A. Introduction

B. Types of Accounts

C. Account Administration and Controls

D. Compliance with the Trust Indenture Act of 1939

E. Other Compliance

A. INTRODUCTION

Corporate trust and agencies are accounts where the bank serves as trustee, agent, or global custodian. Corporate trust and agency services normally concern services performed in connection with the issuance, redemption, transfer, or recordkeeping for debt or equity securities.

Trustees under a bond indenture or trustee for an issue of trust preferred securities are typically the only trust relationships administered by a corporate trust department. For example, under a bond indenture, one trustee is appointed for a given bond issue, but several agents or co-agents may provide various related services to the same issue. It is not uncommon for a single indenture to name both the trustee for the issue and the related corporate agents, such as a paying agent for the issue.

The most common corporate agency activities include stock or bond transfer agent, registrar for stock or bond issues, paying agent for bond interest or stock dividends, dividend reinvestment agent, and escrow agent.

Unlike personal and employee benefit accounts, where the interest of the beneficiary is the primary concern, banks serving in a corporate trust capacity serve two different constituencies. On the one hand, the issue of the security covered under the indenture hires the indenture trustee and pays the trustee's fees. The indenture trustee and other agents owe the issuer of the security effective and efficient administration of the duties assigned under the indenture. On the other hand, a fundamental duty of the indenture trustee is to monitor the issuer's compliance with the terms of the indenture and to take all necessary actions to protect the interests of the bondholders. In fact, the principal reason for appointing a trustee under a bond indenture is for the protection of those purchasing the securities issued under the indenture.

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B. TYPES OF ACCOUNTS

Corporate Trustee

General

Departments that serve as corporate trustees assume the greatest amount of responsibility and potential risk among the various types of corporate trust and agency accounts discussed in this chapter. The responsibilities of the trustee may include some or all of the following: the issuance of bonds, the maintenance of bondholder records, transfer of recorded ownership, the payment of principal and interest, and payment of remaining principal at maturity.

The issuer could be a corporation, state, municipality, quasi-public authority, school, church, or any incorporated organization, which chooses to finance its needs through the issuance of bonds. Bonds may also be distinguished by whether they are secured or unsecured. Examples of secured bonds include mortgage bonds, secured notes and equipment trust certificates. More complex types of issues are securitized or asset-backed securities which are discussed in the Asset-backed/Securitized Debt Issues section. Unsecured bonds are called debentures. Some bond issues are subject to the Trust Indenture Act of 1939 (amended by the Trust Indenture Reform Act of 1990) and others are not. Refer to Sub-section D, Compliance with the Trust Indenture Act of 1939 for additional information on the Trust Indenture Act.

Bonds issued may be sold to the general public, a limited investor group, or a single investor such as an insurance company or governmental agency. Bonds are now typically issued in registered, as opposed to bearer, form. They come in a wide variety of other distinguishing features, such as single or serial maturities; fixed or floating rates of interest; call provisions; convertibility into other types of securities; and sinking fund provisions for payment of principal.

Indenture

The document creating the corporate trust is called a trust indenture, a trust agreement, an indenture, or simply an agreement. The indenture defines the:

- Purpose(s) and/or nature of the debt to be created,
- Nature and description of the bonds to be issued,

- Parameters of administration during the life of the bonds,
- Nature, method, and place of repayment of principal and interest,
- Relationship between the corporation (borrower or obligor), the bank (trustee and/or agent) and lender(s) (bondholder(s)),
- Duties of the respective parties to the indenture,
- Description of the collateral (if any),
- Events of default,
- Actions to be taken in the event of default.

Indentures tend to be of uniform construction and design but may be tailored to include unique provisions. Associated with the indenture is the instrument that perfects a lien on collateral, if any, securing the bonds. These instruments are called the trust mortgage, deed of trust, collateral trust, equipment trust, etc., depending on the type of collateral.

Duties of Trustee

The primary duty of the trustee under the indenture is to perform the duties specified by the indenture. These normally include the following:

- Arranging for the printing and issuance of the bonds,
- Maintaining required records, accounts and documentation,
- Paying principal and interest,
- Holding beneficial title to collateral (if any),
- Safeguarding and appraising collateral (if any),
- Investing idle cash (if permitted or directed under the indenture),
- Ensuring the issue is in compliance with legal requirements,
- Monitoring for events of default under the indenture during the life of the bonds,
- Protecting the interests of bondholders in the event of a default. Transfer agents usually perform three functions.

Stock Transfer Agent

Transfer agents usually perform three functions. First, they issue stock certificates, which constitute an increase in shares outstanding (e.g., original issues, stock dividends and splits, etc.). Second, they maintain records identifying the owners of the shares of stock, how many shares are owned, and which certificates are owned. Third, they cancel and reissue certificates to reflect changes in ownership.

In connection with the latter, certificates and accompanying documents are checked for authenticity and appropriateness; canceled; and replaced by new certificates. The transfer agent sends both the canceled certificates and the newly issued certificates to the registrar for verification. This involves only an in-house transmittal when the institution acts both as transfer agent and registrar. After registration, the newly issued certificates are sent to the registered owners or their representatives and appropriate disposition (destruction, return of canceled certificates to the issuer, or cancellation and retention in a safeguarded area) is made of the canceled certificates.

Refer also to the discussion on registered transfer agents.

Stock Registrar

A stock registrar performs the critical duty of guarding against the over- or under-issuance of a security, sometimes referred to as a record difference, out-of-proof or out-of-balance condition. In addition to checking original issues, the registrar checks each transfer made by the transfer agent: to ensure the genuineness of the certificates presented for transfer; to make certain that the old certificates have been canceled; and to ensure that the number of shares represented by the new certificates does not exceed the number of shares represented by the old (canceled) certificates. In the case of bonds, the indenture trustee normally performs this function. New York Stock Exchange rules permit one institution to act as both transfer agent and registrar for listed securities other than its own.

Much less frequently, banks may be appointed solely as the outside registrar of a stock issue, without the more typical dual appointment as transfer agent and registrar.

Refer also to the discussion on registered transfer agents.

Bond Registrar (Transfer Agent for Registered Bonds)

In the case of bonds, the bond registrar usually performs the duties of both transfer agent and registrar. Usually, the indenture trustee performs the function of bond registrar. On rare occasions, however, there may be a separate bond registrar for an issue.

At one time, corporate, government bonds, and other debt securities were issued primarily in bearer form. Unlike stock issues, which were in registered form, the issuer did not know who held the bonds. The bondholder "clipped" interest coupons attached to the bond and sent them to the trustee or paying agent as interest became due. Eventually, the bond itself matured or was called prior to maturity, and was sent to the trustee for payment.

Today, however, most bond issues are registered for both principal and interest. Under Section 149 of the Internal Revenue Code, in order to qualify for the Federal tax exemption for interest with respect to state, county, and municipal bonds, such bonds must be in registered form. A transfer agent is, therefore, needed to maintain records of ownership. Since bond issues often have a 20- or 30-year maturity, some bearer bonds, (and associated coupons) may still be encountered by examiners.

