# Compliance/Conflicts of Interest, Self – Dealing and Contingent Liabilities

## A. CONFLICTS OF INTEREST

### Definition

Conflicts of interest arise when a fiduciary's duty of loyalty to another opposes with other interests of that fiduciary. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often-quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows:

"Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

The courts have long held that fiduciary transactions not made at arms-length may be set aside at the request of a beneficiary. This presumes the beneficiary was harmed by such transaction and, therefore, the fiduciary assumes the consequences of that harm. Consequently, a fiduciary effectively underwrites transactions involving conflicts of interest.

### Management of Conflicts

The prudent administration of conflicts of interest includes management's (1) recognition that conflicts of interest exist or potentially exist and (2) assurance that there are sufficient procedural and supervisory guidelines to safeguard against breaches of the fiduciary's duty of loyalty. The type and complexity needed and the depth of the written policies governing conflicts of interest depend upon the nature of trust activities conducted and the likelihood that conflicts of interest will materialize. A typical policy may address any number of the following areas:

- Standards governing employee ethics
- Self-dealing and other conflicts of interest such as:

    - Receipt of fees beyond the trustee's fee
    - Securities related activities
    - Own-bank (and affiliate institution) deposits
    - Administration of the discretionary purchase, sale, and retention of securities issued by the bank, its affiliates, insiders and their interests
    - Discretionary purchase, sale, or transfer of assets between trust accounts and the bank, its affiliates, or insiders and their interests
    - Investment in securities underwritten by own-bank or affiliates
    - Relationships with outside service providers
    - Inter-account and Multi-account transactions
    - Contravention of the terms of the governing agreement
    - Privacy

With the exception of an ethics policy, each of these points is addressed later in this section. An ethics policy typically provides guidance with respect to the acceptance of gifts; serving as (an individual) fiduciary under an appointment in which the bank serves as the corporate fiduciary, extensions of credit from discretionary trusts to directors, officers, and employees of the bank and its affiliates, etc. At a minimum, the Board of Directors should receive prior notification of such activities. The ethics policy should also include guidelines for compliance with state and federal bribery statutes. The FDIC has established guidelines pursuant to the Bank Bribery Amendments Act of 1985 to assist bank employees, officers, agents and attorneys in complying with the law. These guidelines are located in the FDIC Statement of Policy, "Guidelines for Compliance with the Federal Bank Bribery Law".

### Management Documentation Standards

The absence of risk in a transaction does not lessen or mitigate a conflict of interest. For example, investments in own-bank deposits may seem to involve little risk and appear to be an innocuous conflict of interest, but as can be seen in Subsection 8.E.3, there are numerous considerations in making such an assessment. Where more onerous situations are encountered, fiduciaries must exercise extreme caution in properly discharging their duties. Examples include the purchase or retention of own-institution stock or the sale of a trust asset to a bank insider. Investments of this nature should not be made unless (1) lawfully authorized by the instrument creating the trust relationship, or (2) a court order, local law, or prior written approval has been obtained from all interested parties. The latter option is not always available, as interested parties may include: the unborn, minors or others lacking the legal capacity to approve a transaction, or beneficiaries (whose interests are contingent in some manner) who cannot be identified at the time of the transaction. Furthermore, while retention of such securities when received in- kind may be allowable under a general power of retention (as opposed to retention that is directed by the instrument or court order), a trustee should exercise caution when making the decision to retain.

Complete documentation supporting management's actions with respect to transactions involving real or potential conflicts of interest, including the prudence of such transactions, is essential and should be readily available. The documentation should include a statement supporting the permissibility of the given transaction, as well as the prudence and suitability for the account involved. It is not unusual for banks to seek court approval for particularly sensitive transactions involving self-dealing or conflicts of interest. Certainly, opinions of counsel provide both guidance and supporting documentation. However, counsel's opinion alone cannot insulate a bank from litigation and loss if management has acted improperly or imprudently.

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## B. SELF-DEALING

Self-dealing always involves a conflict of interest, but not all conflicts of interest involve self-dealing. Self-dealing occurs when a fiduciary is a party to a transaction with itself or its affiliates. For example, in the sale of bank assets to a trust for which the bank is trustee, the bank is both the seller and the purchaser, and so is in fact dealing with itself. Other instances of self-dealing include transactions involving own-bank stock or other own-bank obligations, own-bank deposits, the sale of assets between trust accounts, and the purchase of securities underwritten by the bank, an affiliate or a subsidiary. Dealing with bank insiders is a conflict of interest, but is not self-dealing, though the potential for abuse is no less serious.

A clear statement of law regarding self-dealing was expressed by the U.S. Supreme Court in *Michoud v. Girod*, 11 L. Ed. 1076, 1099:

"The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity . . . . It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells."

These types of transactions may be set aside (considered null and void), after being brought to the attention of the trustee by the beneficiary or the beneficiary's agent. Generally, a court of law will decide these matters. If set aside, a trustee may be liable for damages resulting from, among other things, depreciation, loss of income, or the cost of lost opportunity. The prohibition against self-dealing applies with equal force to affiliates.

As an additional remedy, a beneficiary may ask a court to remove the administrator of a trust or will i the administrator acted under a severe conflict of interest or engaged in intentional self-dealing.

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## C. CONTINGENT LIABILITIES

Certain definite principles and rules governing fiduciaries' actions have been laid down by statutes and court decisions (Common Law). A violation of any of these principles or rules of conduct, or the failure to carry out the terms of the trust instrument or a court order, may constitute a breach of trust and create a contingent liability. Whether a contingent liability becomes an actual liability, in which actual losses are incurred, depends upon the actions of account beneficiaries, the bank, and courts of law.

A breach of trust is a violation by the fiduciary of any duty that a fiduciary owes to a beneficiary. Breaches may occur either by an act of commission or omission. When a breach of trust occurs, the fiduciary is generally charged with: any loss or depreciation in the value of trust assets associated with the breach; any profit earned by the trustee as a result of the breach; or any profit which would have been earned by the account had the breach not occurred. For example, any gains made from trading errors belong to the beneficiary. Conversely, a fiduciary is not liable for any loss or depreciation in the value of trust assets not associated with a breach of trust. This precept recognizes that, when invested, trust principal is at risk and that a fiduciary is not a guarantor of investment results.

One of the primary purposes of examining the trust activities of FDIC-supervised banks is to determine whether the administration of trust accounts has resulted in liabilities against the bank. The liabilities identified are those attributable to the bank, as a result of its actions as a fiduciary, and are not the liabilities of the individual accounts administered. To reflect the degree of likelihood that a contingent liability may result in a charge to capital accounts of the commercial department, the terms Potential Loss and Estimated Loss are used.

The classification system begins with Contingent Liabilities, increases to Potential Losses, and finally, to Estimated Losses. Note that while the wording of the definitions may appear to suggest an overlap of liabilities, there are no overlapping liabilities among these classifications. While the liabilities assigned to the administration of a particular account may include all three classifications (Contingent Liabilities, Potential Losses, and Estimated Losses), that portion of the liability which is assigned an Estimated Loss classification is not also contained in Potential Losses and/or Contingent Liabilities. Likewise, that portion of the liability that is assigned Potential Loss, is not also contained in Contingent Liabilities. The definition of each category of liability follows:

- Contingent Liabilities represent an estimation by the examiner of the gross possible liability of the institution resulting from the purchase of nonconforming investments for trust accounts, unwarranted retention of nonconforming assets, self-dealing, questionable practices and procedures, or other acts of omission or commission which appear not to comply with the terms of the governing trust instruments or applicable provisions of law, and which on accounting may be subject to objection by interested parties. Until appropriate consents, waivers or releases of liability are obtained from interested parties or no liability is determined to exist by a court of competent jurisdiction, the liabilities are regarded as contingent.

  The Contingent Liability category recognizes the possibility that department actions or omissions of action may, depending on: (1) account circumstances, (2) management's corrective measures, (3) ongoing litigation, and/or (4) future, or as yet unknown events, make uncertain whether losses will ever be sustained by the bank.

- Potential Losses represent the examiner's estimate of those portions of the contingent liabilities that may develop into losses to the institution. The amount of losses indicated is potential rather than definite and fixed, pending resolution of the dispute or settlement of the accounts.

  The Potential Losses category acknowledges that losses have an increased likelihood of being sustained. However, due to some measure of uncertainty, such as: ongoing negotiations with beneficiaries or their counsel, a decision not yet rendered by a court, management's ability to appeal a lower court's ruling, etc., it is not yet certain that losses will be sustained.

- Estimated Losses represent the amount of losses that, in the examiner's opinion, appear certain to be sustained by the institution as a result of its fiduciary activities.

  The Estimated Losses category recognizes the reasonable certainty that a known dollar amount of losses will be, or has been, sustained. In such cases, management has: (1) exhausted all of its legal appeals, or (2 agreed to reimburse an account, or (3) is in some manner, beyond its scope of influence or control, being compelled to reimburse an account or pay a known dollar amount of surcharges, penalties, or damages.

  Examiners are reminded that Estimated Losses should be reflected as a reduction in Part 325 capital in the commercial Report of Examination.

Contingent liabilities are based upon: (1) known facts and circumstances, and (2) the likelihood that the fiduciary will be required to make a monetary reimbursement to an account due to the fiduciary's improper actions, whether intentional or negligent. To effectively and accurately identify potential liabilities, contingent liabilities should not be arbitrary or based on speculation, hunches, or guesswork, but based on all pertinent facts available to the examiner. In determining the existence of contingent liabilities, unlike the assessment of Substandard, Doubtful, and Loss in the commercial Report of Examination, the examiner is not being asked to determine the value of an asset. Rather, it is the examiner's duty to determine whether: (1) the fiduciary acted imprudently or negligently in the administration of a fiduciary account, (2) the fiduciary's imprudent or negligent administration caused demonstrable harm to the account, i.e. the account suffered monetary losses or a depreciation in the value of some of its assets, (3) interested parties have or are expected to petition either the fiduciary or the courts for reimbursement for the harm caused by the fiduciary's imprudence or negligence, or (4) the fiduciary has agreed to reimburse such accounts for the harm the fiduciary has caused as a result of negligent or imprudent administration.

