquired by the adviser using soft dollars is inside or outside the safe harbor. Advisers are required to disclose, among other things, the products and services through soft dollar arrangements, regardless of whether the safe harbor applies." The SEC has directed advisers that they "need not list individually each product, item of research, or service received, but rather, state the types of products, research, or services obtained with enough specificity so that clients can understand what is being obtained."

The SEC has also long taken the position that "mixed use items," or products and services that provide both research and non-research benefits (such as in-house computer networks used for other purposes in addition to research), should be allocated between soft dollars and hard-dollars. This requires institutions to allocate the costs associated with these products and to pay for the non-research portion with their own funds.

Refer to subsection E.2.a., located in Section 8 for additional discussion of this topic. Refer to Securities and Exchange Act of 1934 Release No. 34-23170, "Section 28(e) and Soft Dollars" for a discussion of the scope of Section 28(e).

←

D. BROKERAGE SELECTION ON DEPOSIT BASIS - SEC § 28(E)(2)

The Justice Department has long viewed the allocation of brokerage business by banks based upon the volume of demand deposits maintained by a security dealer as reciprocity in violation of antitrust laws. Reciprocity means the use by a company of its power as the buyer of products or services to influence the sale of its own products or services.

Section 28(e)(2) of the Securities Exchange Act of 1934 states "A person exercising investment discretion ... shall make such disclosure of his policies and practices with respect to commissions that will be paid ... at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." Although the Corporation does not require the disclosure of brokerage policies and practices, examiners should review this area to determine whether the bank is complying with its fiduciary duties in the placement of brokerage business. Consequently, the type and amount of deposit relationships maintained by brokerage firms used by trust departments should be ascertained. Examiners should evaluate whether reciprocity (as opposed to the quality of execution, research, cost, or other ancillary services), may have played a role in the selection of brokers.

←

E. BEST EXECUTION

The SEC and the courts have stressed the duty to obtain best execution. The term is usually defined as seeking the most favorable terms for a customer transaction reasonably available under the circumstances. Best execution does not require that the lowest possible commission be obtained, and the SEC has not adopted regulations that require a trade to be executed within a set period of time.

Trust management should consider various qualitative and quantitative factors when determining the quality of execution and should establish policy and procedures to evaluate and demonstrate that trades are made using the following criteria: The selection of broker/dealers should comply with the FDIC Supervisory Policy Statement on Investment Securities and End-User Derivative Activities. The points to consider in determining best execution should consist of research provided if any, best price, speed of execution, certainty of execution, access to initial public offerings, recordkeeping, and the commission rate or spread. These general criteria do not endorse or prohibit on-line transactions.

The SEC has brought enforcement proceedings against investment advisors and those actions have been centered in transactions involving soft dollars, cross trade, affiliated trades, and advisors' failure to disclose execution practices. Failure to use best execution procedures may violate the antifraud provisions under securities law.

Trust investment officers can verify that a particular investment is registered with the SEC via the SEC's EDGAR system. The NASD can provide information on brokers and dealers, such as disciplinary information. States have securities regulators that can provide information and accept complaints for various causes, including but not limited to poor or inappropriate execution, broker/dealer licensing status, and fraud.

←

F. SECURITIES SETTLEMENT PRACTICES

Settlement occurs when the transaction is completed by the exchange of securities and money between the buyer and seller. On settlement date, the buyer receives the securities in either book-entry or definitive (physical) form, and a change in ownership is recorded.

The settlement period is the time between trade date and settlement date. Since 1995, most trades of U.S. government and federal agency securities settle the day after the trade date, which is known as next-day settlement. The standard for corporate debt and equities, American Depository Receipts (ADRs), and municipal securities has been three days. However, an initiative is underway to ultimately allow for straight-through processing (STP), in real-time with multiple currencies. In order for STP to occur, various actions must be implemented, and includes, but is not limited to the following:

- International/Foreign Exchange - Implications to foreign investors trading U.S. issued securities
- Legal and Regulatory - Rule changes to accommodate STP improvements
- Payment Processing - Automated payment process
- Physical Securities - Eliminate the movement of physical securities
- Securities Lending - Implement the Automated Recall Management Systems (ARMS) to improve level of STP in the stock loan recall process
- Real-time trade matching - For fixed income securities

The following is a more detailed explanation of current settlement practices based on the type of investment:

Transactions involving U.S. Treasury and Agency obligations are typically in book entry form, rather than in physical certificate form. Book-entry is an electronic registration, transfer, and settlement system that enables the rapid and accurate registration and transfer of securities with concurrent cash settlement. Book-entry reduces handling costs and quickens transaction completion. U.S. Treasury and Agency book-entry securities are delivered and cleared over the Federal Reserve Wire System (Fedwire) on a delivery versus payment basis. Acceptance of the security automatically debits the payment amount from the buyer's account and credits it to the seller's account. The payment and securities involved are transferred over the Fedwire system. The Federal Reserve Bank of New York maintains the book-entry custody system. All depository banks are eligible to maintain book-entry accounts at their Federal Reserve District Bank, provided that they also maintain a funds account with that Federal Bank.

Mortgage securities settlement procedures are more complex than those for government, corporate, and municipal bonds. The Bond Market Association developed the Uniform Practices for the Clearance and Settlement of Mortgage Backed Securities and Other Related Securities (hereinafter, "Uniform Practices") to establish industry standards for mortgage securities settlements. Since the Uniform Practices are updated frequently, trust management engaged in mortgage and asset-backed securities transactions should keep abreast of current settlement standards.

Corporate and municipal debt securities are available in book-entry and registered, definitive form. Book-entry corporate and municipal bonds settle through the Depository Trust Company (DTC).

Electronic trade processing and recordkeeping systems have improved the trade and settlement time and have reduced failed trades. However, failed trades may occur due to the following reasons:

- The buyer rejects the delivery due to not being in good delivery form or the records of the buyer and seller not matching. The primary reason for this problem is a lack of communication.
- The buyer recognizes the trade, but it is in a different dollar amount.
- The buyer rejects the transaction due to incorrect maturity date, interest rate, or series.

If the receiving party accepts delivery (upon payment) and discovers that it was not a good delivery, then the buyer can correct the error by reclamation. In the reclamation process, the buyer returns the securities with an explanation to the seller (who has already received payment). The seller is obligated to return the payment, if the claim is valid. Either party may make a reclamation if information is discovered after delivery, which, if known at the time of delivery, would have caused the delivery not to constitute good delivery. However, reclamation must be made within the stated time limitations established by the Bond Market Association.

If a trade has a settlement date between a record date and a payable date, delivery of the securities must be accompanied by a due bill. A due bill is a document delivered by a seller of a security to a buyer evidencing that any principal and interest or dividends received by the seller past the record date will be paid to the buyer by the seller upon submission of the due bill for redemption. The record date is the date for determining who will be paid principal, dividends or interest on an issue. Book-entry messages are considered acceptable due bill substitutes for securities transferred over Fedwire (Treasury), DTC (Corporates and Municipals), or PTC (GNMA). Due bills and book-entry messages cease to be valid after 60 days from their issue date. A trust department may experience considerable delays in attempting to recover payments without the use of a due bill, which result in the accumulation of significant principal and interest receivable accounts. If delivery and payment on a trade occur after a record date and on or after a payable date, delivery of the securities must be accompanied by a check for the principal, dividend or interest due.

←

G. SECURITIES TRANSFER AGENT'S MEDALLION PROGRAM (STAMP PROGRAM)

The Securities and Exchange Commission created a universal signature guarantee program that consists of a stamp that serves as a signature by an eligible institution, such as a bank, brokerage, or trust company, that participates in the program. The purpose is to ensure that the person signing the certificate or irrevocable stock or bond power form is the owner or authorized agent. The program also standardizes the signature guarantee by assigning a standard format and numbering system. The latter identifies the financial institution. The stamp is an ink impression applied to a certificate that allows good delivery form. It is not the same as a notary, which attests to the authenticity of documents and contracts and signatures of testator and witnesses.

←

H. SHAREHOLDER COMMUNICATIONS ACT OF 1985

This Act gives the SEC jurisdiction to regulate the proxy processing of all entities exercising fiduciary powers, including trust departments. The Act is implemented primarily by SEC Rule 14b-2, which can be found in Appendix D. The purpose of this regulation is to ensure that beneficial owners of securities are provided proxy materials and other corporate communications within specified time periods. Refer to Operations and Internal Controls - Shareholder Communication Act for additional information and guidance.