For bond issues, the entity that performs transfer agent services is termed the bond registrar. A bond registrar performs all of the functions of the stock transfer agent and the stock registrar.

While unusual, banks are sometimes appointed solely as registrar of a bond issue, without the associated bond trustee duties.

Also refer to the discussion of registered transfer agents.

Mutual Fund Transfer Agent

A mutual fund transfer agent performs the functions of both the stock transfer agent and stock registrar. It maintains ownership records, transfers shares, and ensures the number of shares is kept in balance. A mutual fund's transfer agent is identified in the mutual fund's prospectus.

Two characteristics of mutual fund transfer operations are very different from stock or bond transfers. Mutual funds normally do not issue certificates to evidence ownership. Instead, entries on the books of the mutual fund or its transfer agent identify the owners and record the number of shares owned. In addition, open-end mutual funds do not have a limit on the number of shares issued and outstanding. Therefore, the "registrar function" faces a situation where the total number of shares outstanding is constantly changing (increasing or decreasing, depending upon the volume of purchases or redemptions).

Despite the general statements in the above paragraph, there are exceptions to both. Some mutual funds allow the issuance of share certificates on special request, such as when a customer wants to pledge fund shares as collateral for a loan. While most mutual funds are open-end, with no set number of shares issued and outstanding, "closed-end" mutual funds do have such limits. There are, however, fewer closed-end mutual funds than open-end funds.

Every mutual fund transfer agent must be a registered transfer agent. In addition, operations of mutual funds are subject to the Investment Company Act of 1940.

Registered Transfer Agents

Some institutions transfer securities, which are either listed on a national stock exchange or, more commonly, are registered under Federal securities laws. Section 17A of the Securities and Exchange Act of 1934 and Part 341 of the FDIC Rules and Regulations, require FDIC-supervised institutions that transfer these types of securities (including securities of a parent company or an affiliate) to register with the Corporation as a transfer agent. State non-member banks serving solely as transfer agent for their own registered stock must also register as a transfer agent, whether or not the bank exercises trust powers and regardless of which

department performs the transfer function. Registration as a transfer agent is also required when the institution is merely named as transfer agent for these securities but has contracted with a third-party organization to actually perform all of the transfer processing and recordkeeping, a situation referred to as a private label arrangement.

As part of the registration process, each institution must obtain a FINS (Financial Industry Numbering System) Number from the Depository Trust Company in New York City. The FINS Number is a standardized numbering system used to identify each institutional party (banks, broker-dealers, transfer agents, etc.) to a securities transaction.

As of November 30, 2003, 92 FDIC-supervised institutions were registered as transfer agents. The FDIC utilizes a separate examination report for registered transfer agents and the Registered Transfer Agent Examination Report of Examination is completed for all such banks.

Examiners should note that, if a bank is a registered transfer agent, all bond and stock issues (regardless of which department of the bank transfers the securities) must be processed according to SEC's operational regulations for registered transfer agents. This includes municipal and industrial revenue/development bond issues (which are not subject to securities registration and, were it not for the bank's registration as a transfer agent, would not otherwise be subject to securities transfer regulations).

Stocks must be registered under Federal securities laws, if they meet one of the following two criteria:

- As of January 1, 1998, equity securities must be registered under Section 12(g) of the Securities and Exchange Act of 1934 and SEC regulation 17 C.F.R. Section 240.12g when an issuer has (i) $10 million or more in total assets and (ii) more than 500 shareholders. Refer to 12 C.F.R. Part 335 of the FDIC Rules and Regulations.
- Prior to January 1, 1998, the applicable exemption threshold governing the registration of equity securities is (i) less than $1 million in total assets and (ii) 500 or fewer shareholders.

Less frequently, examiners will encounter corporate bond issues listed on a national securities exchange or mutual funds where the bank has been named a transfer agent. These also require registration as a transfer agent.

Fiscal or Paying Agent

As the fiscal agent for a corporation or a municipality, an institution makes interest payments on coupon bonds (often referred to as bearer bonds) as the coupons are presented; redeems maturing bonds; or prepares and mails interest checks for registered bonds, or dividend checks for stock issues. A fiscal agent may also be called a dividend disbursing agent, coupon and bond paying agent, or some similar name indicative of its duties.

Dividend Reinvestment

Some corporations offer their stockholders the option of participating in dividend reinvestment programs, wherein dividends are automatically applied to the purchase of additional shares of the corporation's stock, either on the open market or directly from the corporation. On the dividend payment date, dividend payments are transferred by the dividend disbursing agent to the dividend reinvestment agent (often the same institution) who purchases shares of the corporation's stock. It may also be possible for stockholders to purchase additional shares through their dividend reinvestment agent. The dividend reinvestment agent usually holds the shares purchased until the participating stockholder requests physical delivery.

Other Corporate Agencies

An institution may also serve as an escrow agent or depository in connection with defaults, mergers, consolidations, reorganizations, initial public offerings, tender offers, or other transactions requiring that securities or funds be deposited with a responsible third-party. The depository may also receive and record the claims of creditors.

Banks are often appointed as:

- Conversion agent (where debt securities are "converted" into equity securities),
- Exchange agent (involving exchange of one class of securities for another, or exchange of bearer bonds for registered bonds),

- Subscription agent (usually involving an invitation to equity security holders to subscribe to a new issuance of additional debt or equity), and
- Authenticating agent (commonly used when the indenture trustee is not located in a major money market city -- the bond registrar is also able to exercise limited authority to authenticate bonds on exchange or transfer).

Lesser-known services are offered to corporations in connection with the voluntary or involuntary liquidation of business enterprises. A business concern, which finds itself in financial difficulties but is not insolvent, may turn over its assets to a trust institution as assignee for the benefit of creditors. A business in financial difficulties, which cannot reschedule its payments owed to creditors, may have a court appointed receiver operate the business until such time as the assets can be liquidated or it becomes evident that bankruptcy can be averted. The duty of a trustee in bankruptcy is to realize as much cash as possible from the sale of the assets of a bankrupt business and, under the supervision of the court, to apply the amount realized to the claims of creditors. Few institutions accept trusteeships in bankruptcy because of the undesirable and unprofitable nature of this type of business.

Asset-backed/Securitized Debt Issues

In recent years, it has become more common for debt securities to be secured by various types of self-liquidating collateral. These asset-backed or securitized debt issues may be secured by a variety of assets, including commercial loans, second mortgage loans, automobile loans, and credit card receivables. The trustee must ensure that the collateral, a pool of loans for example, is properly serviced, payments are properly allocated to principal and interest, and delinquencies are identified and resolved. Accepting such responsibilities is a major undertaking involving considerable potential risk. The pre-acceptance review of such appointments is crucial: to identify the quality of the loans involved; to ensure the bank's ability to monitor the loans and servicer; to evaluate the complexity of the deal structure; and, if necessary, to arrange for back-up services.