**Note**: In many cases, the imprudent or negligent administration of an account, including breach of trust, does not result in contingent liability, potential losses or estimated losses, because the account affected will not have suffered any demonstrable harm by reason of the fiduciary's actions. Examiners must distinguish these instances from those where the fiduciary's actions have caused, or likely will cause demonstrable harm to the account, i.e., actual monetary harm such as the loss of investment principal or the loss of income. Only when the fiduciary's imprudent or negligent administration causes such demonstrable harm will a contingent liability exist. For example, the purchase and/or retention of a nonconforming asset that has not resulted in a monetary loss to an account, is reversible without any monetary losses, and for which no legal action is threatened or pending should not be scheduled as a contingent liability since the account has not suffered any demonstrable harm. Such matters should be described in detail in the Report of Examination, but without any contingent liability assigned. Only those instances where a fiduciary's imprudent or negligent actions have, or are likely to cause an account to suffer monetary losses should be assigned an associated contingent liability.

Examiners should avoid speculating over such questions as: returns on investment, lost opportunities, or what verdict a jury might render. Such speculation is neither the purpose nor the intent of identifying contingent liabilities in the report of examination. The examiner's responsibility is, to the extent possible, to provide a reasonable determination of contingent liabilities.

A meaningful supervisory analysis of the bank's condition is not provided by simply extending the entire dollar value of an investment, the entire dollar value of an account, or the outstanding balance of corporate bonds as contingent liabilities, in place of a reasonable and demonstrable assessment of dollar damages or harm to an account. Nevertheless, where a market value cannot be obtained for an asset because it is of such poor quality, clearly speculative, or of very limited marketability, it is reasonable to extend the book value (cost) of the asset as a contingent liability.

In some situations, a determination of the dollar amount of contingent liabilities cannot be made. Examiners should not refrain from criticizing weaknesses or faulty account administration due to an inability to determine a dollar value of liability. These may include situations where: (1) practices are in contravention of the governing instrument, fiduciary principles, or common law precedents, or (2) the dollar value of damages or potential court surcharges cannot be ascertained because they will not occur until some unknown future date. An example of such a situation would be the structuring of an investment portfolio in a manner favoring current income beneficiaries over remainder men, thus foregoing opportunities for capital appreciation by concentrating investments in fixed income securities. Under these circumstances, the examiner should fully discuss administrative and investment deficiencies, warn management of the inherent risk of loss posed by such practices, and recommend corrective action.

Examiners should be careful when scheduling contingent liabilities arising from pending litigation against the bank in its fiduciary capacity. All litigation should be discussed in some manner in the Report of Examination. The assignment of contingent liabilities with respect to litigation should be based upon: (1) fiduciary management's candid assessment, including the opinion of legal counsel, of the issues subject to the litigation, (2) a sound analysis of the facts and circumstances, and (3) outstanding Division of Supervision Safety and Soundness policies.

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## D. MATERIAL NONPUBLIC INFORMATION

### General Overview and Management Actions

Insider trading, while not defined by the Federal securities laws, refers to the purchase or sale of securities while in possession of material information that is not available to the general public. Information is generally considered to be material when sufficient to induce a person to either buy or sell a security based on that information, e.g., the information is important to making an investment decision with respect to that security.

Banks may come into possession of material, nonpublic information in a number of ways:

- through information developed as a part of normal lending relationships with large commercial customers;
- by a director or officer sitting on the Board of Directors of an outside company;
- through the financing of tender offers, leveraged buyouts, and management buyouts; or
- when serving as advisor for private placements and mergers and acquisitions.

In general, trust accounts maintained in FDIC-supervised banks do not invest in corporations for which the commercial department has extended credit. The commercial department generally lends to local firms, while most trust investments involve either large, national firms or smaller firms that are located outside of the bank's trade area. However, it is possible that a bank could lend to and invest in the same company. This may occur should the bank originate or participate in loans to a national company headquartered in, or with a major facility in, the bank's trade area.

The prohibition against making investment decisions based on material inside information also applies to investments in small publicly traded companies. A bank insider may be aware of material nonpublic information by operation of the first two factors above. Examiners need to be aware of such instances.

Of particular concern is the availability to bank insiders of material inside information concerning the condition of and outlook for the bank itself, or the bank's parent company. It is difficult for a bank insider to be unaware of material changes in his or her own organization. Therefore, the investment in, and trading of, own-bank or parent holding company stock or debt instruments is worthy of particular scrutiny.

Financial institutions should adopt policies and procedures, appropriate to its own circumstances, to prevent the flow of material, nonpublic information from the commercial department to the trust department. Policies and procedures should be established prohibiting the use of material, nonpublic information, when deciding whether to buy or sell securities.

Appropriate procedures may include:

- Denying trust personnel access to commercial credit files;
- Prohibiting trust personnel from attending internal commercial loan meetings;
- Prohibiting bank personnel from serving simultaneously on a trust investment committee and a commercial lending committee; and
- Physically separating trust department personnel from commercial lending personnel.

### Potential Consequences of Inappropriate Administration

The Insider Trading and Securities Fraud Enforcement Act of 1988, which added Section 20A to the Securities Exchange Act of 1934 [15 USC 78t-l], exposes a bank to substantial civil money penalties if an employee is caught trading on insider information and the "control person" has not taken adequate steps to prevent insider trading. Criminal penalties for insider trading have also been substantially increased, both in jail terms and monetary fines. Both the bank and the individual supervising trading activity are also subject to civil penalties should an employee be caught trading on insider information. As such, the bank, in addition to having appropriate written policies and procedures, should also be able to demonstrate that trading activities are adequately supervised and monitored and that its employees have been apprised of the penalties, both civil and criminal, for trading on material, nonpublic information. Adherence to the letter and spirit of Section 344.9 of the FDIC Rules and Regulations will aid the bank in meeting its monitoring responsibilities.

SEC Section 240.14e-3 places similar requirements on the purchase or sale of securities based on material, nonpublic information with respect to tender offers. Refer to the FDIC loose-leaf regulations service under the Miscellaneous Statutes and Regulations tab for further guidance.

SEC Section 240.10b-5 relates to the Employment of Manipulative and Deceptive Devices and provides that it is unlawful for any person to directly or indirectly use any mechanism, make an untrue statement or omission, or engage in any act which would be fraudulent in connection with the purchase or sale of any security. This regulation can be applied to the use of material inside information in making investment decisions for accounts. For instance, if the bank acts on material inside information in making investment decisions, then the actions could be considered manipulative and deceptive and in contravention of SEC Rule 10b-5.

Notwithstanding that trading on material, nonpublic information constitutes an illegal act subject to severe civil and criminal penalties, it is important to keep in mind that the bank, in exercising its discretionary investment authority, has a fiduciary obligation to keep itself apprised of material public information with respect to securities it buys and sells. Policies and procedures should therefore be constructed in a manner to prevent unauthorized individuals from having access to material, nonpublic information, but not be designed in such a manner as to impede the flow of legitimate material public information or restrict the institution's ability to meet the needs of its customers by prohibiting all interaction between the trust department and the commercial department.

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## E. COMMON INSTANCES OF CONFLICT OF INTERESTS AND SELF-DEALING

The most frequently encountered instances of conflicts of interest and self-dealing (hereafter referred to as conflicts) are discussed below. The coverage given is not all-inclusive, but presents issues common to the vast majority of trust institutions. If examiners encounter problems during the review of any conflicts of interest they should be guided by the previous discussion of Contingent Liabilities.

Examiners might encounter a possible conflict situation considered to be an industry practice. Any such situation should be viewed in light of all available information. However, merely because it is an industry practice does not necessarily mean that a fiduciary duty, law or regulation has not been violated. For example, it was the practice of many banks in the 1960s to allocate brokerage business based on demand deposit relationships; however, in 1969 the Justice Department determined this practice to be in restraint of trade and threatened to sue for injunctive relief unless the practice was discontinued. It had been alleged that such banks often gave little or no consideration to the strength and integrity of the broker, the ability to execute orders efficiently, or the quality of research provided. Refer to Asset Management Section, Broker Selection on Basis of Deposits for further discussion.

### Fees Other than for Account Administration

With an increased emphasis on profitability, many fiduciaries have sought and will continue to seek additional sources of revenue. With this focus there is the potential that the fiduciary may fail to act in the best interest of beneficiaries. The fiduciary may be tempted to place its interests before those of the beneficiaries, when it benefits from the investment of trust assets, hence the conflict of interest.

One way to augment revenue is through the receipt of fees beyond the customary trustee fee (fee for account administration). The additional fee is often associated with a mutual fund investment, but with changes in the industry it could occur in other investments as well. Set forth below are some typical situations currently being encountered regarding mutual funds. However, the examiner should be alert to and explore any type of fees a bank receives other than the usual and customary fee for the administration of an account. Such fee(s) should be reviewed with the knowledge of all surrounding circumstances, considering the fiduciary principles and any applicable laws and regulations.

### *Investment in Proprietary Mutual Funds*

Receipt of additional fees beyond the traditional trustee fee is often encountered when investing in proprietary mutual funds. For example, the fiduciary or an affiliate receives a fee for serving as investment advisor to a proprietary fund. The receipt of this additional fee is not necessarily prohibited.

Some states have enacted legislation that makes certain conflict activities such as this permissible. The laws often govern whether both a trust account fee and a mutual fund investment advisor fee can be charged. They also may identify certain customer disclosure requirements and require the fee to be reasonable. Refer to Appendix C for a recap of state statutes authorizing fiduciary investment in proprietary mutual funds.

In receiving this additional fee, a trustee should do the following.