←

I. PROXY VOTING

As a function of equity ownership, a fiduciary has the duty to cast proxy votes for shares of stock held in a discretionary capacity. A policy should be developed which establishes the department's position with regard to voting on routine, as well as controversial, issues. The policy should also establish voting and recordkeeping procedures.

For **ESOP** investing in the employer securities that are **registered** with the SEC, participants must be given full voting rights for stock allocated to their accounts. In addition, the DOL has opined in a letter ruling dated September 28, 1995, that fiduciaries of

ESOP in which participating employees are covered by a collective bargaining agreement must pass through decisions concerning tender offers or proxy voting to the plan's participants and vote as directed.

ESOPs maintained by employers whose securities are **not registered** with the SEC are required to pass through voting rights to participants with stock allocated to their accounts only for the following purposes: Corporate mergers or consolidations; recapitalizations, reclassifications, liquidations, dissolutions, or the sale of substantially all assets. Furthermore, the plan may authorize the trustees to vote allocated stock based on a one vote per participant basis, rather than number of shares basis. IRC 409(e).

Employer stock held in a suspense account, i.e., not yet allocated to participants, may be voted by the trustee, in accordance with their duty to plan participants and beneficiaries.

←

J. FDIC REGULATIONS

FDIC Part 344: Record Keeping and Confirmation Requirements for Customer Securities Transactions

Exceptions to the Regulation

Record Keeping

- o For each customer, account records reflecting all purchases and sales of securities, and all receipts and disbursements of cash [Section 344.4(a)(2)];
- o A separate memorandum (order ticket) for each order to purchase or sell securities (whether executed or canceled). The memorandum must include: (i) the account name(s), (ii) whether the transaction(s) was a market order, limit order, or subject to special instructions, (iii) the time the order was received by the person responsible for effecting the transaction, (iv) the time the order was placed with the broker/dealer, or if there was no broker/dealer, the time the order was executed or canceled, (v) the price at which the order was executed, and (vi) the broker/dealer utilized [Section 344.4(a)(3)];
- o A record of all broker/dealers selected by the bank, and the amount of commissions paid or allocated to each broker during the calendar year [Section 344.4(a)(4)].

Confirmations

- o A copy of the broker/dealer's confirmation and, if any remuneration is to be received by the bank, a statement of the source and amount of the remuneration (refer below for special remuneration provisions). If the confirmation is sent from the bank, it must be sent within one business day from the bank's receipt of the broker/dealer's confirmation. [Section 344.5(a)]; or
- o A written notification (bank confirmation) disclosing specified items of information about the transaction. [Section 344.5(b)] The confirmation may be sent to the customer by mail, FAX, or electronically.

- When a prior written agreement between the bank and the customer provides for different treatment;
- When the bank acts in a principal capacity for transactions involving government or municipal securities;
- When the transaction involves open end mutual funds (where the amount of the bank's remuneration may be based on the number and/or amount of transactions over a given period which has not yet expired), if the customer has been provided a current prospectus which discloses all current fees, loads, and expenses at or before completion of the transaction.
- In discretionary fiduciary accounts (trusts, estates, guardianships, etc., but excluding collective investment funds), the customer may agree to the receipt of transaction information within a "reasonable" time frame other than that specified in the regulation. This alternative arrangement may be a part of the text of the trust agreement. The bank may charge a "reasonable" fee for furnishing such information. [Section 344.6(b)]

  In such discretionary fiduciary accounts, the "customer" is the person having the right to terminate the account. If no such person exists, anyone with a vested interest in the account is the "customer."

- In discretionary agency accounts, the bank must mail an itemized statement to the customer not less than once every three months. The statement must provide a detail of investments in the account, together with uninvested cash balance(s). It must also show all transactions during the statement period. [Section 344.6(c)]

  If the customer requests, the bank is required to provide written notification conforming with Section 344.5. In such instances, the confirmation must be provided "within a reasonable time." The bank may charge a "reasonable" fee for furnishing these confirmations.

  - The term "reasonable," when applied to the time to provide confirmations as above, has not been interpreted to date. It must be applied in light of: (i) any provisions of the instrument, (ii) state law and regulation (if any), and (iii) the facilities and capabilities of the fiduciary institution.
  - The term "reasonable," when applied to the fees which may be charged as above, has not been interpreted to date either. It must be applied in light of: (i) any provisions of the instrument, (ii) state law and regulation (if any), and (iii) the bank's pricing for equivalent statements, such as deposit or loan statements.

