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	Notice	Memorandum	X

TO: Regional Directors

FROM: Nicholas J. Ketcha Jr.
Director

SUBJECT: Nondeposit Investment Products (NDIP) and Recordkeeping Requirements Questions and Answers

1. **Purpose.** This memorandum provides answers to commonly asked questions regarding retail sales of NDIPs and recordkeeping requirements.
2. **Background.** Sales of NDIPs can increase a bank's marketplace competitiveness, provide customers with additional services, and bolster earnings. However, NDIPs are financial assets that are not FDIC-insured and may contain investment risk. NDIP sales at insured depository institutions may potentially confuse customers and expose banks to contingent liabilities or reputation risk.

Outstanding guidance that governs this activity consists of the Interagency Statement on Retail Sales of Nondeposit Investment Products, Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products, and Nondeposit Investment Product Examination Procedures. Examiner review of NDIP activity at financial institutions has generated many questions concerning the application and interpretation of these three documents.

3. **Supervisory Policy.** Examiners should use the attached Question and Answer document as a supplement to currently outstanding guidance when reviewing retail sales of nondeposit investment products at insured financial institutions.
4. **Action Required.** Distribute this memorandum to all examiners.

Attachment

Transmittal Number: 98-058

What is a proprietary mutual fund for purposes of completing the NDIP Examination Results System (ERS)?

In general, a proprietary mutual fund is a mutual fund to which a bank, its subsidiary or affiliate, serves as investment adviser. In most instances, these funds are primarily marketed to a bank's or banking organization's customers. The following three data fields in the NDIP ERS relate to proprietary mutual funds: 1)Types of Proprietary Product(s) offered, 2)Proprietary Product(s) Advisor, and 3)Total Asset Size of Proprietary Products (thousands).

Types of Proprietary Product(s) Offered data field has a pull down menu with various selections for those types of proprietary products offered by the subject bank.

Proprietary Product(s) Advisor/Manager data field has a pull down menu with three selections to identify the investment advisor to the proprietary fund. The user can select either "bank", "bank affiliate", or "bank subsidiary" for this data field.

Total Assets in Proprietary Products (thousands) data field is intended to capture the size (in thousand dollar units) of the proprietary mutual fund(s) and proprietary annuity products offered by the banking organization. The total reported in this field is not limited to only those products sold to customers of the bank being examined.

For example, presume that First Bank, our subject SNM bank, is a wholly-owned subsidiary of First Bancorp. First Bank sells NDIP, including the A Fund, a money market fund, which is part of a group of funds known as the "First Group" funds. The "First Group" funds, comprised of the A, B, and C funds, are advised by First Securities Corporation. First Securities Corporation is a wholly-owned subsidiary of First Bancorp; therefore, it is an affiliate of First Bank.

The "First Group" funds are proprietary mutual funds to First Bank. In the ERS, the examiner would select the best description for the A Fund, in this case "Money market fund," from the pull-down menu in the Types of Proprietary Products(s) Offered data field. The examiner would also select "bank affiliate" for Proprietary Product(s) Advisor/Manager data field. Lastly, for the Total Assets in Proprietary Products (thousands) data field, the examiner would enter the size (in thousand dollar units) of all of the "First Group" mutual funds (the A, B, and C funds) and annuity offerings, if any. This information should be available from either the state nonmember bank or the holding company.

If a situation arises that is similar, but doesn't exactly fit the definition of a proprietary product in this document, examiners should contact their regional,

Senior Capital Markets and Securities Specialist to determine if a product is a proprietary product.

When conducting examinations, the procedures for proprietary products should be applied to the extent that they are relevant for the individual affiliate banks. In the above example, First Bank would not be expected to maintain oversight for proprietary product operations if the holding company or lead organization has already done so. However, management of First State Bank must maintain oversight of all NDIP sales activity on their premises.

How frequently should the board review its written NDIP statement?

According to the Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement), the board should review its written NDIP statement periodically. That is, the board should review and update its NDIP statement whenever a material change to the NDIP program occurs. If no material change to the NDIP program occurs, the board should review its NDIP program at least annually.

Do the Interagency Statement's guidelines apply to the sale of government securities?

A retail sales program for government securities conducted in the lobby area is subject to the Interagency Statement, regardless of whether the institution is a registered government securities broker/dealer. Sales of government securities made from a depository institution's registered government securities broker/dealer department away from the lobby area would not be subject to the Interagency Statement. If an institution is a registered government securities broker/dealer, its actions are governed by the regulations issued under the Government Securities Act as well as Part 368 of the FDIC's Rules and Regulations which sets standards for conduct and suitability of investment recommendations to customers purchasing government securities.

