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Regulatory Bulletin

Handbook: Thrift Activities
Subject: Nondeposit Investment Sales

Section: 640
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Nondeposit Investment Sales
RESCINDED

Summary: This bulletin revises and updates the OTS examination guidelines regarding sales of nondeposit investment products and provides for the distribution of revised Thrift Activities Handbook Section 640, newly entitled Nondeposit Investment Sales.

For Further Information Contact: The OTS Regional Office in which you are located or Robyn Dennis of the Thrift Policy Office, Washington, D.C., at (202) 906-5751.

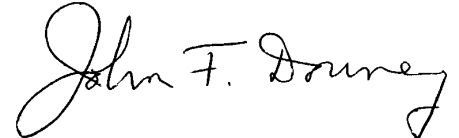
Regulatory Bulletin 32-4

Attached is the new Thrift Activities Handbook Section 640, which replaces the existing section, Securi-

ties Brokerage, in your Thrift Activities Handbook. The section is now entitled Nondeposit Investment Sales to more accurately reflect the scope of the activity. Certain corrections are shown and, in addition, new procedures for examination of proprietary funds were added. A new appendix C is added, Questions and Answers about Nondeposit Investment Products, to aid

examiners and savings associations by answering frequently asked questions. Changes are shown in bolded italics.

Attachment



—John F. Downey
Executive Director, Supervision

CHAPTER: Related Organizations

SECTION: Nondeposit Investment Sales

Section 640

Introduction

The risk-focused approach to examining related organizations, as detailed in Handbook Section 610, Overview, allows flexibility in setting the examination scope. The scope must be reasonable and prudent, yet sufficient to evaluate the extent to which a subsidiary poses a risk to the parent thrift. This Section focuses on specific regulatory restrictions, policy standards and safety and soundness concerns associated with securities brokerage activities.

A securities brokerage subsidiary can be an important element of a parent thrift's overall business strategy. It can provide a parent thrift with the potential to increase consolidated earnings, retain customers (certificate of deposit (CD) holders seeking higher returns and investment alternatives), cross-sell its services to provide a full range of financial products, and diversify its investments.

Thus far, thrifts are not directly involved in securities brokerage activities although there is no statutory prohibition against direct sales. Thrifts, unlike banks, are not exempt from the definitions of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934. Thrifts would, therefore, be required to register as a broker-dealer to sell nondeposit investment products directly. In the event that a thrift did register as a broker-dealer and received OTS approval to offer such products, the guidelines contained herein would be useful in determining whether the thrift maintains appropriate safeguards. This section ***applies to the sale of stocks, mutual funds, and variable rate and fixed rate annuities.*** This section, however, does not apply to sales of nondeposit investment products to nonretail customers, such as sales to institutional customers and fiduciary accounts administered by the thrift. ***In addition, this section does not apply to pure insurance products such as credit life insurance.***

Retail sales, on thrifts' premises, of nondeposit investment products (or "investment products") have become increasingly prevalent. Thrifts have traditionally conducted such activities through a service corporation subsidiary. In many cases, the subsidiary offers securities brokerage services in the thrift's offices ("on-premises") where deposit taking and other thrift functions are performed. Thrifts usually engage in securities brokerage activities on an "accommodation basis" such as providing customers

with access to promotional materials, telephones for placing orders with a broker and limited banking services related to the service corporation's brokerage function, however, they may also directly lease space to a brokerage dealership under certain conditions.

Two primary areas of concern regarding on-premises sales of investment products is the thrift's overall exposure to loss and whether customers fully understand the characteristics and risks associated with such products. Thrift and service corporation management and boards of directors should establish prudent internal controls, such as those described in this Section, to ensure that securities brokerage activities comply with sound business principles as well as applicable regulatory requirements and restrictions. The level of detail contained in internal policies and procedures will depend on the structure and complexity of the brokerage activities.

While the purpose of this Section is to assist regulators when evaluating the effect of a service corporation's securities brokerage program on the parent thrift, the risk assessment issues that are discussed will generally apply to other third party arrangements involving on-premises sales of investment products. You should be aware that some differences do exist. For example, OTS regulations pertaining to service corporations (i.e., activities restrictions and operating standards) do not apply to lease arrangements between a thrift and a third party. Also, customer referral arrangements between service corporations and their parent thrifts are generally not permissible under a thrift/nonsubidiary lessee relationship.

To determine the level of risk associated with a service corporation's brokerage activities, the regulator must obtain an understanding of the securities brokerage program, applicable OTS policy and regulatory standards and the securities brokerage environment. Specifically, this Section discusses the topics summarized below.