- Ensure that all applicable legal and regulatory requirements are met. If reasonableness is an element of the governing law, the reasonableness of fees associated with the investment in a proprietary mutual fund is a critical issue that a fiduciary should resolve prior to using such funds as discretionary investment vehicles.
- Determine that the investment is authorized by the governing trust instrument, is appropriate for the purpose of the account and/or the needs of the beneficiaries, and is prudent.

Guidance on investing in proprietary mutual funds is found in proprietary mutual funds. Additional conflicts regarding the use of proprietary mutual funds are discussed in Subsection 8.E.2.d.

### *Receipt of 12b-1 Fees*

The receipt of 12b-1 fees from mutual funds is not unusual. The existence of this fee is disclosed in a fund's prospectus. The receipt of 12b-1 fees and how they affect ERISA and non-ERISA accounts is discussed in the Asset Management section of the Manual, Section E, and the Employee Benefit section of the manual Subsection 5.H.7.f(13). Also refer to Appendix D and the Southeastern Growth Fund, Inc. request for a No-action letter, regarding the rebating of 12b-1 fees.

Department of Labor Advisory Opinion 2003-09A, dated June 25, 2003, indicated that a trust company's receipt of 12b-1 fees from mutual funds, the investment advisers of which are affiliates of the trust company, for services in connection with investment by employee benefit plans in the mutual fund, would not violate section 406(b)(1) and 406(b) (3) of ERISA when the decision to invest in such funds is made by an employee benefit plan fiduciary or participant who is independent of the trust company and its affiliates. The opinion also allows for the use of proprietary funds of an affiliate, so long as the trustee does not provide investment advice to the participants and the participants are free to choose non-proprietary funds.

The receipt of 12b-1 fees is required to be disclosed in the prospectus of all mutual funds. However, even if adequate disclosure is given and no regulations are violated in connection with these fees, trust departments must continually perform due diligence procedures to ensure that all investments are chosen with the interest of the beneficiaries in mind. Furthermore, trust departments must be aware of state laws regulating securities.

One issue expected to receive the scrutiny of Congress and the SEC is the charging of 12b-1 fees by mutual funds who have closed their funds to new investors. Since the purposes of 12b-1 fees are to promote and distribute the funds to new investors, the need to charge these fees to existing investors is questioned.

### *Receipt of Other Fees from Mutual Funds*

General Overview

There is the increasing potential for fiduciaries to receive other fees from mutual funds beyond the traditional 12b-1 fee. These are often incentive based fees and may include payments structured as reimbursement for services (e.g. sub accounting fees, shareholder service fees, or shareholder administration fees) or payment for the bulk transferring of business to another mutual fund provider.

A reimbursement for service arrangement offers compensation in the form of fees to the fiduciary that invests assets in a particular fund. Information on this type of fee is found in the mutual fund's prospectus. The fee is structured as a payment reimbursing the fiduciary for performing standard recordkeeping and accounting functions, on behalf of the mutual fund, for the fiduciary accounts invested in the mutual fund. Generally, there is a master or omnibus account (sub-transfer agent) with the mutual fund's transfer agent and the sub-accounting is on the bank's recordkeeping system. There is typically an electronic interface between the omnibus account and the fiduciary's recordkeeping system for individual client accounts. It may also cover ancillary services such as responding directly to questions or requests from customers whose funds have been invested in the mutual fund, forwarding shareholder communication, etc.

Regardless of the source of the fee, the decision to pace a fiduciary asset in a particular investment should be consistent with governing laws. Many states have modified laws to allow such fees, but have placed certain restrictions requiring compliance with standards of prudence, such as the quality of the investment and its suitability for an account. State laws may also require that fees be reasonable. State law, however, may not define what constitutes a reasonable fee. Whether or not state law requires fees to be reasonable or defines what is reasonable, management should consider the reasonableness of the fees received. State law often provides a good framework within which to evaluate the administration of this conflict of interest. Other pertinent issues include the permissibility of such fees under the governing document (the document may be silent) and whether the investment is in the best interest of a particular trust account. Documentation supporting all of these issues should be maintained by the fiduciary.

Caution: There is no uniform law requiring that such arrangements be disclosed to trust customers, but disclosure is encouraged. State statues may require disclosure and there are ERISA requirements to be considered. (See next subsection) In some states, the disclosure requirement is met by providing the client with a copy of the fund's prospectus, which includes a reference to shareholder service fees. Some states also require annual disclosure of the fee arrangement.

From a risk management perspective, it is essential that the fiduciary conduct a thorough due diligence review prior to receiving such fees from any mutual fund provider. The due diligence process should include the following: (These procedures also are contained in Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation SR99-7, "Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest", March 26, 1999.)

- *Reasoned Legal Opinion* - Receipt of a legal opinion or citations of law that address the legality of this form of compensation. This includes Federal and State regulations. Examples of issues to be addressed include permissibility of the investment and compensation under applicable laws, trust agreement, or court order, as well as any applicable disclosure requirements or reasonableness standard for fees found in the governing law.
- *Policies and Procedures* - Policies and procedures should be developed to specifically address the acceptance of fees and other compensation from any mutual fund. Ideally, the policies would address who has the authority to accept the fee and what type of analysis and documentation are required to support the investment decision when such fees are received. It should also address monitoring the receipt of the fee to ensure compliance with governing law(s), and reporting compliance with the established policies to the appropriate authority.
- *Analysis and Documentation of Investment Decisions* - Minimum investment criteria should be established to support the investment decision-making process. Refer to Section 3.F.4 for discussion of the asset management aspects of investing in mutual funds.

ERISA Accounts

Receipt of any such fee for employee benefit accounts subject to ERISA would appear to be a violation of Sections 406(b)(1). ERISA Section 406(b) (1) prohibits a fiduciary from dealing with plan assets in its own interests or for its own account. ERISA Section 406(b)(3) provides that a fiduciary with respect to a plan shall not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."

The Department of Labor (DOL) has not issued any definitive statement on the subject of the retention of "sub-accounting fees" by fiduciaries. Trust management should be encouraged to obtain a favorable ruling from the DOL prior to accepting any such fees for accounts subject to ERISA. DOL has, however, issued Advisory Opinions (AO) 97-15A and 9716A, respectively referred to as the "Frost" and "Aetna" opinions, which provide useful guidance. These AO's are discussed in detail in Subsection H.7.f.(13). Mutual Funds, Receipt of 12b-1 Fees, located in Section 5.

- In AO 97-15A, "Frost", the DOL took the position that a bank with discretionary authority to invest in a mutual fund that pays the bank a 12b-1 fee would appear to violate ERISA Section 406(b)(1) because it involves a conflict of interest. Even if a fiduciary does not administer or control investments in a plan, but has authority to delete or substitute mutual funds, the fiduciary may be able to cause 12b-1 fees to be paid to itself. In both situations, however, DOL took the position that if the fees were used to offset the plan's liability to the trustee (e.g., reduced the expense of administering the plan and thus not retaining the fees), the fiduciary would not violate Sections 406(b)(1) or (b)(3).
- In AO 97-16A, "Aetna", the DOL restated that the mere receipt of a fee or other compensation from a mutual fund in connection with a plan's investment would not in and of itself violate Section 406(b)(1) or (b)(3) if a service provider did not advise or otherwise exercise authority or control to cause a plan to invest in a mutual fund. Service providers, however, retaining the authority to delete or substitute the mutual funds made available to plan participants might be deemed to exercise the necessary discretionary authority to cause the payment of fees to themselves. Once again, he DOL took the position that if the fees were used to offset the plan's liability to the trustee, the fiduciary would not violate Sections 406(b)(1) and (b)(3).

It is important to note, however, that the practice of receiving fees for "secondary" shareholder services from proprietary mutual funds has not been determined by the DOL to violate any of the prohibitions of DOL PTE 77-4. "Secondary" shareholder services could include transfer agent, custodial, administrative, and accounting services provided to the mutual fund for which the plan fiduciary also serves as an investment advisor.

In those cases where an institution, as a plan fiduciary, improperly accepts mutual fund servicing fees, examiners should recommend that the fees either be returned to the individual accounts invested in the mutual funds providing the fees or that the servicing fees be used to offset plan expenses.

## Securities-Related Activities

There is the potential that conflicts that are not readily evident may occur with various securities-related transactions. Included in this section are some of the more common situations that may be encountered. For each, there are unique reasons to consider it a conflict, but the underlying concept is that the bank receives a benefit from the transaction and the benefit is usually in a form other than cash/fees.

### *Soft Dollars*

The term soft dollars refers to an arrangement in which a discretionary money manager (for example, a trust department or investment advisor) receives, in addition to transaction execution, investment research services from a broker/dealer in exchange for the brokerage commissions from executing transactions for discretionary client accounts. Hence, the money manager receives investment research that is purchased with the funds of discretionary client accounts, i.e. those accounts which actually pay the broke/dealer's commission. Hard dollars, on the other hand, involve the money manager purchasing investment research services with its own funds. In a soft dollar arrangement, the money manager is said to be paying up, i.e. paying more than the actual cost of executing a transaction.

Soft dollar arrangements present a conflict of interest since the money manager personally benefits from transactions involving trust assets. The purchase of investment research services with the commission dollars of a beneficiary or client, even if used for the benefit of the beneficiary or client, could be viewed as also benefiting the money manager in that the money manager is relieved of the obligation to produce the research himself or to purchase it with hard dollars. This is not to imply, however, that soft dollar arrangements are necessarily improper, since broker/dealers often provide an important service in producing and distributing investment research. Congress acknowledged as much when it added Section 28(e) to the Securities and Exchange Act of 1934, which permits money managers to consider the provision of investment research, as well as trade execution services, in evaluating the cost of brokerage services without violating their fiduciary responsibilities. Section 28(e) provides a safe harbor that permits, in certain circumstances, money managers to use commissions paid by discretionary accounts to acquire investment research as well as trade execution services. Excluded from the safe harbor provisions are transactions in futures or transactions done on a principal basis.