How do sweep accounts function and does the Interagency Statement apply to these accounts?

A sweep account is a hybrid account that combines elements of insured deposits and NDIPs. Sweep accounts employ pre-arranged, automatic funds transfers from a deposit account to a brokerage account that may purchase NDIPs (including retail repurchase agreements) when the account rises above a preset dollar balance. Sweep accounts also include accounts that use pre-arranged, automatic sales or redemptions to replenish a deposit account that falls below a preset dollar balance. When sold to retail customers, the Interagency Statement's guidelines generally apply to transactions involving these types of accounts. For compliance with the Interagency Statement, the minimum disclosures and written acknowledgments

need only occur when each account is opened, not at each and every subsequent “sweep” transaction.

There are confirmation and recordkeeping requirements under applicable Treasury regulations of the Government Securities Act for transactions involving sweep accounts that sweep funds into government securities in a custodial arrangement (17 CFR 450.4(b)(1)). Under these Treasury regulations, the confirmation or safekeeping receipt for such securities must identify the issuer, maturity date, par amount, and coupon rate of the security being confirmed.

Repurchase agreements involving a U.S. Government or Agency security held by a depository institution in a custodial function is covered by Treasury regulations in 17 CFR 403.5(d). Under these regulations, the custodian must do the following: 1) Obtain an original of the repurchase agreement, 2) confirm in writing the specific securities that are the subject of a repurchase transaction, 3) disclose to the counterparty that the funds and/or securities held pursuant to the repurchase agreement are not insured deposits, 4) in the event that the depository institution is granted by the counterparty with the right to substitute securities pursuant to the repurchase agreement, provide certain disclosures as set forth in 17 CFR 403.5(d)(1)(v), and 5) maintain possession or control of the securities that are subject of the repurchase agreement.

Part 344.6(d) addresses notification requirements for banks effecting a securities transaction for cash management sweep accounts as defined in Part 344.3(c).

How does Part 344 apply to cash management sweep account transactions involving repurchase agreements?

Although repurchase agreements are not specifically addressed in the definition of a security in Part 344.3(m), Part 344 generally applies to cash management sweep account transactions involving repurchase agreements. Cash management sweep account transactions should not be included in the calculation of the de minimus transaction exceptions from the recordkeeping requirements that are discussed in 344.2(a)(1) and (2). However, the notification requirements of 344.6(d) apply to banks effecting a securities transaction for cash management sweep accounts. There are also instances where disclosures and/or confirmations are required under the Treasury Regulations of the Government Securities Act for each sweep transaction into a repurchase agreement involving a U.S. Government or Agency security held by a depository institution in a custodial function (17 C.F.R. 403.5(d)).

Are insurance products or annuities NDIPs and are they covered by the Interagency Statement?

The Interagency Statement states that annuities are NDIPs. This includes both variable and fixed rate annuities. However, the Interagency Statement does not specifically address insurance products. Some insurance products, such as whole life, variable life, and universal life insurance, have an investment component, and, therefore, are considered NDIPs under the Interagency Statement.

Certain insurance products are not investment products. Term life insurance has no investment component and is not an NDIP. Hazard insurance products, such as credit life, auto, fire, and disability insurance, are also not NDIPs. Thus, the Interagency Statement would not apply to sales of these insurance products.

Bank management and sales personnel must comply with other state and federal requirements that regulate insurance sales, such as licensing requirements, product restrictions, requirements to make appropriate recommendations to customers, anti-tying restrictions, anti-coercion restrictions, and applicable confidentiality laws.

Are trust department activities covered by the Interagency Statement?

The Interagency Statement does not apply to fiduciary accounts administered by a depository institution. However, the disclosures prescribed by the Interagency Statement should be provided to non-institutional customers who direct investments for their fiduciary accounts, such as self-directed individual retirement accounts. Agency accounts where the institution has sole or shared investment discretion (e.g. investment management accounts) are fiduciary in nature and are exempt from the Interagency Statement. Some agency accounts allow the customer to retain sole investment discretion. These accounts are not fiduciary in nature and the Interagency Statement applies to transactions involving these accounts. Self-directed employee benefit accounts such as 401(k) accounts are not subject to the Interagency Statement as ERISA law considers them to be fiduciary accounts. The Interagency Statement does not apply to custodial accounts (other than self-directed retirement accounts) where the institution is performing ministerial acts such as collecting interest and dividend payments for securities held in the accounts and handling the delivery or collection of securities or funds in connection with a transaction.