Servicing of the loan pool cannot be delayed. There have been instances where major problems have arisen when the loan servicer went out of business or was otherwise unable to properly service the underlying loans. In such cases, the bank trustee must promptly ensure continued servicing, which may involve considerable unanticipated, and perhaps unreimbursed, costs.

The trustee is responsible for ensuring that adequate backup arrangements exist to handle such a situation if it should arise. The trustee itself can arrange to be the backup servicer, or it can use a third-party servicer. Considerations of selecting a backup data processing and/or loan servicer are similar to those used to select other third-party data processing services.

Either a "hot site" or a "cold site" can serve as backup. A "hot site" is dedicated exclusively to servicing the collateral; no other work is performed. The advantage is instant availability. Maintaining such a site, however, which may never be used, is extremely expensive. A "cold site" performs other work (such as the bank's own data processing center). Costs are much lower, but a cold site's capacity to service additional loans must be assured.

In each case, the trustee must ensure that the backup servicer:

- Has hardware and software compatible with that used by the original servicer; and
- Has adequate capacity to continue with its own work as well as service the loan portfolio.

As in any data processing service arrangement, a written contract should be in place. Further guidance on considerations in selecting a data processing servicer is contained in the Serviced Institution Control Guidelines chapter of the *FFIEC IT Examination Handbook*.

Municipal Trustee Issues

Secondary Market Disclosures for Municipal Issues

In 1995, the SEC Rule 15c2-12 [17 CFR 240.15c2-12] significantly changed the requirements governing the public disclosure and availability of financial information related to issuers of municipal debt securities. The rule was designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with the underwriting of municipal securities by brokers, municipal securities dealers, and "participating underwriters". With some limited exemptions, it applies to the underwriting of municipal securities with an aggregate principal amount of $1,000,000 or more. The disclosure and financial requirements of

"participating underwriters" are contained in Section 15c-2-12(b). A "participating underwriter" is prohibited from purchasing or selling municipal securities in connection with an offering, unless there is a written agreement or contract for the benefit of holders of these securities to provide directly, or "indirectly through an indenture trustee or a designated agent" required information. [Section 15c2-12(b)(5)]. Therefore, as indenture trustee for a municipal issue, a bank may be responsible for providing the required financial information, if the indenture trustee has entered into a contract to provide the required information for an issuer or underwriter.

The required information that must be provided to each nationally recognized municipal securities information repository (NRMSIR), and to the appropriate state information depository, if an, includes the following:

- annual financial information for each obligated person for whom this information is presented in the final official statement issued in conjunction with the underwriting of the issue.
- notice of any of the following events with respect to securities in the offering, if material:
    - principal and interest delinquencies
    - non-payment related defaults
    - unscheduled draws on debt service reserves reflecting financial difficulties
    - substitution of credit or liquidity providers, or their failure to perform
    - adverse tax opinions or events affecting the tax-exempt status of the security
    - modifications of the rights of security holders
    - bond calls
    - defeasances
    - release, substitution, or sale of property securing repayment of the securities
    - rating changes
- notice of the failure of any person required to provide annual financial information by the date specified in the written agreement or contract in a timely manner.

Notification to the Municipal Securities Rulemaking Board may be substituted for the requirements to notify the NRMSIR's for the items above.

In addition, SEC Rule 15c2-12(b)(5)(i) requires the written contract for the benefit of holders of securities to indicate those to whom annual financial information and notices of material events will be provided. The written contract also must cover the following: (1) the type of financial information and operating data to be provided annually; (2) the accounting principles used to complete the financial statements, including any requirement for audited statements; (3) the date on which annual financial information will be provided and to whom.

The NRMSIR's are private information vendors. As of June 21, 2004, there were four NRMSIR's and three state information depositories. The NRMSIR's were the following: Bloomberg Municipal Repositories, DPC Data, Inc., FT Interactive Data and Standard & Poor's Securities Evaluations, Inc. The State Information Depositories (SID's) have been established for Texas, Michigan, and Ohio, are in addition, the Municipal Securities Rule Board (MSRB) also operates the Municipal Securities Information Library and Continuing Disclosure Information systems, which provide similar information.

For those concerned with disclosure obligations for municipal securities, the "preliminary note" to SEC Rule 15-c2-12 refers the reader to the following: Securities Act Release No. 7049 and Securities Exchange Act Release No. 33741, FR-42 (March 9, 1994). SEC Rule 15-c2-12 replaces the voluntary industry standards promulgated by the American Bankers Association's Corporate Trust Committee, which were known as Disclosure Guidelines for Corporate Trustees.

Defeasance Activities with Municipal Bonds

A defeasance is a type of municipal debt financing which enables the issuing government entity to reduce the amount of interest it pays on outstanding bonds. For example, an entity that has outstanding bonds carrying high interest rates issues new debt at a lower (current) rate. The proceeds are used to buy State and Local Government Series U.S. Treasury securities (SLGS), which pay enough interest to pay the interest on the old outstanding bonds. SLGS are offered for sale to issuers of state and local government tax-exempt debt to assist in complying with yield restrictions or arbitrage rebate provisions of the Internal Revenue

Code. The SLGS program was established in 1972 and approximately eight percent of municipal securities are subject to advance refunding, according to the July 1, 2004, "Report on Transactions in Municipal Securities" by the SEC. The securities can be sold, but typically mature when the old bonds reach their call date, providing a steady source of funds to retire the old debt. This process allows municipalities to pay less on a current basis. SLGS cannot be transferred by sale, exchange, assignment, pledge or otherwise.

Defeasance financings are *also referred to as arbitrage bonds*. The use of arbitrage for new bond issues was limited by the Tax Reform Act of 1986. Under the Act, annual calculations must be made of all earnings to report income in excess of allowable yields. Earnings of impermissible arbitrage must be placed in a rebate fund for payment to the IRS every five years. Failure to comply can cause an otherwise tax-exempt municipal bond issue to become taxable retroactively to the date of issuance.

Although compliance with the requirements for defeasance financing under the Tax Reform Act of 1986 is generally the responsibility of the issuer, the trustee is often responsible for establishing and maintaining the rebate fund. While other parties should make rebate calculations, the trustee is responsible for ensuring that the proper actions are taken to protect the interests of the bondholders.

Global Custody

Global custody refers to the cross-border safeguarding, settlement, servicing, and reporting of investor securities on a worldwide basis. This line of business has experienced significant growth over the last 20 years as a result of the continuing expansion of the international flow of capital and investment. The customers of global custody services are holders of large pools of investment assets, mainly securities. These customers include institutional investors, insurance companies, public entities, mutual funds, banks and trust organizations.

The main services provided by global custodians are:

- The safekeeping of cash and securities
- The settlement of securities trades
- The servicing of securities held in custody

Accurate and timely reconciliation of customer cash and securities positions is essential to maintaining control over customer assets. Effective reconciliation procedures and timely follow-up of open items are essential for the proper management of safekeeping services.

Securities trades are normally processed through a broker, who in turn, notifies the global custodian of the details of a trade. The settlement process is more complicated than the normal process in the United States due to international variances.