The acquisition of investment research services paid for by the commission paid by non-discretionary accounts, i.e. non-managed accounts, is **not** protected by Section 28(e). Non-discretionary accounts do not benefit from the investment research provided by the broker/dealer. The purchase of investment research services with the commissions paid by non-discretionary accounts should be explicitly permitted in the written agreement governing these accounts and disclosed to all interested parties.

A fiduciary exercising investment discretion is under the general duty to obtain best execution, which generally includes considerations such as the most favorable price for the securities, the lowest commission, the prompt and accurate execution of orders, the prompt and accurate confirmation of orders, and the prompt and accurate delivery of securities or proceeds. Prior to1975, when brokerage commissions were fixed and nonnegotiable this was not an issue. Since the advent of fully negotiable brokerage commissions on May 1, 1975, a fiduciary exercising discretion has been legitimately able to pay more than the lowest available brokerage commission if it also receives research services. As noted above, this limited safe harbor protection is provided by Section 28(e)(1) of the Securities Exchange Act of 1934.

The identification of soft dollars compensation is difficult. While brokerage commissions are generally readily identifiable, problems have arisen when non-research items have been claimed to represent research. The SEC has issued an interpretative release focusing on whether the product or service provides lawful and appropriate assistance to the money manager's investment decision making. If the service provided has a "mixed use" - meaning research and non-research components (such as computer hardware) - the money manager should make a reasonable allocation of the cost according to its use. The portion of the service used in the investment decision-making process can be paid with commission dollars, while those services that provide administrative or other non-research assistance should be paid with hard dollars. Refer to Appendix D - Securities Exchange Act of 1934 Release No. 34-23170 Section 28(e) and Soft Dollars.

Potential conflicts of interest related to use of soft dollars include:

- Investment advisers may choose broker-dealers based on a business related association. Additionally, the choices may be made solely on the basis of soft dollar products and services, to the exclusion of execution quality. The resulting trades could have both higher commissions and lower quality trade execution.
- Soft dollar arrangements could encourage increased transaction orders to pay for more soft dollar products and services. These arrangements might cause advisers to "over-consume" research because of the indirect nature of the transaction.
- Fiduciaries might be tempted to purchase products and services with only marginal research applications, such as periodical subscriptions, computer terminals or communication services, such as telephone, fax, etc.
- The lack of adequate controls could allow mixed uses for soft dollars, including products and services not used for research and not protected by safe harbor provisions of the Securities and Exchange Act of 1934. When different types of products are bundled together, management must be aware of any tendency to overpay for the research portion of the bundled services, in order to pay with commission dollars.
- Products and services purchased with soft dollars are often bundled together in such a way that a manager does not know what he/she is paying for each service.

Before an institution begins to receive soft dollar benefits, policies and procedures governing the proper use and monitoring of soft dollars transactions should be in place. Management must be able to demonstrate that soft dollar benefits constitute bona fide investment research. In complex operations, this may be done with a budget that identifies the soft dollar benefits to be received and how they will be used. General guidelines for the use of soft dollars include:

- A fiduciary may retain soft dollar services and materials from a broker (or other source) for investment transactions generated by discretionary accounts, if the soft dollar payments are (1) not prohibited by the governing account instrument and (2) comply with the SEC's safe harbor requirements.
- A fiduciary may not retain soft dollar payments from a broker (or other source) for investment transactions generated by nondiscretionary accounts, since a nondiscretionary account cannot justify paying higher brokerage commissions to receive investment research which would not benefit the account. Nondiscretionary accounts may, however, agree to soft dollar transactions if specifically permitted in the instrument, or by the grantor, or, after full disclosure, by all account beneficiaries.
- A fiduciary must disclose specific types of products, research, or services obtained with soft dollars so that customers understand what is obtained with the commissions. This is required whether or not the product is subject to the safe harbor provisions of Section 28(e).

There are also specific requirements for different types of fiduciary accounts. Refer to Subsection 5.H.7.f.(19) for employee benefit accounts subject to ERISA. Also refer to the SEC's Release No. 3423170 in Appendix D for additional information on soft dollar arrangements.

### *Use of Own-Bank or Affiliated Brokerage Service*

A conflict of interest arises when a fiduciary uses its own or an affiliate brokerage service to execute the trust department's securities transactions. It may also arise if a discount broker located in the commercial department is used (typically the third-party provider of non-deposit products). The problem is not the payment of commissions, provided they meet the concept of best execution and follow the concepts outlined in Section 3. The problem concerns other fee sharing arrangements, such as splitting of commissions or the payment of rent based upon the volume of transactions.

FDIC General Counsel's Opinion No. 6, states, in part, "If the bank intends to utilize the contractual arrangement with the broker/dealer for transactions executed in connection with trust department accounts, the bank should not receive any additional compensation from the broker/dealer with regard to those transactions, i.e., the bank trust department should not share in any commission associated with the transaction. To do so would raise possibilities of a breach of fiduciary obligation toward the bank's trust account customers." Several FDIC Advisory Opinions address some limited situations in which it might be proper to share in such commissions. However, in background discussions, those opinions generally stress that best execution objections can be raised when only one broker is used, and the bank may be open to a charge of churning, if it has discretion and the commission splitting arrangement is dependent upon the volume of trades. See FDIC Advisory Opinions 83-14, 83-15, 83-17, 83-18, 84-10, and 85-10 for further guidance.

Since the bank may profit indirectly through paying brokerage fees to an affiliate, the use of an affiliated brokerage service raises many of the same issues discussed in Subsection 8.E.1 - Fees Other than for the Administration of an Account. Also, the use of an affiliated brokerage service would appear to constitute a prohibited transaction under Section 406(b) of ERISA. While there is an apparent exception allowing reasonable transaction fees, the Department of Labor, in practice, has approved this exception only under very narrow conditions. Refer to the discussion in Subsection 5.H.7.f.(1) and Prohibited Transaction Class Exemption (PTE) 86128.

The use of an own-bank or affiliated municipal brokerage department raises additional issues. It is a conflict for the fiduciary to direct discretionary transactions to an own-bank or affiliated municipal securities broker. This is particularly the case, when securities are purchased from the dealer's inventory (securities in which the dealer has taken a market position). When securities are purchased from the dealer's inventory, rather than on the open market, the possibility exists that the securities are being sold at above market prices, or that securities which cannot otherwise be sold profitably on the open market are being sold to the trust department. The purchase of any security at an above market price is an abusive self-dealing practice. Arrangements should be made for the reimbursement of any losses suffered by accounts that purchased any security at an above market price. Realized losses and depreciation should be extended as Contingent Liabilities. Refer also to the discussion of underwritten securities later in this section.

Appropriate policies and procedures should be in place prior to entering into a brokerage service arrangement, regardless of whether the bank's brokerage services, an affiliated brokerage firm or a discount broker providing nondepot products will be used. Other considerations include:

- Whether brokerage services must be performed on a nonprofit basis, requiring documentation of transaction costs;
- Whether best execution is being obtained; and
- Whether accounts are protected from potential churning.

In view of these and other fiduciary and legal requirements, the bank should be able to conclusively demonstrate, preferably through the opinion of competent legal counsel that any such use conforms to all applicable laws and regulations and that no fiduciary duty has otherwise been violated.

### *Securities Trading Practices*

Problems arise when an employee puts his/her interests ahead of the interests of the beneficiaries in executing trades. A classic example is front running, which is an illegal practice whereby an individual knows that a block trade will influence the price of the security; the individual places his trade to profit from the effects of the block trade. Policies or procedures should prohibit such transactions. Furthermore, policies and procedures should prevent employees from trading under the auspices of the bank, e.g., the employee should not be allowed to use the trust department's accounts with brokerage firms to effect personal trades.

Another potential conflict arises when trading errors result in a potential profit or loss to the beneficiary of a trust or participant in a defined contribution retirement plan such as a 401(k). Given that a fiduciary must put the beneficiary's interests first, losses resulting in trading errors must be absorbed by the bank, and any profits must flow through to the account or beneficiaries thereof. Part 406(b) of ERISA prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account; consequently, any gains acquired by a fiduciary resulting from trading errors would result in an apparent error of the regulation.

Market Timing Trading in Mutual Funds

Market timing is the frequent purchase and redemption of mutual fund shares, exchange-traded funds (EFTs), or variable annuity or life contract, in an attempt to take advantage of a lag between a change in value of a fund or contract, and the reflection of that change in the fund or contract's share price. For example, time zone arbitrage is the buying of mutual funds that own securities in a foreign market at the previous day's net asset value, knowing that subsequent events occurred since that market closed will likely assure a profit. This practice may dilute the value of shares held by long-term shareholders; interfere with the management of the portfolio; and increase brokerage and administrative costs.

Management of defined-contribution plans such as 401(k)s must be aware of market timing trades by plan participants. An indication of such trading may be frequent trades. By allowing a few participants to benefit by taking temporary profits, participants interested in long-term gains may be armed.

An illegal form of market timing trading is late trading, which allows individuals to purchase mutual fund shares after 4:00 p.m. Eastern Time at the net asset value (NAV) for that day, when regulations require those shares to be priced at the NAV of the next day's close. Traders profit by trading on positive or negative after-hours news of major holdings of the mutual funds.

To address these and other concerns, the SEC issued the final rule for Disclosures Regarding Market Timing and Selective Disclosures of Portfolio Holdings. The effective date of the rule is May 28, 2004, with implementation on or after December 5, 2004. The rule requires mutual funds, EFTs, and variable annuity or life contracts to describe their policies and procedures for deterring frequent purchases and redemptions of the shares. The rule also allows a fund to reserve the right to reject a purchase or exchange request for any reason, as long as the fund discloses this ability in the prospectus. The fund disclosure must state whether the restrictions on frequent purchases and redemptions will be uniformly applied to trades occurring in omnibus accounts at intermediaries, such as investment advisers, broker dealers, transfer agents, third party administrators, and insurance companies. In disclosing the entities making frequent purchases and redemptions, mutual funds will be required to identify the group rather than the individual group member for 401(k) plans; this will be disclosed in the Statement of Additional Information (SAI), rather than in the prospectus.