The Business of Securities Brokerage

Securities brokerage firms are regulated at the federal and state levels. The OTS does not review these entities to determine whether they comply with securities rules and regulations. The regulator should, however, evaluate the effect on the parent thrift of a brokerage firm's relationship with its service corporation. The oversight of brokerage firms by securities regulators

provides important information in determining the appropriate scope of a service corporation review. The extent to which a service corporation's brokerage program complies with securities laws, rules and regulations can materially affect the entity's viability, the thrift's exposure to loss and the public's overall perception of the parent thrift.

Policy on Sales of Investment Products and Referral Activity

Securities brokerage activities and related customer referral practices that occur on a thrift's premises must be performed in a manner that is consistent with the interagency policy detailed in Thrift Bulletin (TB) 23-2. The bulletin sets forth operating safeguards that management must implement to clearly distinguish insured deposits from uninsured investment products in order to minimize customer confusion and the overall level of risk presented to the thrift. Additionally, OTS regulatory requirements and restrictions that apply to specific aspects of on-premises securities brokerage activities are also discussed (i.e., transactions with affiliates, relationships with service corporation subsidiaries).

Service Corporations' Securities Brokerage Program

Securities brokerage activities conducted through a thrift's service corporation must be limited to those that are preapproved or specifically authorized by the OTS. The brokerage program must comply with OTS regulatory requirements (i.e., maintenance of separate corporate identities, usurpation of corporate opportunity) that generally apply to all service corporations as detailed in Handbook Section 610. Service corporations, unless operating as an independent brokerage operation, generally use third parties to sell, market, or otherwise provide brokerage services to its customers, but these arrangements must be monitored in a prudent manner. The various aspects (i.e., sales practices, disclosures, advertising) of a service corporation's brokerage activities and potential areas of risk, are detailed throughout this Section.

Description of Securities Brokerage

A detailed discussion of the securities brokerage business and its complex regulatory environment is beyond the scope of this Section. However, the following general information is pertinent to the regulator's review.

How Securities are Sold

Securities in the United States are bought and sold in two primary markets: the over-the-counter (OTC) market and stock exchanges. Service corporations engaging in securities brokerage activities deal in the OTC market. This market consists of a nationwide network of "brokers" and "dealers" who buy and sell stocks and bonds to and from each other and to and from customers. While brokers conduct transactions in securities for the accounts of others, dealers engage in the business of buying and selling securities for their own account. The term broker-dealer describes an entity (i.e., corporation or joint venture) that engages in both activities. A "principal" is an officer or partner of a brokerage firm who is responsible for a certain functional area. Sales persons employed by broker-dealers are referred to as "registered representatives" at the federal level and as "agents" by state authorities. Representatives and agents must be licensed in accordance with applicable federal and state laws.

Types of Brokerage Services

Service corporations are often distinguished as providing either "discount" or "full brokerage" services. A discount brokerage operation generally deals only in buying and selling securities. It offers no investment advice and makes no margin loans (loans that permit securities trades on credit with a deposit of a specified portion of the sales price maintained in a customer account). A full-service broker-dealer offers comprehensive services including investment advice and margin loans in addition to a full range of products.

The two major types of brokerage transactions are agency and principal. The most common type of transaction in service corporations is an agency transaction in which the broker-dealer acts on behalf of a customer only and is compensated through commissions. A principal transaction occurs when the broker-dealer trades securities for its own account.

Investment advice offered through a service corporation may be provided on an individual or standardized basis. Individual advisory services generally involve the assessment, by a registered representative, of a customer's financial condition, investment goals and other factors to recommend the appropriate mix of investments for the client. Standardized investment advisory services may entail providing one of several categories of advice to an investor based on a

determination of what is suitable given that person's financial status and goals. Such services might include purchase and sale recommendations derived from an independent advisory service or from the principals of the brokerage firm.

There are a number of different ways in which a service corporation can offer securities brokerage services. These range from a very minimal commitment to the formation of a full-service brokerage dealership. The following types of brokerage programs are the most common.

Referral Marketing

This is an arrangement where the employees of the thrift or its service corporation refer customers to a 1-800 telephone number. The number reaches a broker-dealer that has a contractual agreement with the service corporation. The agreement should stipulate the percentage of the gross commissions that the service corporation is to receive. Service corporation or thrift employee functions are generally limited to handling the transfer of funds between customer accounts and making telephones or promotional material available to prospective brokerage customers.

Turnkey Program

Under this arrangement, the service corporation enters into an agreement to make available customer names, telephones and desk space to a broker-dealer's registered representatives. In return, the broker-dealer provides the service corporation with a percentage of commissions (generally 50%) generated from the brokerage program. This arrangement typically does not involve substantial, if any, upfront fees to be paid by the service corporation. The registered representatives are exclusively employed by the broker-dealer and all customer contact relating to securities sales occurs through the broker-dealer's employees. Thus, the broker-dealer must recruit, screen, train, and manage the sales force.