Servicing securities in global custody involves the following functions: (1) collection of income; (2) monitoring and processing corporate actions; (3) proxy voting; (4) processing tax reclamations; (5) foreign currency exchange; (6) cash management; and (7) international securities lending. The first three functions are similar to those performed in domestic custody accounts. The last four functions involve other risks due to the additional aspects of international income tax collections, which may vary, and the risks associated with currency fluctuations.

Sub-custodians

Sub-custodians often are used by the global custodian to provide local securities safekeeping services, to act as local settlement agents and to provide related services in local overseas markets. Sub-custodians provide the local operational, regulatory and legal expertise applicable to their particular region. Due to the key role of sub-custodians in the global custody business, effective management of the sub custodian network is essential for successful management of global custody.

The selection and oversight of sub-custodians is crucial to a well-managed global custody operation. Before selecting a sub-custodian, the global custodian should perform a due diligence review of the creditworthiness and operational and informational systems capabilities of the sub-custodians available in a given regional market. In addition to a rigorous initial screening of sub-custodians, the global custodian should monitor the performance and credit quality of each of its sub-custodians on an ongoing basis including periodic on-site visits to the sub-custodian. The use of technology and telecommunications is also a very important

element of an effective sub custodian network. Building a technological bridge between the clients, their global custodian, and the sub-custodian network is a key component of a prudently managed global custody program.

Trust Preferred Securities - Trustees

Trust preferred securities represent preferred stock issued by a trust, usually a Delaware statutory trust, created for the sole purpose of investing the proceeds from the sale of preferred stock and common stock in a subordinated bond or debenture. The trust created is a subsidiary that invests in the subordinated debt of the trust's parent company. The parent will purchase the common stock issued by the trust, usually representing at least 3% of the trust. The only asset of the trust is the subordinated bond or debenture from the parent and the only income received is the interest payments received on the subordinated debt, which is used to pay dividends on the preferred stock issued by the trust.

Under the Trust Indenture Act of 1939, the sale of subordinated debt in conjunction with the issuance of preferred securities requires the appointment of an indenture trustee. The duties of the indenture trustee for the subordinated debt do not differ from the duties of other indenture trustees. The trust formed to issue the preferred and common stock usually requires a Delaware trustee, in the case of a Delaware trust, and the appointment of a property trustee. The property trustee is the holder of record, for the benefit of the holders of the preferred securities, of the subordinated debt. In the event of default, the property trustee, whose duties are essentially those of an indenture trustee, acts to protect the interests of the holders of the preferred stock. A property trustee is required to exercise the care, skill of a prudent person. In addition, the trust agreement provides that the property trustee is a trustee for the purposes of the Trust Indenture Act.

The parent normally will issue a guarantee for the benefit of those holding the preferred securities. There will be a preferred security guarantee trustee, usually the same as the indenture trustee, to enforce the guarantee if necessary. The parent's guarantee, however, is unsecured and subordinated to other creditors with respect to existing and future senior debt. In contrast to many bond indentures that contain restrictions on the issuance of senior debt or requirements to maintain minimum liquidity levels, the indenture governing the issuance of preferred stock and the related trust agreement contains no or very few restrictions on the parent company's financial activities.

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C. ACCOUNT ADMINISTRATION AND CONTROLS

The administration of corporate trusteeships and agencies generally requires fewer discretionary decisions and actions than do personal or employee benefit trust accounts. However, they do require a higher level of documentation, automated services, and an in-depth knowledge of securities, security-related laws, industry practices, etc. Duties and actions are specified in the indenture and the corporate trustee/agent is limited to the provisions of the indenture. It assumes or performs additional duties and functions at its own risk.

As in all areas of fiduciary administration, the bank should have adequate written policies and procedures governing account acceptance conflicts of interest, internal operations, auditing, and profitability.

Pre-Acceptance Reviews

One of the most important aspects of good corporate trust administration occurs before accounts are accepted. This is the decision-making process of whether or not to accept a corporate trusteeship or agency account. Many financings are driven by timing considerations, often the result of perceived market windows or regulatory deadlines. Nonetheless, the due diligence review must not be neglected. Factors to be considered include:

- the financial strength of the obligor, both currently and anticipated over the life of the bond issue;
- the size and character of the issue;
- the integrity of the issuer;
- the existence of, and potential for, conflicts of interest;
- the environmental liability potential;
- the capacity and capability of the corporate trust department to perform its duties and fulfill all responsibilities based on a thorough analysis of the requirements of the indenture;

- the probability of profitable administration to the department. In regard to profitability, the "cash float" of principal, interest, or dividends held as bank deposits was often an integral consideration in past fee structures. With greater emphasis on cash management, this is less of a factor today; and
- operational considerations, such as the capability of the information systems to properly handle the administrative requirements of an issue.

Appointment Documentation

Complete documentation for each trust indenture is of utmost importance. In this regard, a listing of documentation items is included on the Corporate Trust Line Sheet, included in Appendix B - Examination Aids. In general, banks should not accept accounts without obtaining the necessary appointment documentation.

Some of the same types of documentation required for a commercial loan should be maintained in conjunction with the administration of a corporate trust, for example, a corporate resolution authorizing the debt, in this case a security. In corporate trust appointments, the absence of required documentation may seem inconsequential, but could have a major impact at a later date.

Appointment documentation is governed by the type of appointment being accepted (bond trustee, transfer agent, paying agent, etc.), the characteristics of the securities issue (bonds, stocks, convertible securities, etc.), and the issuing organization (corporations, local government agency, state government agency, etc.). Some issuers are from regulated industries, such as banking, broadcasting, utilities, or communications, where regulators may impose other requirements.

Conflicts of Interest

The trustee must also exercise prudent judgment and avoid potential conflicts of interest that might prevent it from acting under duty of loyalty. For issues subject to the Trust Indenture Act of 1939, prohibited conflicts must be identified in the indenture. Section 310(b) of the Trust Indenture Act (15 U.S.C. Section 77jjj(b)) establishes procedures for the disqualification of an indenture trustee in instances involving conflicts of interest. Section 311 of the Act (15 U.S.C. Section 77kkk) addresses situations in which the indenture trustee is a creditor of the issuer of the securities. For securities not subject to the Trust Indenture Act, the existence of conflicts of interest is an equally important consideration. Indenture trustees have been held liable for losses suffered by bondholders in cases where it was determined that the indenture trustee acted in a way that placed its own interest ahead of that of the bondholders.

A bank should avoid accepting an appointment as indenture trustee for a securities issue of a corporation with which it also has a creditor relationship. In such cases, when an obligor defaults under an indenture where a bank is both a creditor and the indenture trustee, doubts may arise concerning whether the bank placed its own interests (by attempting to improve the bank's credit position or chances of repayment) ahead of its responsibility to protect the interests of all bondholders. Similarly, when a bank acts as trustee for more than one debt issue (or more than one debt tranche) of an issuer, questions about the indenture trustee's impartiality may also arise.