The rule requires mutual funds and managed separate accounts that offer variable annuities, other than money market funds, to explain their use of fair value pricing. The rule states that funds are to use fair value pricing any time that market quotations for their portfolio securities are not readily available, including when they are unreliable. For domestic large cap funds, fair value pricing will be used under very limited circumstances, such as when the stock exchange closes early or trading is halted in a specific security. Conversely, for mutual funds that have securities which are traded overseas, then the use will be more common. Disclosures for either circumstance will be included in the prospectus.

For fund of funds, the SEC requires the disclosure to refer the investor to the underlying fund prospectuses.

Banks should have policies and procedures which address trading in mutual fund shares. Management must review and understand mutual fund prospectuses to determine what practices related to trading are allowed. Furthermore, for employee benefit accounts, managers should have programs to detect and prevent plan participants from engaging in market timing trading.

The management of bank-sponsored proprietary mutual funds must prohibit any practice that could prove detrimental to the shareholders.

### *Proprietary Pooled Investment Vehicles*

Conflicts involving the use of proprietary investment products are frequently tied to the generation of additional fee income. When a bank, as fiduciary, invests fiduciary assets in proprietary products, a key consideration is whether the bank is acting in the best interest of the beneficiary or in its own interest. A common example is the continued use of a poor-performing proprietary investment product in order to maintain a critical mass of assets under management. In doing so, the fiduciary benefits from economies of scale and earns additional fee income at the expense of the beneficiary, who sacrifices the potentially higher return that could be obtained from investing in better performing mutual funds. This is a particularly sensitive situation if trust accounts own a majority of the shares of a proprietary mutual fund.

Important guidance regarding investment in proprietary mutual funds is found in Asset Management, Section 3, and in the Employee Benefit section, Subsection H.7.f.(11). Subsection 7.F.12 - Section 9.18(b)(8) Self-Dealing and Conflicts of Interest, Subsection 7.K - Proprietary Mutual Funds, and Subsection 7.L - Conversion of Collective Investment Funds to Mutual Funds discuss potential conflicts of interest regarding duties of loyalty and prudent investment management. Special coverage of this topic may also be found in state law.

### *Use of Only One Fund Family*

Fiduciaries sometimes offer only one family of funds as its mutual fund investment option. Management may feel that it is easier to obtain reliable information and that they receive specialized attention due to the volume of the department's aggregate investment. This rationale is used in addition to the fee incentives previously discussed. Management may feel that these benefits compensate for the continued inclusion of a poor-performing fund as an investment option. However, the benefits of the use of only one fund family does not justify holding a poorly performing investment; and may represent a conflict of interest if the department is placing its interest, i.e. easing the administration of an account, ahead of the interest of the beneficiaries. To the appearance of such conflicts, management should ensure that all investments meet the trust department's approved investment criteria. Refer to Section 3 Mutual funds, for a discussion of the investment selection process.

### *Research Analyst Affiliate Relationships*

Potential conflicts of interest arise in a trust department affiliated with an investment company that conducts securities research. The conflicts occur when research analysts work for firms that have investment banking or other business relationships with issuers of the recommended securities, or when the analyst or firm owns securities of the recommended issuer. The recommendations must not be influenced by the relationships that affiliates have with the company being analyzed, including relationships related to investment banking and trust activities. In 2002, the SEC approved rule changes made by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) which are designed to improve the objectivity of investment research provided by research analysts. Provisions in these rule changes include:

- Research analysts may not be subject to the supervision or control of the firm's investment banking department.
- Disclosures are required of any investment banking relationship with any company that was subject to an investment report.
- Research analysts employed by members of the NYSE or NASD may not receive compensation based on specific banking services transactions.
- The manager or co-manager of a subject company's offering may not publish research about the issuer for 40 days following an initial public offering and 10 days following a secondary offering.
- Member firms must disclose in research reports whether the firm or its affiliates, including banks and trust departments, own 1 percent or more of the common equity securities of the company being analyzed.
- Research analysts have prohibitions on purchasing or receiving pre IPO shares, trading in recommended securities 30 days prior and 5 days after issuance of a report, and trading contrary to the analyst's own recommendations.

While these regulations only apply to registered investment advisors, the above rules provide guidelines for the conduct of research analyst affiliates. Please refer to NASD Rule 2711, Amendment to Research Analysts and Reports.

### *Proxy Voting*

As discussed in Chapter 3, Asset Management, trust department management should establish policies regarding casting proxy votes for shares of stock held in a discretionary capacity. The purpose of these policies is to ensure proxies are voted in the best interest of the clients, and that all conflicts of interest are disclosed. An example of a conflict of interest is when a Trust Department votes on proxies for shares of stock of a corporation that it holds in discretionary accounts, and at the same time performs investment banking or other services for this corporation.

In 2003, the SEC adopted new rule 206(4)-6 [17 CFR 275.206(4)-6] and amended rule 204-2 [17 CFR 275.204-2] under the Investment Advisers Act of 1940 relating to proxy voting. These rules and rule amendments require advisors registered with the SEC to adopt policies and procedures to ensure that the adviser votes proxies in the best interest of clients, to disclose to clients information about those policies and procedures, to disclose to clients how they may obtain information on how the adviser has voted their proxies, and to provide clients with information about how their proxies are voted. Furthermore, the rules require advisers to maintain certain records relating to proxy voting.

Violations of the proxy voting regulations in the Investment Advisers Act of 1940 can result in substantial civil penalties. For example, on August 19, 2003, the SEC imposed a civil money penalty of $750,000 on Deutsche Asset Management, Inc., the investment advisory unit of Deutsche Bank AG, for failing to disclose a material conflict of interest in its voting of client proxies for the 2002 merger between Hewlett-Packard Company (HP) and Compaq Computer Corporation.

### *Trading During Blackout Periods*

The term blackout period refers to an interval of time of more than 3 consecutive business days during which employees may not adjust the investments in their employee benefit pension plans, e.g. 401(k) plans. These blackout periods occur most frequently when the plan is undergoing certain changes, such as modification of investment options or replacement of plan record keepers. During a blackout period, the participants cannot make changes to the investments. The fiduciaries have effectively taken control away from the participants resulting in potential conflicts of interest; fiduciaries may be held liable if something goes wrong.

One of the most newsworthy conflicts of interest that caused substantial injury to beneficiaries occurred in 2001 at Enron Corporation. During a blackout period in which the pension plan trustee was changed, employees were not allowed to sell their Enron stock held in their 401(k) plans, and the stock lost much of its value. Corporate insiders, who had information regarding the deteriorating condition of the company, were able to sell their stock outside of the plan at much higher prices than employees who were required to wait until the blackout period ended.

In the wake of the Enron scandal, Congress passed the accounting reform bill known as the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Section 306(a) of the Act makes it "unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly to sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer."

Section 306(b) of Sarbanes-Oxley requires a thirty-day advance notice of any blackout period. The notice must be written in a manner calculated to be understood by the average plan participant and include the following:

- The reasons for the blackout period,
- An explanation of the investments and other rights affected;
- A statement informing the participants and beneficiaries that they should evaluate their investment selections in light of their inability to direct or diversify their investment choices during the blackout period.
- The name, address and telephone number of the plan administrator or other person responsible for answering questions about the blackout period.
- Such other matters the Department of Labor may require by regulation.

Sarbanes-Oxley provides three exceptions to the 30-days' advance notice requirement:

- The first exception applies when a fiduciary, acting with care, skill, prudence and diligence, determines that deferral of a blackout period would undermine the plan's exclusive purpose of providing benefits to participants and their beneficiaries and of defraying reasonable expenses of administering the plan.
- A second exception applies when the inability to provide the notice timely is caused by unforeseeable events or events out of the control of the plan administrator.
- A final exception applies if the blackout occurs in connection with a merger, acquisition, divestiture, or similar transaction involving the plan where individuals either become or cease to be plan participants.

Fiduciaries must document all exceptions to the 30-days' advance notice requirement.

Please refer for more information to Section 306 of Sarbanes-Oxley.

### *Advertising Investment Performance*

Trust Departments that publicize the investment performance of their discretionary accounts must ensure the advertisements do not contain misleading, inaccurate, or exaggerated claims. Even factually correct statements may be inappropriate, if these statements lead clients or potential customers to believe extraordinarily strong performance achieved in the past can be expected in the future. Types of misleading advertisements include:

- Publicizing superior returns achieved over a period of time, implying that investors can be reasonably assured that these returns can be expected in the future.
- Identifying selective stocks that have performed well, without identifying all the stocks in the portfolio being managed or when these stocks were purchased.
- Comparing stocks to a dissimilar index. For example, a portfolio may contain numerous high-tech or small cap stocks and the advertisements will compare results to an index of large cap stocks, such as the S & P 500.
- Advertising performance without identifying the risks involved. All ads promoting investment performance should indicate that future recommendations may not be profitable or equal past performance.

SEC Rule 206(4)-1 under the Investment Advisors Act of 1940 prohibits the distribution of several types of advertising considered fraudulent or misleading. Additionally, the SEC Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 require disclosures when mutual fund performance is presented in sales material. While these rules only apply to Registered Investment Advisors, these rules can be used as guidelines in developing policies and procedures designed to preclude misleading advertising. Furthermore, management must be careful not to portray itself as an investment advisor.

## Use of Own-Bank or Affiliate Bank Deposits

### *General Overview*

When a fiduciary allows investments in proprietary investment products, there is an inherent conflict between the best interests of the account beneficiary and the interest of the fiduciary. Investments in own-bank and affiliate-bank deposits (hereafter referred to as own-bank deposits) provide a benefit to the commercial department, by generating revenue from fiduciary deposits. For example, the commercial department may purchase a short-term investment, such as selling Federal funds, or a medium-term investment, such as a loan or a security. The choice depends upon the aggregate size and maturity of fiduciary deposits. Own-bank deposits may be used on a deposit by deposit basis or on a pooled basis, such as in sweep or master deposit accounts. Refer to the master deposit account discussion in Section 7.