Examiners should use the following table as a general guide for their reviews of trust department activities. In instances where the Interagency Statement does not apply, other safety and soundness guidelines may pertain. This table is not a substitute for examiner judgment and discretion.

TRUST DEPARTMENT ACCOUNTS		
<u>Account Type</u>	<u>Description</u>	<u>Interagency</u>

		<u>Statement</u>
Fiduciary Accounts	Accounts where a financial institution having fiduciary powers has sole or shared investment discretion. Examples: trustee, executor, administrator, guardian.	Interagency Statement does not apply.
	Accounts where non-institutional customers direct investments for their fiduciary accounts. Example: Self-directed IRA and Keogh plans in trustee or custodial accounts.(1)	Three minimum disclosures from the Interagency Statement apply.(2)
Agency Accounts	Accounts where the institution has sole or shared investment discretion. Example: Investment management accounts for individuals.	Interagency Statement does not apply.
	Accounts where the customer has sole investment discretion. Example: An agency account that is not a fiduciary account relationship.	Interagency Statement applies.
Self-directed employee benefit accounts	Employee directs own investment transactions, within a range of choices given by plan sponsor. Example, 401(k), 403(b), profit-sharing, ESOPs.	Interagency Statement does not apply.
Custodial Accounts (other than self-directed retirement accounts)	The institution is performing ministerial functions such as collecting interest and dividend payments for securities held in the accounts and handling the delivery or collection of securities or funds in connection with a transaction.	Interagency Statement does not apply.

- (1) - Banks may offer self-directed IRA and Keogh accounts to customers in custodial or trustee accounts without first obtaining FDIC consent to exercise trust powers. Note that when banks offer these products in a retail transaction outside of the trust department, the Interagency Statement's guidelines apply to NDIP sales involving these accounts.
- (2) - The Interagency Statement's three minimum disclosures are the following: (a) not insured by the FDIC (b) not a deposit or other obligation of, or guaranteed by, the depository institution and (c) subject to investment risks, including possible loss of the principal amount invested.

As part of the safety and soundness examination, the EIC or his/her designee should conduct a review of all retail sales of NDIPs, including any retail sales that may occur in a trust department. In the event that a trust department examination is being performed concurrently with the safety and soundness examination, the EICs of the respective examinations should coordinate their NDIP reviews. When trust examinations are performed independently of safety and soundness examinations, examiners should refer to the guidance contained in the Trust Examination Manual regarding NDIP activities.

Has the IRS changed the tax laws for IRA investments in collectibles?

No, but Congress has changed the tax laws to permit a wider range of precious metal investments in IRAs. Prior to 1998 it was permissible to invest IRA funds in United States American Eagle gold coins, but not in collectibles such as art, precious metals, gems, stamps, or antiques. Beginning in 1998, the term “collectibles” no longer includes most precious metals, and IRA funds can now be invested in certain platinum coins as well as certain gold, silver, palladium, and platinum bullion. Such investments, however, are only permitted to the extent that the physical possession of the bullion is in possession of the IRA trustee. The metals must also be of a quality equal to or exceeding the minimum fineness that a contract market (as defined by the Commodity Exchange Act) requires for metals which may be delivered in satisfaction of a regulated futures contract.

Does the Interagency Statement apply when a bank refers a customer to a broker/dealer not on bank premises?

The Interagency Statement applies, to the extent of the bank’s activities, to sales made as the result of a bank referral, where the bank receives a referral fee, or other monetary benefit, even when the broker is not on bank premises.

How can bank management achieve a distinct physical location in a limited space setting?

There may be instances, such as a supermarket branch, where it is not possible to establish a separate physical location where NDIPs are sold. In these situations, where physical considerations prevent sales of NDIPs from being conducted in a separate area, bank management has a heightened responsibility to create a “distinct” location by ensuring that appropriate measures are in place to minimize customer confusion. These measures could include placing an increased emphasis on such things as minimum disclosures or proper signage.

How does the Interagency Statement apply to selling NDIPs and insured products from the same customer service desk?

In some institutions, the customer service desk is used to offer CDs, open new checking or savings accounts, and sell NDIPs. The focus of the Setting and

Circumstances portion of the Interagency Statement is to encourage banks to take reasonable steps to minimize customer confusion by selling NDIPs in an area that is physically distinct from the area where insured deposits are taken. According to the Interagency Statement, employees should not conduct NDIP business in the routine deposit-taking area. Examiners must determine whether the customer service desk constitutes a routine deposit-taking area on a case-by-case basis.