Conflicts of interest are permissible for issues subject to the Trust Indenture Act of 1939, provided the issue is not in default. Once default occurs, however, unless a "curing" of the default occurs within the 90-day period set in Section 310(b) of the Trust Indenture Act, the trustee is required to resign. Refer to subsection D - Compliance with the Trust Indenture Act of 1939 for a more detailed discussion of conflicts of interest.

Generally, conflicts of interest place the bank in a position of increased risk, especially when a default occurs. Therefore, potential and actual conflicts of interest should be identified and resolved prior to acceptance and monitored for the length of time the security remains outstanding. Some banks make prior arrangements to resign in favor of another trustee in the event of default. Often, the successor trustee requires indemnification for the original trustee's acts.

Environmental Liability

Trust departments that serve as trustee for bond issues secured by real estate should have policies addressing the environmental risks related to real estate. These policies should cover the types of environmental audits and other procedures to be followed in order to ascertain whether any proposed real estate collateral for corporate trust issues is contaminated. Prior to beginning the

foreclosure process on real estate, a determination should be made, through an environmental audit or otherwise, that the property subject to foreclosure is free of environmental contamination. Failure to take reasonable precautions before taking title to potentially contaminated real estate could subject the trustee to considerable liability. Refer to subsection F.7.b in Section 3, Environmental Liability, for more information about environmental risk.

Administration and Controls

General

The bank's corporate trust department is frequently operated separately from the personal trust department, often maintaining separate books and records. The corporate trust function may be located in a different area than the rest of the trust department. It is not uncommon for personal and employee benefit accounts to use one data processing system, while corporate trust activities use another. Examiners should review the organization, including recordkeeping systems, of corporate trust services during the pre-examination planning process.

Operational Issues

While appropriate processes, procedures and controls differ somewhat between bond trusteeships and corporate agency appointments, the following operational considerations apply to most appointments

Tickler Systems

Corporate trust administration, in the absence of default, involves various administrative and operational duties that are periodic and time sensitive, such as monitoring compliance with bond covenants, paying interest and principal, and administering funds and collateral. Ticklers, whether manual or automated, should be set up for all periodic events to ensure that all administrative and compliance responsibilities are completed within required timeframes. The tickler system should identify items that are past due, such as the failure to pay interest and principal, the failure to obtain annual certificates of compliance, failure to obtain insurance certificates, etc. Such events may, depending upon the terms of the indenture, call for acceleration of the payments due, and should be closely by senior management. Senior management is responsible for determining how the trustee should proceed in instances of delinquent compliance with bond covenants.

Unissued and Cancelled Securities Certificates

Appropriate inventory controls should be placed on supplies of blank certificates. The supply of blank certificates should be limited to the quantity needed, to be issued as part of the original distribution of the securities or as replacement certificates for loss, missing or stolen securities. Access to the certificates should be limited to appropriate personnel. A listing of the certificate numbers should be kept and periodically reconciled to the certificates held in inventory. Any breaks in inventory should be reported and investigated.

The trustee should also have appropriate controls over cancelled securities certificates. The fraudulent use of cancelled securities certificates presents significant problems and potential cost to investors, creditors and broker-dealers. Securities certificates that have not been properly cancelled can be used to defraud the public and financial institutions. Stolen certificates that were not properly cancelled have been subsequently sold to investors and used as collateral for loans. Pursuant to SEC Rule 17AD-19, written procedures for the cancellation, storage, transportation, destruction, or other disposition of certificates should provide for the following:

- Controlling access to any cancelled certificate facility.
- Physically marking certificates with the word "cancelled" in a clear and conspicuous manner, unless the transfer agent's procedures require the certificate to be destroyed within 3 business days of cancellation. Tiny perforations that do not **deface** the certificates are not consistent with the rule.
- Maintaining a secure storage area for cancelled certificates.
- Maintaining a retrievable database of all of its cancelled, destroyed, or otherwise disposed of certificates. The information required to be maintained includes the CUSIP number, certificate number, denomination, registration, issue date, and cancellation date.

- Requiring that the physical transportation of cancelled certificates be conducted in a secure manner and that a record of the certificate transported be maintained. When cancelled certificates are transported, the trustee should receive notice that the certificates were delivered. In the case of non-delivery, the trustee should investigate the circumstances regarding the non-delivery. If the non-delivery is not resolved, the certificates transported should be reported to the Securities Information Center (SIC) as lost, missing, or stolen securities, as required by SEC Rule 17f-1, which is applicable to all banks (not just trust departments) that accept or handle certificates.
- Requiring that authorized personnel of the transfer agent, supervise, witness and document the destruction of certificates.

When performing the bond registrar function, the trustee, or outside registrar if one has been appointed, should ensure that proper controls are in place to prevent physical under or over-issuances of securities. A trustee, or outside registrar, responsible for a physical over-issuance of securities, may be required to buy-in the excess securities issued. If the bank is a registered transfer agent, the registrar function must comply with the SEC operational requirements of 17 C.F.R. Section 240.17Ad.

Administration of Funds

Most corporate rust appointments, whether as trustee under a bond indenture or under a corporate agency agreement, involve the disbursement of funds for principal, interest, or dividends. In addition, the corporate trustee or agent may have to administering various related funds, such as sinking and reserve funds. Banks should have processes and procedures for independently validating the accuracy of funds held for interest, principal and other disbursements. Procedures should provide for the validation of principal, interest and dividend payments for outstanding, as well as called or matured issues. In large departments, such validation normally would be accomplished by separating the administrative function from the operational function. The administrative review should act as a check on operations, by verifying the accounting records relating to an issue. In smaller departments the audit function can validate the accounting records relating to corporate trust appointments. Out-of-balance issues should be identified, reported to management, and receive prompt attention until resolved.

For all issues, records should accurately indicate the amount of principal, interest and dividend payments that are due and have not been paid. Funds held for the payment of interest or dividends (payable on different coupon or dividend dates) should be segregated. Payments may be segregated by establishing separate control accounts for each payment, increases control over funds held for distribution and facilitates the reconciliation and escheatment of unclaimed funds. The maintenance of separate payment accounts prevents for interest and dividends also prevents payment errors.

Reconcilements

Examiners should review the trust department's reconciliation procedures. Disbursement accounts should be reconciled after each payment date. The standard bond printout, listing the current principal outstanding, outstanding bonds that are due but not presented, and the amount of cash on held for matured but not presented bonds, should be periodically reconciled to the department’s operational records. Principal outstanding can be validated by comparing the department's automated records with the issue's legal documents. The trustee's records can also be compared to the obligor's records. The obligor of an issue also tracks the principal amount outstanding, and few obligors will transfer funds to the trustee in excess of what the issuer owes for interest or principal.

Escheatment

Controls over returned mail should ensure that returned interest, dividend and principal payments are properly accounted for and protected from theft, misuse or misapplication. Unless allowed by state law, issuers are not entitled to a return of unclaimed interest and dividend payments. Instead, unclaimed funds are subject to state escheat and unclaimed property laws. Without appropriate processes and procedures to govern the administration and disbursement of funds, corporate trustees and agents face the risk of violating state escheat and unclaimed property laws. Without proper accounting controls, escheatable funds cannot be identified and may be misused to cover unrelated operational losses or reported as miscellaneous income. Refer to subsection E2.b - Escheatment Litigation for a discussion of cases involving the failure to escheat funds to the proper authorities.