Investment in own-bank deposits is a common practice, legally permitted by almost all states. Many governing agreements include standardized language allowing the fiduciary to invest in own-bank deposits. The language may be narrow and reference only time deposits, or very broad and allow any type of deposit. Fiduciaries often claim that a low risk tolerance and the relative safety of principal are valid considerations when choosing federally insured deposits as trust investments. There are, however, many alternative investment options that provide current income with comparable safety. Therefore, investment decisions based purely on these factors should be evaluated critically.

If management uses own-bank deposits as an investment option for the trust accounts it administers, basic guidelines and monitoring procedures should be established. These include appropriate policies, the monitoring of historical trends, and documentation that management has satisfactorily resolved the inherent conflict of interest posed by such investments. Written policies should address the use of own-bank demand and interest-bearing deposits. Documentation should include a review of alternative investment vehicles, the competitiveness of the interest rates paid on own-bank deposits, and appropriate approvals for such investments. Management should document that the bank has acted in the best interests of the account beneficiaries.

There are no specific guidelines addressing the propriety of various deposit terms, such as the maturity of the deposit, the rate of interest, the dollar size of own-bank deposits, or the percentage of total account assets invested in own-bank deposits. Therefore, examiners must determine whether the deposit(s):

- Are permitted under local and Federal law;
- Are permitted under the governing instrument;
- Met the objectives and needs of the account at the time of the investment;
- Provide the best investment alternative, considering alternate investment options available; and
- Provide a documented competitive rate of return.

### *ERISA, Deposit Insurance, and Pledging*

In assessing such conflicts, there are issues to be considered beyond the broad concepts of permissibility under state statue and the governing agreement. Such issues include ERISA prohibitions, Federal deposit insurance, and pledging requirements. Management should have knowledge of and appropriate policies for each of these areas.

<u>ERISA Considerations</u>

Section 408(b)(4) provides an exemption from the prohibited transactions provisions of Section 406(a) that would otherwise prohibit the investment of plan assets in the deposits of a bank that is also a fiduciary to a plan. Therefore, both own bank pension plans and the pension plans of other institutions may invest in such deposits provided that "(A) the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or (B) such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliate thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment." Refer to Section 5, Subsection H.9 for additional discussion.

Therefore, investing employee benefit funds in own-bank interest-bearing deposits is a conflict that is not prohibited, but must be carefully managed to ensure that the interests of beneficiaries are protected. Even if authorized by the governing instrument and/or permitted by statute, such transactions must be made in good faith, e.g., permissive authority does not relieve the fiduciary of its duty of care and skill in the investment selection process. This requires interest rates to be competitive, and the fiduciary to have considered alternative investments and determined that the investment are both prudent and proper in light of the investment options available.

<u>Deposit Insurance</u>

Another consideration is the overall volume of discretionary investments in own-bank deposits held by an account. Generally, the amount of own bank deposits held by an individual account (non-municipal account) should not exceed Federal deposit insurance coverage, unless the excess is adequately secured by other means. Section 24 of the FDI Act prohibits the pledging of bank assets to secure investments in non-public deposits, unless specifically approved via a Part 362 application.

In general, deposit insurance of fiduciary and other trust department accounts operates on a pass-through basis, with coverage provided to each beneficiary of each account. In most employee benefit accounts, deposit insurance is provided to the plan participant. It should, therefore, be uncommon for uninsured deposits to exist as long as each beneficiary's interest in fiduciary deposits does not exceed $100,000. The fiduciary institution must, however, adhere to certain requirements and there are some exceptions to the general rules. See Section 10 – Deposit Insurance of Trust Funds of the manual for further discussion.

Pledging Requirements

The pledging of bank assets to secure private deposits, generally for amounts not covered by FDIC insurance, is not a permissible activity for national banks, except for funds awaiting investment or distribution. In order for a state nonmember bank to pledge assets to secure private deposits, the bank must file an application for approval under Part 362 of the FDIC's Rules and Regulations.

### *Suitability of Own-Bank Deposits*

In establishing policies and procedures, management considers if the pattern of use of own-bank deposits exposes the institution to claims that the deposits in general were not made in good faith or were not chosen with the requisite care and skill. This is especially important if fiduciary funds are swept daily to an own-bank interest bearing deposit account. For individual accounts, the policies and procedures should focus on the amount of own-bank time deposits, non-interest bearing demand deposits, the reasonableness of the interest rate received and whether these deposits are allowed by the governing instrument and state law.

Maturity and Size/Volume

To demonstrate that management is effectively monitoring this activity, policy and procedures should set parameters to guide the length of time own-bank deposits may be used and the level invested, such as a dollar amount or percentage of account assets. These parameters may be general in nature, but should include all own-bank deposit products used. There should be a method to report and monitor exceptions, with the level of detail depending upon the extent of use. For example, if an own-bank deposit product is used for daily sweeps, monitoring would be more extensive than for the infrequent use of time deposits. The monitoring of sweep activity should be on the same basis as the monitoring of similar investments with a third party.

Unless authorized by the governing instrument, court order or local law, trust funds should not be permanently invested in own-bank deposits. In general, discretionary funds that are awaiting investment or distribution should not be invested in own-bank time deposits. The short-term nature of deposits does not relieve fiduciary institutions from their duty of loyalty, or the principles of care and skill when making investment decisions.

Uninvested Funds, Demand Deposits

Management must establish a formal system of monitoring uninvested funds. The combined income and principal cash of all the department's accounts are generally deposited into one account. The key consideration is not the aggregate amount on deposit, but rather, the reasonableness of the uninvested balances of the individual accounts, considering both the individual account's liquidity requirements and the fiduciary's duty to make trust property productive.

To properly manage the conflict inherent in own-bank demand deposits, the amount held in demand balances of each account should be restricted to the minimum necessary. There have been a number of lawsuits in the past based on the fiduciary's management of demand deposits and its concurrent use of the funds for lending and investments, together with the benefit gained on the float of demand deposits. For employee benefit accounts subject to ERISA, of particular note is the Labor Department's position regarding Float Management; refer to Section 5, Subsection H.7.f.(3) and Advisory Opinion 93-24A.

Reasonableness of Interest Rates Paid

After taking into consideration the amount, term and type of deposit, management should be able to demonstrate that own-bank deposits pay a competitive rate of interest. In assessing the reasonableness of the interest rates offered on own-bank deposits, management should not rely solely on comparisons with interest rates offered by local depository institutions. Management should endeavor to obtain the *highest prudent rate of return possible*. Generally, national money market rates, as well as the interest rates offered by depository institutions nationwide, should be considered as a comparative benchmark when making such investment decisions. This is especially important when management uses own-bank deposits as a cash sweep vehicle.

The decision to use own-bank interest-bearing deposits should take into consideration the term of the deposit and the competitiveness of the interest rate paid. Each decision to invest in own-bank deposits must be properly supported and documented in the bank's records. Management must demonstrate that a valid basis existed for the use of own-bank or affiliated bank deposits.

## Investment in Own-Bank or Affiliate Company Securities

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

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

Fiduciaries are required to take an active shareholder role with respect to the companies whose securities it holds in a discretionary capacity. By exercising their shareholder right to vote in an informed and responsible manner they are afforded the opportunity to influence the management of those firms. Fiduciaries cannot readily claim a passive investor defense for not actively performing their role as shareholder. Doing so would evidence both imprudence and negligence as a fiduciary. Based upon the foregoing discussion, a fiduciary is required to vote own-bank stock held in a discretionary capacity, which places the fiduciary in a position of divided loyalty - it must place the interests of the account beneficiaries ahead of its own interest (which may not be the same), thus presenting a conflict of interest.

The voting of own-bank stock is further complicated when the fiduciary possesses, but is prevented from using, inside information (refer to Material Nonpublic Information). The fiduciary's ability to vote own-institution securities may also be influenced or restricted by local law or Federal law (e.g., ERISA, and Title 12 USC Section 61 with respect to National Banks).

In order to avoid the appearance of divided loyalty, many management teams have made a decision not to invest discretionary fiduciary funds in own-bank or affiliated company securities. However, many have not taken this same strong stance on securities that are received in-kind.

There are a number of actions that management may take to manage such conflicts of interest. The measures center primarily on the investment decision making and voting processes.

- *Investment Decision* - Management should fully document its rationale for retaining own-bank stock or obligations. For example, did management made the decision to purchase the shares or were the shares received in-kind. If shares are received in-kind, management should use diligence in selling such assets at an early date, unless the trust instrument, court order, or local law authorizes their retention. Typically, the retention of such securities is directed by the governing instrument or specific authority to retain such investments is obtained from all interested parties. Since state laws vary considerably with respect to the retention of own-institution stock received in-kind, it is important that the examiner be aware of the applicable state law.
- *Voting Responsibility* - When co-fiduciaries or others hold specific legal authority to exercise voting rights over such securities, management should permit such individuals or entities to vote the securities. When no other individuals or entities hold such authority, trust management should vote the securities exclusively in the best interests of the account beneficiaries, and document the rationale for how it voted the shares. Failure to exercise voting rights or continued voting with management (without exception or reason) can be viewed as a breach of trust. The reasons supporting a decision not to vote fiduciary shares should be fully documented. In order to ensure that shares are being voted independently, several trust departments have contracted with independent third parties to review all proxies and vote them in the best interest of the beneficiaries.

## Sale or Purchase of Trust Assets to or From the Bank, Bank Insiders, Agents, or Affiliates

The sale or purchase of assets between an account and the bank, bank insiders, agents, or affiliates is an inherent conflict of interest. Inevitably, management is confronted with the dilemma of serving two diametrically opposed interests, one interest seeking the highest sales price and the other seeking the lowest sales price. Such transactions pose serious risk to both the account and the fiduciary, and should be scrutinized as to permissibility and fairness. The fiduciary, as arbiter and beneficiary of these transactions, may also be compelled to stand behind them as guarantor. Below are examples of such transactions, with suggested risk management procedures.