Limited situations may exist where physical considerations prevent sales of nondeposit products from being conducted in a distinct area. However, by offering both insured and uninsured products at the same desk, management has increased the potential for customer confusion. Consequently, management has a heightened responsibility to ensure that appropriate measures are in place to avoid customer confusion.

What can tellers say to customers about the availability of NDIPs?

Tellers and other employees not authorized to sell or recommend NDIPs can make statements to customers that are directional in nature and can refer them to the NDIP sales area. Factual statements, such as stating that the bank provides investment services, without any attempt to discuss a specific investment product, provide a recommendation, or make a sale, are permissible.

How do examiners assess that bank NDIP salespersons have qualifications and training that are the substantive equivalent of NASD representatives?

In the majority of situations, banks utilize third party employees or dual employees to sell NDIPs to bank customers. These individuals must be licensed by the NASD to sell NDIPs. Thus, these individuals possess the qualifications suggested by the Interagency Statement.

In less frequent instances, individuals employed solely by the bank sell NDIPs to bank customers. These bank employees should adhere to high professional standards and be qualified to sell NDIPs. As exam procedures indicate, bank management is responsible for determining that bank representatives' qualifications and training are the substantive equivalent of the appropriate NASD license requirements. Management's policies should clearly express qualification and training standards and management should be able to demonstrate how their standards compare to the NASD requirements. Further, management should retain a complete personnel file for each bank NDIP sales representative that documents the representative's qualifications and training. It should not be necessary for examiners to assess individual representative's qualifications and compare them to the NASD requirements, primarily because that should have been documented by management before the representative was hired. Thus, the examination focus should generally be placed on management's assessment of the representative's

qualifications and management’s training program. Management should research each representative’s background with regulatory agencies and previous employers. Prior to employment and periodically thereafter, management should verify that all NDIP sales representatives are properly licensed and/or qualified to sell NDIPs.

The following chart is a general summary of the licensing requirements for securities representatives who sell various types of products:

<u>Types of Sales Representative</u>	<u>Product</u>	<u>Licensing Requirement</u>
Bank only representative	NDIP except insurance products and annuities	None**
	Insurance and annuities	State licensing requirements*
Dual employee of bank and third party broker <u>or</u> third party only representative	Mutual funds and unit investment trusts	Series 6 and State licensing requirements*
	Equities and Bonds	Series 7 and State licensing requirements*
	Variable life insurance and variable annuity products	Series 6 and State licensing requirements*
	Insurance products not requiring NASD licensing	State licensing requirements*

*- Licensing requirements differ from state to state.

** - Prior to implementation of Proposed Part 342.

How can examiners access historical records of formal actions against registered securities representatives?

It is bank management’s responsibility to obtain historical records regarding registered securities representatives prior to contracting with these individuals to sell NDIPs. After securities representatives have been selected, management should periodically contact the NASD to determine if any complaints or formal actions have been filed against the representatives operating in its institution.

Management should maintain a file documenting its inquiries to the NASD and any formal actions or complaints against its securities representatives. If management has not inquired with the NASD regarding its securities representatives, or it is essential for an examiner to obtain information from the NASD, he/she can request that the regional Senior Capital Markets and Securities Specialist contact the NASD.

How frequently should sales representatives update customer information?

The Interagency Statement says that customer information should be updated periodically. While no specific standard exists for this recommendation, bank representatives should update customer information such as investment objectives, financial condition, tax status, and other relevant factors at intervals sufficiently frequent to properly recommend investments to the customer in subsequent transactions. This flexible approach is also used by the NASD for sales representatives under their supervision.

What is a “nominal” referral fee?

The Interagency Statement does not provide a specific approved range of “nominal” referral fees. The banking agencies have evaluated referral fees on a case-by-case basis. However, American Brokerage Consultants, Inc., performed a 1996 survey concerning bank retail investment services. The survey results indicated that most banks pay referral fees in a range between \$5 and \$15. This does not necessarily mean that a referral fee above this range is excessive. Examiners should use judgment in determining whether a referral fee structure encourages unqualified or unauthorized employees to make sales recommendations.

Is it acceptable for management to tie the compensation/bonus of audit or compliance personnel to NDIP sales performance?

In order to maintain autonomy, independent review or audit personnel should not receive any incentive compensation related to NDIP sales.