Bond Trusteeships

When an institution is appointed bond trustee, it normally also serves as bond registrar (transfer agent) and paying agent. Refer to the material under those captions, as well as to material under the Corporate Agencies caption that follows this material.

Proper administration of the underlying collateral is vital, including the identification and control of environmental risk where real property is concerned. Extreme care must be taken by the trustee regarding the timing of collateral foreclosure so that the interests of all parties to the indenture are fairly served. A trustee's failure to appropriately protect the interests of bondholders before, and subsequent, to default, can result in liability and loss to the trustee. Proper maintenance of the collateral, including periodic verification or continuance of Uniform Commercial Code (UCC) filings, is required. The trustee should ensure that the initial filings were in the appropriate jurisdiction and should verify that continuance is filed, if under UCC Article 9. Should the trustee prematurely foreclose on collateral, the obligor may incur liability. If foreclosure is inordinately delayed, bondholder interests may suffer severe loss of value.

Many bond trusteeships involve the maintenance of separate funds, used for sinking funds, construction, building maintenance, etc. The assets of these funds are invested according to the provisions of the bond indenture. The bank trustee usually has little or no discretion in such investments. Proper separation of the various funds, investment of their assets, and administration of these funds are essential.

The trustee must not only provide reports and recordkeeping for the issuer but also must protect the interests of the bondholders. The reporting of distributions, and interest and dividend payments, to both tax authorities and security holders is also required of the trustee. These responsibilities are important since the trustee can be held liable if the bonds default and subsequent loss is attributable to the trustee's negligence. The acts of omission as well as commission by the trustee are critical in the event of default.

Many bond issues are complex and impose numerous duties on the indenture trustee. For instance, credit enhancements such as letters of credit and municipal bond insurance may have their own requirements which the trustee must monitor. The risks of managing such issues must be adequately addressed by the bank and reviewed by the examiner. For example, letters of credit may be issued for a 10-year period covering a bond with a 30-year maturity. The indenture may provide for mandatory early redemption, if no letter of credit covers the issue, or if the creditworthiness of the letter of credit issuer drops below a certain quality. The trustee must monitor the status of the letter of credit and its issuer to ensure compliance with the indenture.

In recent years, bond issues have become more complex. Moreover, interest rates, for instance, may be indexed to other indices. Derivative securities have also become common. These increasingly complex securities present new types of risks to bond trustees, who must know their responsibilities and have adequate policies and procedures in place to manage the risks.

Default Administration

In the case of a default, the indenture trustee is responsible for protecting the interests of the bondholders. There are two types of default: technical and substantive.

Technical default occurs when the issuer does not comply with specific covenants in the agreement. However, the failure to comply, in and of itself, does not cause nonperformance. Examples of technical default include failure to: provide periodic financial statements, provide audited financial statements, demonstrate compliance with specific provisions of the indenture, etc. However, the manner in which the indenture trustee responds is important. Unlike many large corporate issuers that have sophisticated compliance systems to ensure that bond covenant requirements are satisfied, smaller, less sophisticated issues may often fall into technical default. In such cases the trustee must act in a timely manner to bring the issuer back into compliance with the bond covenants. The trustee should promptly inform the issuer of the noncompliance and give the issuer a deadline for curing the technical default, for example 30 to 90 days, or more if circumstances make a longer deadline reasonable. In the event that the issuer fails to cure the technical default by the deadline given, the trustee should notify the issuer that a default will be declared if the issuer does not cure the technical default by a certain date, for example within 30 days. If the issuer still has not cured the technical default by the given deadline, the trustee should declare a default and consult the bondholders to determine whether to waive the default or accelerate the payment of principal. Trustees that fail to act in an appropriate and timely manner when technical defaults occur risk being held liable for inaction or negligence, in the event of a subsequent substantive default.

In contrast to technical defaults, substantive events of default include the failure to make required interest, principal or sinking fund payments; the bankruptcy or insolvency of the obligor; or a cross default on other obligations, such as loans or other bonds. The trustee should take timely and appropriate actions to ensure that bondholders realize the maximum amount of repayment of principal and interest due. Failure on the part of the trustee to act on the bondholder's behalf could result in bondholders claims that the trustee, through negligence, caused monetary losses and seek reimbursement of those losses.

In administering defaulted bonds, the trustee should employ legal counsel and request bondholder involvement. Bondholders should be promptly informed of substantive default events. The trustee should communicate with any bondholder committee nominated by all the bondholders and seek direction from that committee. Within reason, when the principal is at risk, trustees should defer to the bondholders of the defaulted issue. Any modification in the bond indenture and other governing documents should not be made without the consent of bondholders. A decision to waive the default should be made by the bondholders.

The trustee must act quickly to secure any collateral, if the defaulted issue is secured. Securing the collateral, however, might entail complications if the collateral is a business or some other facility requiring professional management or contaminated real estate. The trustee is not required to seek all remedies or pay out of its own funds the expenses related to those remedies. In most cases, the trustee should obtain an indemnification agreement from the bondholders before pursuing certain remedies, along with a commitment that it will be reimbursed for expenses incurred.

Corporate Agencies

The administration of corporate agencies does not involve discretionary actions, but does require accurate recordkeeping, prompt posting of accounting records, timely reporting, and staff thoroughly trained in related laws, regulations, and standard industry practices. The performance of agencies requires technical expertise, open communication between interested parties, and an efficient operating system. As in all other aspects of fiduciary operations, the corporate agency function should be fully covered by written policies approved by the trust committee and board of directors.

Unlike the long-term relationships of bond trusteeships, corporate agency accounts are often moved to another institution: if the bank does not perform to the expectations of the securities issuer, if the bank's performance results in investor complaints to the issuer, or if the bank does not offer the full range of services expected by the issuer. The importance of pre-acceptance reviews is just as valid for corporate agencies as it is for bond trusteeships.

When the bank is serving as a paying agent, the obligor deposits the necessary funds with the bank, which prepares, and issues checks in payment of the interest, dividends or bonds. When bonds are fully registered, an interest check is sent to the holder of record. In the case of coupon bonds, the coupons must be presented for payment. Coupons are received in several ways but normally flow through the banking system and the related clearinghouse process.

Many stock transfer appointments also involve the administration of dividend reinvestment plans and/or stock purchase plans. The proper administration of the funds received accurate recordkeeping, the prompt execution of orders, and the issuance of accurate investor statements are all important operational imperatives. Section 344.6(f) of the FDIC Rules and Regulations requires that periodic plans (such as stock purchase plans or dividend reinvestment plans) provide the customer not less than once every three months a written statement showing: (1) the funds and securities in the custody or possession of the bank, (2) all service charges and commissions paid by the customer in connection with a transaction, and (3) all other debits and credits of the customer's account involved in the transaction. If the customer requests it, the bank must provide the information listed in Section 344.5 of the FDIC's regulations, except in those cases where the customer does not remunerate the broker/dealer.