- Own-bank or affiliate repurchase agreements - Refer to Section 3 for a discussion of this activity.
- Management purchasing own-bank, parent or affiliate stock held in an account. Such transactions may, or may not, be permitted under local law and the governing instrument. If permitted, the transactions should always be effected through non-affiliated third party brokers. Such transactions should always be covered by adequate written policies and documented as to the legal authority to engage in the transaction. Written approvals should also be obtained from all interested parties. Caution: this option is not always available, as interested parties may include the unborn, minors or others lacking the legal capacity to approve transactions, or beneficiaries who cannot be identified at the time of the transaction.
- Sale of assets to an account. This type of transaction must always receive careful evaluation by trust management. In addition to permissibility and fairness considerations, management must document the necessity for purchasing assets from itself or insiders when, as investment manager, it has numerous investment alternatives. When the legal authority to engage in the transaction is absent, and/or documentation as to the fairness and necessity of the transaction is either lacking or insufficient, such transactions should be scheduled for criticism. Consideration should be given to scheduling a Contingent Liability as discussed in the previous portion of this Section under Contingent Liabilities.

Section 23B(b)(1) of the Federal Reserve Act provides certain restrictions on fiduciary purchases of securities or other assets from an affiliate of the bank or its subsidiary. This provision is not directed toward transfers of trust departments (the "fiduciary book of business"), but is noted here because it is contained in Section 23B and it impacts the conduct of trust department business. Such purchases are prohibited unless permitted by the governing trust instrument, governing law, or court order. It is important to note that the term "permitted" is used in the statute, suggesting that Congress did not intend to require that express authorization for such purchases be incorporated into trust agreements.

## Investment in Securities Underwritten by Own-Bank or Affiliates

Banks purchasing, as a fiduciary, securities for which the bank or an affiliate of the bank serves as an underwriter, is engaging in a self-dealing transaction. This traditionally occurred with municipal bonds. With the enactment of the Gramm-Leach-Bliley Act in 1999, the potential for such self-dealing transactions will increase, due to increased securities underwriting activity by financial subsidiaries of banks and bank holding companies.

Underwriting syndicates are composed of dealers that buy newly issued securities from issuers at a fixed price and sell them to the general public. Therefore, banks or bank affiliates participating in an underwriting syndicate have a vested interest in selling at a profit the securities underwritten. Failure to sell the securities in the open market at a price at least equal to the price paid by syndicate members (or the underwriting bid) constitutes a loss to the broker/dealer. Undivided syndicates are composed of dealers that share in the overall profits or losses on the sale of all securities sold by the entire syndicate.

The following policies and procedures should be in place to govern such purchases.

- Use of the same investment decision criteria for purchases of securities underwritten by the fiduciary or by its affiliates as is used when purchasing securities from non-interested parties (e.g., the normal investment criteria associated with any purchase decision).
- Compliance with the applicable law(s) and regulations governing such purchases. In particular, consideration to the relevant aspects of Section 23(b)(1)(B) and 23(b)(2) of the Federal Reserve Act.
- Assurance that the fiduciary is not making a market for the security and did in fact purchase the security at open market value.

Examiners should also be aware that the purchase of securities underwritten by the bank, its affiliates, or a member of an undivided syndicate in which the bank or affiliate is a member during the existence of the syndicate, is an apparent violation of Section 23B(b)(1)(B) of the Federal Reserve Act. Section 23B(b)(1)(B) states that a member bank "whether acting as principal or fiduciary shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank." However, Section 23B(b)(2), as amended by Section 738 of the GLBA, provides an explicit statutory exception "if the purchase or acquisition of such securities has been approved, before such securities are initially offered for sale to the public, by a majority of the directors of the bank based on a determination that the purchase is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities."

Consequently, if a trust department held full investment discretion over an account and purchased securities during the existence of a syndicate, the transaction would not be a violation of Section 23B as long as a majority of the Board (who are neither officers nor employees of the bank) approved the transaction prior to the initial offering. Nevertheless, the transaction would be considered a conflict of interest and self-dealing. Any abusive situations or apparent violations of Section 23B should be discussed with management and appropriately noted in the Report of Examination.

### *Other Transfers and Agency Relationships between Affiliates*

Instances may be encountered where, in lieu of an outright sale transaction, fiduciary business has effectively been transferred via written agreement. If a trust department enters into an agency relationship with certain affiliated entities, Section 23B(a)(2)(B) may apply. This requires the relationship to be on terms comparable to those existing for similar relationships where no affiliation exists. As previously noted, bank-to-bank and bank-to-trust company transactions are not covered by Section 23B. Where a sale transaction has not occurred, but an agency relationship has arisen, the discussion on Outside Contracting for Fiduciary Services in section G of this manual also applies.

In FDIC Legal Opinion on FRB Section 23B Fees and Affiliated Employee Benefit Plans, dated March 10, 1995, the FDIC has opined that a bank holding company's profit sharing plan may be an affiliate of the bank within that holding company. The opinion indicates that plans meeting certain prerequisites would be subject to both sections 23A and 23B. Therefore, dealings between a bank and such a plan, or a trust department and such a plan, should be reviewed in light of this opinion. (In particular, the definition of "affiliate" and "covered transaction" in Section 23A(b)(1) and (7) and23B(d)(1) and (3) should be reviewed for purposes of this determination). Also, refer to Compliance - Employee benefits, Prohibited Transactions, for additional comments on this subject.

## Relationships with Outside Service Providers

As with all other fiduciary activities, management's selection of outside service providers should be based exclusively upon the best interest of account beneficiaries, and not on the ancillary services or benefits that service providers may provide to the bank or trust department. Basing such relationships upon such ancillary services represents a breach of the duty of loyalty and a conflict of interest. Trust department management should support the reasonableness of the trust department's relationships with the outside service providers through a properly documented due diligence analysis. Refer to Section 10 - Outside Contracting for Fiduciary Services for further discussion.

Banks may have standing relationships or commitments with securities brokers, mutual funds, insurance agents, real estate agents, accountants, etc. Such relationships may include some form of rebate or reimbursement, whereby the bank receives a financial incentive for directing business to the service provider. The rebates and reimbursements may take various forms. Some may be based on a percentage of broker commissions (e.g., equity trades), or a percentage of the total dollar value of transactions executed (e.g., fixed income securities or mutual fund purchases). Some rebates may be hidden as a reduction in the price of a good or service due to the volume of assets invested, the number of items held in safekeeping, or the extent of services purchased. An example of the latter would be to use the bank's external audit firm to perform audits for closely held businesses held in trust accounts or in the preparation of taxes for the trust customers, with the bank receiving a reduction in the cost of its annual audit and the trust customers assessed a full fee.

Regardless of the form of such compensation, the following guidelines should govern such financial reimbursement arrangements. The arrangement must be (1) in the best interests of the account beneficiaries and (2) permitted by applicable laws and the governing instrument. With respect to agencies and revocable trusts, prior written approval should be obtained after a full disclosure of the financial arrangements made to the customer. Periodic account statements should provide either a line item disclosure of the fees associated with such arrangements or a disclosure of the total annual fees associated with an account's usage of such services. Account statements should not report income, or gains/losses, on a "net" (net of applicable fees) basis. Net reporting is considered misleading and deceptive, and should be criticized by the examiner.

## Inter-Account Transactions

Inter-account transactions occur when assets are sold directly from one account to another, bypassing a non-affiliated third party broker. While attractive from the standpoint of reducing or eliminating commissions paid to third parties, the fiduciary must demonstrate that the transactions' terms were as advantageous to all parties, involved had these transactions been conducted through a third party. Management must:

- Comply with Applicable Laws and Regulations - Applicable regulations include Section 344.8 of the FDIC's Rules and Regulations, which requires investment managers to have written policies governing the crossing of buy and sell orders on a fair and equitable basis.
- Establish Adequate Written Polices.
- Develop Procedures to Monitor and Report Inter-Account Transactions Inter-Account transactions should be reported to the appropriate supervisory level. Management should be alert to situations where trust officers may be engaging in such transactions in an effort to dispose of assets, either because they were erroneously or improperly purchased, or because they have depreciated in value. The sale of assets between accounts under these circumstances would constitute a breach of trust and result in a Contingent Liability on the part of the bank. It may also involve a violation of FDIC Section 344.8(a)(4).

An example of a situation where an inter-account transaction would be appropriate is the transfer of assets between related accounts. For example, the sale of an interest in a closely held business from one trust account to another related trust account (where the accounts share the grantor, beneficiaries, remaindermen, etc., and (1) where the sale is directed or authorized by the grantor, or the governing instrument, or (2) where the written approval of all beneficiaries and, if necessary, remaindermen, is obtained, or (3) where the transaction is approved by a court of law). Also, as noted above, the department should have written policies governing this type of transaction. As with all conflicts of interest, fiduciaries should seek to avoid inter-account transactions, and limit them to instances that provide demonstrable benefits to all accounts involved.

## Multi-Account Transactions

Multi-account transactions are intrinsically neither good nor bad. When permissible under local law or the governing instrument, they can, and in some instances, would be expected to occur in the normal course of business. In a typical multi-account transaction, the fiduciary purchase or sell shares in large blocks and allocate the shares purchased or sold among accounts. If the block was purchased at different prices from more than one broker, management must take extraordinary care to ensure that all aspects of the allocation, including the price of the security, number of shares, and commissions charged is fair for all parties.

Management must ensure that all accounts are treated fairly in the allocation process and that proper policies are in place to govern such transactions. Accounts, by virtue of their size or other consideration, must not be permitted to benefit unfairly at the expense of other accounts. FDIC Section 344.8(a)(3) requires investment managers to have written policies governing fairness in the execution of multi-account securities transactions.