- In all nondiscretionary accounts (fiduciary and agency accounts, but excluding dividend reinvestment and similar periodic plans), the customer may opt to waive the confirmation.

  The agreement (or separate disclosure statement), however, must clearly indicate that the customer may receive a confirmation within regulatory time frames at no additional cost. [Section 344.6(a)] The waiver must be sufficiently prominent that the customer realizes what is being waived. It may be either a separate disclosure document or included in the body of the trust agreement. If included in the agreement, the waiver may not be buried in "boiler plate" text. The waiver should be positively affirmed by the customer with a separate signature or initials, or by having the customer check a box.

- In cash management sweep accounts, the bank must provide the customer a written statement for each month in which a purchase or sale of a security is effected in a customer's account. If no transactions occur in the account, a written statement must be provided to the customer at least quarterly. [Section 344.6(d)]

  - On December 22, 1998, the FDIC Legal Division issued an interpretation which provides that the monthly statement requirement in 344.6(d) for sweep accounts does not apply to sweeps performed for fiduciary and agency accounts in trust departments. The monthly statement requirement applies only to sweeps from retail deposit accounts of the commercial bank. However, if sweeps for the retail deposit accounts are routed through the trust department, the monthly statement requirement would apply. They would not be exempted merely because they were routed through the trust department.
  - Sweeps into repurchase agreements collateralized by government securities fall under U.S. Treasury Department regulations for government securities dealers, which require a daily confirmation [subject to the requirements of 17 CFR 403.5(d)] and do not permit the monthly/quarterly statement of Section 344.6(d).

- Collective investment funds may follow the same provisions as in OCC Regulation 9.18(b)(6). [Section 344.6(e)]
- Periodic plans (such as stock purchase or dividend reinvestment plans) must provide the customer written statements at least quarterly. The statement must detail the asset holdings of the account, charges and commissions paid by the customer, and all account transactions. The bank may charge a "reasonable" fee for providing this information. [Section 344.6(f)]
- Retail bank customers may not waive the receipt of confirmations or statements, even by written agreement.

  - Settlement of Securities Transactions
  - Written Policies and Procedures

    - The supervision of traders or others who transmit orders or execute transactions in securities for customers;
    - The supervision of all officers and employees who process orders for notification or settlement purposes, or perform back office functions with respect to securities transactions; and
    - Fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time.

- Officer/Employee Reporting of Personal Investment Transactions

    - Bank directors are not covered by this provision. However, bank directors who are also officers of the bank are required to file the reports, when applicable.
    - Reports are required when transactions made by the covered officers and employees (or on their behalf) aggregate to more than $10,000 during the calendar quarter. All transactions in U.S. Government and agency securities [defined in Section 344.3(i)], and all mutual fund shares, are excluded when calculating the $10,000 threshold. The same securities are also excluded from the reporting requirement.
    - Reports must be provided to the bank within 10 days after the end of each calendar quarter.
    - Personal investment transaction reports are required whether or not the bank falls under the 200 securities transaction threshold exemptions of Section 344.2(a)(1).
    - Reports are required only if transactions have occurred. There is no requirement for "no-activity" reports to be filed by covered officers and employees with the bank.

- fraudulent, deceptive and manipulative acts,
- improper use of material inside information, and
- other abusive practices.
- "front running" - A practice where an investment manager purchases securities for his/her own personal interest prior to an anticipated purchase of the same securities by the accounts for which he/she acts as investment manager. For example, the money manager may purchase securities for his/her personal account ahead of a purchase of the same securities by institutional accounts, since the purchase of a large block of securities could cause the price of the securities to increase.
- "insider trading" - transactions where an individual uses nonpublic material inside information (covered by the SEC's Rule 10b5-1), typically concerning the condition of a company or impending announcements (mergers, takeovers, profits/losses, new products, product recalls, etc.) which may materially affect the price of a company's stock, to benefit personally from investment transactions (refer also to Section 8. D. Material Public Information),
- "scalping" - trading for small gains over a short period of time, usually within a day. In some cases, this involves taking advantage of very narrow spreads in volatile markets. "Scalping" may be indicative of trading securities with advance knowledge of portfolio changes (particularly with respect to very large portfolios, usually the trust department's entire discretionary portfolio), or knowledge of material inside information.
- transactions with the institution's fiduciary accounts, and
- compliance with the provisions of the bank's code of ethics that restrict or otherwise require the reporting of securities trading by the bank's investment management staff for their personal benefit. Practices typically covered by an investment code of ethics include:

    - clearance in advance of personal trades;
    - delays of "x" period before buying or selling a security recently traded for discretionary trust accounts;
    - restrictions on short-term trading, such as requiring the holding of a stock for a designated period of time before taking a profit, perhaps dependent on whether a security is held in discretionary trust portfolios or recent trades in such securities;
    - selling short or investing in options on stocks, bonds and commodities held in trust accounts;
    - prohibitions against purchases of initial public offerings (IPOs), which are often hard to get and may be easily "flipped" for a quick profit; and
    - improper placement of personal investment transactions through the institution's brokerage accounts.

- All transactions must be reported; there is no $10,000 filing threshold;
- Directors are covered by the report, as they are considered "access persons" under the SEC rule; and
- The reports must be covered in the mutual fund's code of ethics. [Note that a model code of ethics has been prepared by the Investment Company Institute].

←

K. COMPLIANCE WITH SEC REQUIREMENTS

Securities and transactions in securities are largely governed by Federal law. The following discussion addresses some important aspects of securities regulation which are relevant to trust departments. Special reports or notices may need to be filed in those accounts holding equity securities which are registered under Federal securities laws. These requirements may apply to the trust department as a whole, to individual trust accounts, and to individual transactions. Others apply to the selection of brokers, the placement of brokerage transactions, and mutual fund 12b-1 fees.

- Marketable Securities
    - If the bank controls more than 5 percent of a registered company's outstanding stock, it must file notices under Section 13 of the Securities Exchange Act of 1934. Refer to the discussion in K.1.a. below, under the caption 13D and 13G, Acquisition Statements for Registered Equity Securities.
    - If the bank has discretion over $100 million or more in stocks and convertible bonds, it must file quarterly 13F reports under SEC regulations. Refer to the discussion under Quarterly SEC 13F Equity reports in K.1.b. below.
    - If a "person" controls 10 percent or more of a registered company's outstanding stock, a filing under Section 16 of the Securities Exchange Act of 1934 may be required. Refer to K.1.c. below.
    - SEC Rule 144 governs the sale of restricted securities. Refer to K.2 below.
- Acquisition Statements for Registered Equity Securities - SEC 13(d) and SEC 13(g)
- Reports of Equity Holdings - SEC 13F
- Section 16 Statements for 10 percent or More Holders of Registered Stocks
    - Not Applicable to Trust Departments
- Restricted Equity Securities - SEC Rule 144
    - the securities must have been beneficially owned for at least two years,
    - the number of shares sold in any three-month period must not exceed the greater of 1 percent of the total outstanding securities of the same class, or the average weekly trading volume for the class of securities during the four-week period preceding the sale, and
    - the securities must be sold either in a broker's transaction or in transactions directly with a market maker.

- the holding period requirement applicable to the resale of limited amounts of such restricted securities by any person will be reduced from two years to one year, and
- the holding period applicable to the resale of unlimited amounts of restricted securities held by non-affiliates is reduced from three years to two years.
- Under SEC Regulation S-T (17 CFR 231.10 - .601) the SEC requires the electronic submission of all reports, statements, and schedules filed pursuant to:
    - Sections 12(b) and 12(g) of the Securities Exchange Act of 1934;
    - the Trust Indenture Act of 1939 (other than applications for exemptive relief filed pursuant to section 304 and section 310 of that Act);
    - Sections 13, 14, and 15(d) of the Securities Exchange Act of 1934;
    - Sections 8, 17, 20, 23(c), 24(e), 24(f), and 30 of the Investment Company Act of 1940; and
    - the Public Utility Act.
- "Temporary Hardship Exemption" hardcopy filings are permitted under Regulation S-T (Rule 201), for unanticipated technical difficulties. "Continuing Hardship Exemption" hardcopy filings are also permitted under Regulation S-T (Rule 202), if the filings cannot be submitted electronically without "undue burden and expense."
- Under the revised reporting requirements of **17 CFR 249.325**, banks which electronically submit Form 13F may submit a copy of the form to their banking agencies either: (a) in hardcopy; or (b) electronically, if the agency is capable of receiving the filings in electronic format (the FDIC currently receives this form in hardcopy).