As with bond trusteeships, the bank must not only provide reports to the obligor but also must provide investors with periodic statements and provide tax authorities and security holders with reports of interest and dividend payments.

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D. COMPLIANCE WITH THE TRUST INDENTURE ACT OF 1939

General

Certain bond issues, and their administration, must comply with the Trust Indenture Act of 1939 (TIA) [15 USC 77aaa - bbbb], as amended. Only bonds issued by corporations are potentially subject to the TIA; municipal bond issues (including industrial development and industrial revenue issues) are not covered. Bonds issued by banks are exempt from the TIA. All Trust Preferred Securities are subject to the TIA.

The TIA requires the use of an independent trustee in connection with the public offering of debt securities. The TIA generally provides that debt securities may be issued only pursuant to a trust indenture governing the responsibility and liability of the trustee.

The Trust Indenture Reform Act of 1990 [PL 101-550 Title IV, 104 Stat. 2721] simplified the information required in an indenture. It also eliminated the automatic disqualification of banks as indenture trustee when the bank has director interlocks with the issuer, or has served as underwriter for the issuer. The 1990 law requires the trustee to resign in circumstances when an issuer defaults and the trustee is a lender to the issuer.

The full text of the Trust Indenture Act and implementing SEC regulations appear in Appendix F of this Manual. Some regulatory filings must be submitted electronically. Refer to subsection K.3. Electronic Submission of Forms and Notices, located in Section 3.

Applicability

Exemptions for various types of securities are contained in Section 304. In addition, certain SEC rules issued provide further guidance concerning the exemptions in Section 304. Two important exemptions are:

- non-indenture securities totaling less than $5,000,000, when issued within a consecutive twelve-month period (TIA Section 304 (a)(8) and 17 CFR 260.4a-1 of SEC Rules)
- securities that have been or will be issued under an indenture which limits the aggregate principal outstanding at any one time to $10,000,000; the exemption is limited to securities issued within a 36-month period by the same issuer (TIA Section 304 (a)(9) and 17 CFR 260.4a-3 of SEC Rules)

The exemptions described above are *aggregate* exemptions. For example, an issue of $10 million or less would have to be qualified with the SEC if, under the indenture, additional bonds aggregating more than $10 million may be issued for public distribution. TIA Sections 304(a) through (e), as well as the SEC Rules noted above, may be found in Appendix F.

Compliance

The TIA imposes stringent duties on the issuer and the trustee of indenture securities. The requirements for registration and exemption under the Act are provided by Section 305, as well as implementing regulations.

The TIA generally requires that the indenture include certain provisions. For example, the issue must be administered according to its indenture. Specific provisions regarding conflicts of interest are detailed in Section 310. An annual report to bondholder is required by Section 313. Actions required in the event of default are covered by Section 315.

Other important areas covered in the TIA include: (1) the appointment of the bond trustee, (2) conflicts of interest, (3) the administration of the issue, and actions in the event of default. These are briefly summarized below.

Trustee Appointment Requirements

- There must be one or more trustees, at least one of whom shall be a corporation appropriately organized and subject to Federal or State supervision or examination. [§ 310(a)(1)]
- The trustee must have at all times a combined capital and surplus of not less than $150,000. [§ 310(a)(2)]

Conflicts of Interest

- The indenture must provide that, in the case of an event of default, if a conflict of interest exists, the trustee must eliminate the conflict of interest within 90 days or resign. If the trustee fails to comply, it must (within 10 days after the expiration of the 90-day period) transmit notice of such failure to the bondholders. [§ 310(b)(i) and (ii)]
- Section 310(b) specifies in detail prohibited relationships between the trustee and either an obligor or an underwriter, if:
    - it acts as trustee under more than one *indenture* (not issue) of the same obligor (with some exceptions) [§ 310(b)(1)];
    - it, or any of its directors, or executive officers, is:
        - an underwriter for the obligor with respect to the indenture securities [§ 310(b)(2)];

  - a director, officer, partner, employee, appointee, or representative of the obligor, or an underwriter for the obligor with respect to the indenture securities (with exceptions) [§ 310(b)(4)];

- it directly or indirectly controls, or is directly or indirectly controlled by, or is under direct or indirect common control with, an underwriter for the obligor with respect to the indenture securities [§ 310(b)(3)];
- more than certain specified percentages of the trustee's voting securities are beneficially owned by the obligors, underwriters, and their respective officials [§ 310(b)(5)];
- an issue is in default and the trustee is the beneficial owner of, or holds as collateral security, more than specified percentages -

  - of the security in default [§ 310(b)(6)], or
  - of certain categories of the issuer's securities [§ 310(b)(7)], or

- an issue is in default and the trustee holds, in specified fiduciary capacities, 25 percent or more of the outstanding securities [described in item (5) above] [§ 310(b)(9)]; or
- the bank-trustee is, or becomes, a creditor of the obligor (with exceptions). [§ 310(b)(10)]

- If the trustee is (or becomes) a creditor of the obligor within three months prior to default, it must set aside any repayment received during this period, or after default, in a special account to be divided pro rata between the trustee bank and the bondholders (with some exceptions). [§ 311]

Trustee Administration of Issue

- Bondholder annual reports. If certain events have occurred (primarily involving the debt issue but also including changes in the conflicts of interest described above), the trustee must send a report to the bondholders at intervals of not more than 12 months. If no changes have occurred, no report is required. [§ 313(a)]
- Bondholder periodic reports. If: (1) changes have occurred in the bond issue's collateral, or (2) the trustee claims large reimbursable advances, a report must be sent to bondholders within 90 days of such occurrence. [§ 313(b)]

Administrative Filings with Trustee by Issuer

- The obligor must file with the trustee: (1) an annual certification as to compliance with the indenture, (2) copies of annual reports, and (3) other information and documents. These must also be filed with the SEC [§ 314(a)(1), (2), and (4)]. The content of the various reports is specified by Sections 314(b) through (e).
- The obligor must provide the trustee with lists (names and addresses) of the bondholders, and the trustee must maintain such lists. [§ 312(a)] The trustee must provide such lists to any three or more bondholders upon written request. [§ 312(b)]

Actions in the Event of Default

The indenture must contain provisions setting out the duties and responsibilities of the trustee prior to, in case of, and after, default. [§ 315]

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E. OTHER COMPLIANCE

Laws and regulations in the corporate trust area are technical and require a high level of knowledge and training. In addition to the Trust Indenture Act of 1939, other laws and regulations exist that are supplemented by standard industry practices and the specific rules established by the various stock exchanges on which the securities are listed.

Lost, Stolen and Counterfeit Securities

Registration

Pursuant to SEC Rule 17f-1 [17 CFR 240.17f-1], a central database for the collection and dissemination of information about lost, stolen, and counterfeit securities has been established. In general, all insured banks and every registered transfer agent must register with the Securities Information Center (SIC) as either a direct or indirect inquirer. The rule also imposes certain reporting and inquiry requirements.