Can employees receive gifts or awards for NDIP referrals?

The intent of the Interagency Statement was not to eliminate or criticize creative incentive programs for NDIP referrals. Rather, the referral fee guidelines of the Interagency Statement were designed to discourage referral fee programs that establish incentives that may result in unsuitable investment recommendations or sales to customers. Gifts or prizes that exceed a one-time nominal benefit should generally be avoided. For example, a trip, cruise, or similar benefit of similar

significant value should not be used as an incentive for employees credited with the most referrals for a given time period.

When a branch manager isn't an NDIP representative, can he/she receive compensation based on the performance of the NDIP sales program?

The Interagency Statement does not directly address compensation paid to a branch manager. It is reasonable for management to pay a bonus to a branch manager based on achieving the institution's overall goals and objectives, including sales goals for NDIPs. A branch manager should not receive referral fees, or a share of these fees, unless he or she is referring customers to an NDIP representative. Also, a branch manager should not receive sales commissions, unless he or she is a trained and qualified NDIP sales representative and is selling NDIPs to customers. Any compensation practice should be structured so as not to engender unsuitable recommendations to bank customers.

How does bank management ensure that a third party networker is complying with the Interagency Statement?

It is management's responsibility to ensure that third-party employees comply with all applicable regulations and the Interagency Statement. The third party networking agreement should authorize the bank to have access to those records of the third party that are necessary to evaluate compliance with all laws, regulations, and the Interagency Statement. Management should periodically review NASD and SEC examination reports, the third party's internal audit report, and the findings of the bank's independent review program to ensure compliance with regulations and the Interagency Statement.

Which requirements of Part 344 apply to sales made by dual employees who are engaged to sell NDIPs under a third party networking arrangement?

Part 344 exempts transactions performed for a bank customer by a registered broker/dealer provided that the customer has a direct contractual agreement with the broker/dealer (i.e. a signed account agreement) and the broker/dealer is fully disclosed to the customer. This exemption applies to dual employee arrangements, where a bank employee is working under the supervision of the broker/dealer. However, dual employees are subject to the reporting requirements of Part 344.9 for personal securities trading.

Which bank employees are required to file quarterly reports on personal securities trading according to Part 344.9?

The quarterly reporting requirements extend to both bank and trust department personnel, including dual employees who sell NDIPs under a third party

networking arrangement. Any officer or employee who makes investment recommendations, participates in these recommendations, or obtains information regarding which securities are purchased, sold, or recommended is subject to the reporting requirements of Part 344.9. The quarterly reports should be filed with the bank, not with the FDIC. Directors are excluded from these reporting requirements, unless they are also officers.

Which securities transactions are exempt from the quarterly reporting requirements of personal securities trading in Part 344.9?

The following personal securities transactions are exempt from the reporting requirements of Part 344.9:

- 1) Transactions that benefit the officer or employee over which he/she has no direct control (e.g., a pension plan)
- 2) open-end mutual fund transactions
- 3) transactions in government securities
- 4) all transactions involving an aggregate of \$10,000 or less during the calendar quarter.

What securities activities of subsidiaries and affiliates are covered by Part 337.4 of the FDIC's Rules and Regulations?

The present version of Part 337.4 primarily governs securities underwriting activities of a bank's subsidiaries and affiliates. Only the notification requirement contained in Part 337.4(d) of this regulation applies to a bank's brokerage subsidiary that is merely selling (not underwriting) securities. None of Part 337.4's provisions apply to a bank's brokerage affiliate that makes retail sales of NDIPs to bank customers. The notification requirement and the other more restrictive provisions of Part 337.4 apply to a subsidiary or an affiliate that is conducting activities that the Banking Act of 1933 (the Glass Steagall Act) prohibits a bank from conducting, which are primarily underwriting.

Some of the provisions of Part 337.4 are expected to be moved into Part 362. (See the proposed revisions to Part 362 that were issued in Financial Institution Letter 97-97, on September 23, 1997.) If adopted as proposed, Part 362 will require a bank's underwriting subsidiary to meet certain notification, corporate separation, and regulatory capital requirements in order for the subsidiary to engage in underwriting activities without first obtaining the FDIC's consent. Under the proposed revisions to Part 362, a bank would not be required to provide notification to the FDIC prior to acquiring or operating a subsidiary that is engaged in certain securities investment activities. In addition, the proposed revisions to

Part 362 would not require that bank's and their underwriting affiliates meet all of the provisions of the current version of Part 337.4(c).