## Contravention of Terms of the Governing Instrument

Failing to act according to the terms of the agreement or deviating from the governing terms of the agreement without proper authority may give rise to a contingent liability. The contravention may be due to circumstances beyond the fiduciary's control, such as an unforeseen event, or may be due to breaches of the fiduciary's duties. The latter might involve an investment decision or a failure to consult with a co-fiduciary. Contraventions due to unforeseen circumstances are an inherent risk of fiduciary activity. However, contraventions caused by the failure of the fiduciary to properly administer an account are unacceptable.

### *Ambiguous Language*

Contraventions may occur when the terms of the instrument are ambiguous. In such instances, the fiduciary *may be* permitted to consider circumstances and conditions outside of the instrument to determine the settler's intent. One method of limiting such risks is to carefully review the governing agreement prior to accepting an account in order to ensure that the language of the agreement is precise and that all of the fiduciary's powers and duties are clearly defined in the agreement. This applies to both revocable and irrevocable trusts, since, due to future events, a revocable trust may become irrevocable.

### *Changing Circumstances*

Frequently circumstances regarding either the settlor, the beneficiary or conditions affecting the administration of the trust will result in contraventions of the governing instrument. An example is the receipt of instructions from the settlor that contradict the terms of the original agreement. Management must be cautious when following the settlor's directions subsequent to the creation of the governing agreement. Unless the instrument permits the revocation or the modification of the agreement, the terms may not be changed. If the trust is revocable, it should be amended to permit the otherwise impermissible act. Another example occurs when required actions become impossible, illegal, or due to a change of circumstance, defeat the original purpose of the trust. For example, older trusts were written with very restrictive investment directions, such as only permitting investments in the direct obligations of the United States. Years later the trust, which may be small, may need to generate income and principal growth for an incapacitated remainderman. A mutual fund investing in U.S. Government and Agency securities may be a suitable investment, except for the very restrictive investment provisions of the original trust agreement. In the absence of an emergency, the trustee should first obtain authorization from a court of competent jurisdiction before deviating from the terms of a trust. A trustee who deviates from the letter of the trust without the sanction of the court and/or beneficiary does so at the peril of afterward having to provide evidence that the deviation was both necessary and appropriate.

### *Unauthorized Commingling of Assets*

There should be no unauthorized commingling of assets by a fiduciary. In the following instances, however, commingling is allowed:

- State law permits a trustee to deposit uninvested funds belonging to several fiduciary accounts into a single deposit account.
- Assets are held in a special form of partnership, called a nominee, to facilitate the purchase, sale, and collection of income. Most governing agreements (personal, agency, and employee benefit) allow for assets to be held in a nominee name.
- Funds are invested in collective investment funds. Most modern trust agreements allow for this type of investment.

In all other respects, unless specifically permitted by law, assets of each fiduciary account should be kept separate from both the assets of other fiduciary accounts and the assets of the bank. In carrying out this responsibility, the bank should identify all assets with the name of the fiduciary account. For example, mortgages, deeds, stocks, and registered securities should be in the name of the bank as fiduciary for the account. If the bank is acting in an agency or custodial capacity, registration would be in the name of the principal, unless otherwise directed or authorized by the governing agreement. Such authorization, however, is common.

### *Nonconforming Investments*

Accounts must not hold nonconforming assets. For personal trust accounts, nonconforming investments are those that do not conform to state law, the terms of the governing instrument, or, in the case of employee benefit plans subject to ERISA, investments that do not conform with the plan documents (refer to Subsection 5.H.3), do not meet the prudence and diversification requirements of ERISA, or which result from transactions prohibited by ERISA (refer to Subsection 5.H.7).

### *Failure to Invest*

All funds, including income and principal cash, should be made productive, unless the trust instrument, local law, court order, or a party empowered to direct investments provides otherwise. A fiduciary's failure to invest may result in liability for the loss of income. When required to invest in a particular investment vehicle, the failure to do so will result in liability for the loss of any increase in value if the investment appreciates. Any decision to leave cash uninvested should be properly documented.

### *Acts Without Consent or Approval of a Co-Fiduciary*

When there is more than one trustee, the general rule is that they cannot exercise the powers conferred upon them unless they agree. As such, co-fiduciaries should execute the duties of their office in their joint capacity. *Where discretion is required*, as distinguished from purely ministerial acts, the *joint action of the trustees is required unless the trust instrument or applicable statute provides otherwise*. The decision to purchase, sell, or distribute (invade principal) trust property involves the exercise of discretion requiring the joint action of the co-fiduciaries, and should have the written approval. Absence of documentation evidencing joint approval may expose the bank to the risk of loss in the event actions are subsequently challenged.

In certain instances, Section 405 of ERISA makes a fiduciary liable for the wrongful acts of co-fiduciaries. Refer to Subsection 5.H.6.a for a discussion on how proper allocation procedures will permit one fiduciary to insulate itself the actions of co-fiduciaries.

## Privacy

Conflicts of interest related to privacy include breaches of loyalty due to the sale of confidential information to third parties and to maintain control over trust property. The first breach may occur when the sale of non-public customer information to increase fiduciary revenue supersedes the beneficiaries' need or desire for confidentiality. The second breach may occur when the fiduciary fails to adequately safeguard confidential information. The current concern in this area focuses on information aggregators. Information aggregators assemble client information, often financial in character, from various on-line sources and present the client's information in a single convenient interface. The activity is sometimes referred to as screen scraping, and is addressed in the next subsection. Regardless of the cause of the breach, adequate policies and procedures are required to control conflicts arising from consumer privacy issues. Refer to Section 10 of the Manual for a discussion of the required contents of a privacy program.

### *Privacy and On-line Banking*

When a fiduciary offers on-line access to client information, the potential exists that an unauthorized entity or person may access the information. Even when done with the permission of the client, such on-line access can expose the fiduciary to liability for failing to properly safeguard confidential information. Essentially, the client provides the information aggregator with pin numbers and passwords to all their financial accounts and the aggregator enters each entities system, collects the client's data, and presents it to the client in a combined format. In many cases, trust and agency agreements do not allow the sharing of information with parties other than the beneficiaries. Methods for managing the risk to the fiduciary include:

- Separating fiduciary customer information from general customer information on on-line systems, e.g., separate pin and password to access fiduciary information;
- Informing customers of the potential risks of screen scraping and adding language to written on-line user agreements to address this activity;
- Modifying the language of governing documents (trust and agency agreements) to allow for this activity;
- Including cautionary disclosures on the fiduciary's website which request customers to notify the fiduciary if they have provided an information aggregator with on-line access to account information; and/or
- Establishing procedures for monitoring screen scraping activity.

## Prohibitions against Tying Arrangements

Trust departments and banks must be aware of potential conflicts of interest when they condition the price or availability of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank. Although Section 106 of the Bank Holding Amendments of 1970 prohibits this type of activity, the regulations specifically permit tying arrangements if the customer is required to obtain a "traditional bank product" such as a "loan, discount, deposit or trust service". Section 106 also prohibits a bank from preventing a customer from obtaining a product or service from a competitor, unless the condition is imposed in a credit transaction to ensure the soundness of the credit. Tying arrangements are prohibited by the Sherman and Clayton Anti-trust Acts; however, these acts require showing that a practice harms the public, while Section 106 has no such requirement.

The difficulty for a bank or its trust department is understanding what is a traditional bank product. The Board of Governors of the Federal Reserve System has provided the following specific examples of traditional bank products as guidance:

- All types of extensions of credit, including loans, lines of credit, and backup lines of credit;
- Lines of credit and financial guarantees;

- Lease transactions that are the functional equivalent of an extension of credit;
- Credit derivatives where the bank or affiliate is the seller of credit protection;
- Acquiring, brokering, arranging, syndicating and servicing loans or other extensions of credit;
- All forms of deposit accounts, including demand, negotiable order of withdrawal (NOW), savings and time deposit accounts;
- Safe deposit box services;
- Escrow services;
- Payment and settlement services, including check clearing, check guarantee, ACH, wire transfer, and debit card services;
- Payroll services;
- Traveler's check and money order services;
- Cash management services;
- Services provided as trustee or guardian, or as executor or administrator of an estate;
- Discretionary asset management services provided as fiduciary;
- Custody services (including securities lending services); and
- Paying agent, transfer agent and registrar service.

Several other types of arrangements are allowed under Section 106. The regulations do not prohibit a bank from imposing conditions in order to enhance the credit of its borrowers, such as requesting additional collateral, requiring insurance on collateral or restricting a borrower's total debt, even at a competing institution. Section 106 also does not restrict non-bank affiliates from requiring a customer to use bank's services. Furthermore, a bank may require a customer, in accepting bank services, to choose from a combination of traditional and non-traditional products, so long as the customer can fulfill its obligation to the bank solely through traditional products.

Some specific examples of violations are cited by the Federal Reserve. A bank may not require a borrower to do any of the following in order to obtain a loan:

- Purchase an insurance product from the bank or an affiliate of the bank (a prohibited tie);
- Obtain corporate debt or equity underwriting services from an affiliate of the bank (a prohibited tie);
- Sell the bank or an affiliate of the bank a piece of real estate unrelated to the requested loan (a prohibited reciprocity arrangement); or
- Refrain from obtaining insurance products or securities underwriting services from a competitor of the bank or from the competitor of an affiliate of the bank (a prohibited exclusive dealing arrangement).

As tying arrangements can be very complicated, it is imperative that management establish policies and procedures to ensure that bank employees comply with the anti-tying prohibitions of Section 106. The procedures should include education and training, particularly for personnel that have direct contact with customers for purposes of marketing and selling the bank's products, especially in the bundling of traditional and nontraditional products. Trust department employees should be aware that securities underwriting, insurance products and securities advisory services are not considered traditional banking services for the purposes of Section 106. Furthermore, employees should be free to seek legal advice in the event of a potential violation of Section 106.