Reporting

Pursuant to SEC Rule 17f-1, banks and registered transfer agents must report to the SIC instances of missing, lost, stolen, or counterfeit securities. Securities certificates that are subsequently recovered must also be reported. The rule does not include securities that have been escheated, called for redemption, subject to litigation, or when the issuer is in bankruptcy. Bond coupons are also not considered securities certificates for this rule. Reports are required for all corporate securities having a CUSIP number, municipal securities, and bearer U.S. Government securities. Reports must be confirmed in writing on SEC Form X-17F-1A.

In the corporate trust function, the most likely application of this reporting requirement is when the bank, in its bond or stock transfer function:

- Is notified by a security holder of lost or stolen securities certificates. This occurs when the security holder requests a replacement certificate. Normally, the transfer agent creates an internal "stop transfer" order and issues a replacement certificate. The security holder is usually required to furnish an indemnification bond as a part of this process. The indemnification bond protects the bank in the event a lost or stolen certificate received in good faith is presented for transfer later and the bank is required to honor the certificate by purchasing replacement securities in the open market.
- During the securities transfer process, the transfer agent identifies:
    - counterfeit certificates, or
    - valid certificates previously reported as lost or stolen, or
    - valid certificates listed as paid or canceled on the transfer agent's books.
- The bank determines that securities certificates are missing from the bank's blank certificate inventory.

It is important to note that the rule was amended in 2004 and clarifies that the rule covers the life span of a certificate, from the time it is printed to the time destroyed.

The bank should file a report with SIC in each of these situations. Under Section 353.3(d)(2) of the FDIC Rules and Regulations, the filing of suspicious activity reports is not required for lost, missing, counterfeit or stolen securities, if the bank files a report as required by the reporting requirements of 17 CFR 240.17f-1.

Inquiries

Banks are required to make routine inquiries of the SIC by the end of the fifth business day after a certificate comes into its "possession or keeping". Furthermore, inquiries must be made about the SIC before the certificate is sold, used as collateral, or sent to another reporting institution. Normally, the inquiry requirement does not apply to the corporate trust function. There are provisions in the Rule governing situations where certificates are received from sources other than customers. Refer to SEC Rule 17f-1(d)(1), which appears under the Miscellaneous Statutes and Regulations tab in Volume III of FDIC's looseleaf regulations service.

State Escheat Laws

While escheatment laws primarily involve deposits, banks acting as bond trustee, securities transfer agent, and paying agent must comply with state abandoned property laws for checks and securities certificates which are undeliverable, as well as for book-entry accounts for which the owner cannot be located. Funds on deposit to pay unclaimed dividends, bond coupons not presented

for payment, bonds not presented for payment, as well as funds in suspense accounts, may be subject to state escheat laws. However, institutions should establish and implement adequate procedures to ensure compliance with the applicable law.

Administratively, each state has its own dormancy period. Over the years, these have tended to become shorter. In addition, every state establishes rules as to where abandoned property must be sent. States also set their own publication and notification requirements, have their own individual forms to be completed, and set their own dates for transmitting escheated funds. Due to the different administrative and legal requirements of each state, it has been difficult both for bank personnel and for examiners to verify compliance with escheat laws.

Legal Background

Escheat laws vary from state to state and may not exist in some states. One state may claim that its escheat laws apply to dormant funds which are concurrently claimed by another state. One state might claim the property based on the location of the trustee/transfer agent bank (or broker/dealer), while another state might claim the same property based on the physical or legal headquarters of the issuing organization. Yet another state might issue rules based on the stock exchange where the security was traded. It was possible for several states to claim the same funds. Bank trustees and transfer agents were often faced with conflicting claims.

In *Delaware v. New York*, 113 S. Ct. 1550 (1993), the U.S. Supreme Court resolved the differences among state laws concerning the right to receive unclaimed securities distributions. In that decision, the Court provided the following rules for resolving such disputes:

- We therefore resolve disputes among States over the right to escheat intangible personal property in the following three steps. First, we must determine the precise debtor-creditor relationship as defined by the law that creates the property at issue. Second, because the property interest in any debt belongs to the creditor rather than the debtor, the primary rule gives the first opportunity to escheat to the state of "the creditor's last known address as shown by the debtor's books and records." Finally, if the primary rule fails because the debtor's records disclose no address for a creditor or because the creditor's last known address is in a state whose laws do not provide for escheat, the secondary rule awards the right to escheat to the state in which the debtor is incorporated. 113 S. Ct. at 1556
- For purposes of the second rule under the *Delaware v. New York* standard, the Court held that "intermediaries" such as banks or securities firms who hold unclaimed securities distributions in their own name on behalf of the beneficial owners of such distributions are the relevant "debtors" with respect to the application of state law. In reaching this conclusion, the Court stated:

From an issuer's perspective, the only creditors are registered shareholders, those whose names appear on the issuer's records. Issuers cannot be considered debtors once they pay dividends, interest, or other distributions to record owners; payment to a record owner discharges all of an issuer's obligations. 113 S. Ct. at 1559.

Escheatment Litigation

Two high profile lawsuits occurred during the latter part of the 1990's and resulted in significant media and regulatory attention being placed on the escheatment practices of corporate trust departments. In 1995, a former officer in the corporate trust department of the Bank of America, San Francisco, California, filed a lawsuit against the bank. The state of California, the city and county of San Francisco and 300 local governments later joined the suit in 1997. The plaintiffs claimed that between 1977 and 1995, the bank or its predecessor, Security Pacific, mismanaged the proceeds of several bond issues for which it was serving as paying agent. The bank was accused of escheating insufficient amounts of unclaimed funds, charging excessive fees on bond trust accounts and destroying or losing critical records. Other allegations included claims that the bank mishandled payments for bonds that had been called so that it could maximize the earnings realized on the float of such funds and that it made unauthorized investments in order to generate higher fees. The case was settled out of court for $187 million.

The second lawsuit began when New York State auditors discovered in 1994 that the amount of unclaimed funds at Bankers Trust Corporation, New York, New York, had declined significantly from the prior year. Auditors became suspicious when bank employees thwarted their attempts to obtain records explaining the reduction in the amount of unclaimed funds of the bank's books. The FBI, the Manhattan U.S. Attorney's office and the Federal Reserve took over the investigation in November 1998. According to newspaper reports, three former executives were indicted on various Federal charges that they systematically

diverted $19.1 million of unclaimed customer's funds to the bank's own accounts. The funds were used to bolster the department's financial results, cover budget shortfalls, and even pay for the office Christmas party. The bank settled with Federal and New York State authorities in March 1999 by paying $63.5 million in fines and returning the $19.1 million in unclaimed funds that it acknowledged diverting to revenue.

Other Laws and Regulations

There are various other laws, regulations, rules and practices that affect the administration of accounts in a corporate trust department, such as bankruptcy laws, the rules and regulations of the various securities exchanges where securities are listed, Municipal Securities Dealer Regulations (refer to the Corporation's handbook covering municipal securities dealer activities) and the standardized operating procedures within the securities industry.