Joint Venture

This is an arrangement between a broker-dealer and the service corporation that generally involves certain start-up costs and various operating expenses (i.e., office and computer equipment, telephones, promotional materials, and licensing and training

expenses for employees). Registered representatives are usually dual employees of the service corporation or parent thrift and the broker-dealer. A senior officer of the broker-dealer should be responsible for monitoring the registered representatives' compliance with applicable securities laws and regulations. The percentage of commissions retained by the service corporation should be detailed in a written agreement along with other contractual obligations. (Refer to the discussion of "Third Party Arrangements.")

Independent Broker-Dealer

A thrift may establish its service corporation as an independent broker-dealer. This arrangement requires a substantial commitment of managerial and financial resources. The financial commitment requires basic start-up costs and continuing operating expenses such as: legal and securities consultation fees, training, various registration and licensing costs, and computer/software costs. A broker-dealer is responsible for registering itself with the Securities and Exchange Commission (SEC) and appropriate state regulatory bodies. The broker-dealer must, among other requirements, become a member of the National Association of Securities Dealers (NASD) and, as a member, is required to meet minimum capital requirements, submit periodic reports, monitor compliance with laws and regulations governing securities brokerage, and obtain required insurance coverages.

Scope of Regulation

Securities transactions in the United States are regulated at the federal and state levels. Generally, federal regulation governs transactions of an interstate nature. State laws may vary in scope, but apply to activities and products transacted within their borders. Broker-dealers are regulated at the federal level by the SEC. They must be registered with the SEC to engage in business on an interstate basis, and must also comply with any registration requirements of the states and self-regulating organizations (SROs) such as those of the exchanges or the NASD.

While broker-dealers and their employees must adhere to registration or licensing requirements, the products that they sell must also be registered. At the federal level, securities must be registered with the SEC. The SEC has no legal authority to determine whether a security is offered to the public. It can only require that an issuer provide adequate, relevant

information to enable a potential buyer to make an informed decision regarding the purchase. Additionally, state law generally requires that securities be registered or otherwise approved by state authorities.

Since broker-dealers maintain custody of the funds and securities of their clients, the SEC requires that they show evidence of financial responsibility, and establish mechanisms for customers to recover funds should the broker-dealers become insolvent or otherwise unable to meet their responsibilities. There are three principal ways in which this is accomplished:

- **Net capital rules.** Broker-dealers are required to maintain certain levels of capital. These levels generally depend on the activities in which they engage. Many service corporations structure their program to comply with the SEC's policy on networking arrangements so that the net capital rule is not enforced. This generally occurs when a service corporation is associated with a registered broker-dealer. Arrangements between service corporations and third party broker-dealers are very common.
- **Handling of customer funds.** Broker-dealers must comply with requirements for segregation of customer funds and securities. Thus, broker-dealers must implement adequate measures for ensuring that client and broker funds and securities are maintained separately.
- **Maintenance of industry-wide protective fund.** The Securities Investor Protection Corporation (SIPC) is responsible for the oversight of this fund. The purpose of the fund is to satisfy claims of customers if a brokerage firm becomes insolvent. This fund is maintained through assessments of members. The SIPC may borrow funds from the United States Treasury in the event that assessments are insufficient to cover its obligations.

Federal and state laws also include anti-fraud provisions that address manipulation of securities trading markets. These laws apply to, among other things, insider trading based on nonpublic information, as well as actions and statements by management designed to deceive others.

As can be seen, broker-dealers must conduct their business in accordance with extensive, and often complicated, federal and state statutes and regula-

tions. The NASD, SEC and state authorities regularly examine broker-dealers. The OTS regulator can consult with appropriate regulatory authorities and request copies of recent examination reports or other records that may be pertinent to the service corporation review. Violations of securities laws or other concerns of securities regulators should be considered when evaluating the viability of a service corporation's brokerage program and the level of risk presented to the parent thrift.

Policy on Sales of Investment Products and Referral Activity

Thrifts, through their service corporations or third party lease arrangements, provide on-premises securities brokerage services to their customers. These services and other program features should be described in a written statement, adopted by management *of the thrift or the service corporation*, that also contains a summary of internal controls that serve to minimize the level of risk involved.

The OTS's examination authority covers all on-premises sales or recommendations of investment products by a thrift's service corporation or a third party, as well as sales that result from customer referrals for which the thrift receives a benefit. It includes sales of investment products and advisory services initiated from the thrift's premises by telephone or by mail. The purpose of the review is to determine the adequacy of internal controls in containing the level of risk presented to the thrift and minimizing potential customer confusion between FDIC-insured and non-FDIC insured investment products. (Refer to Handbook Section 340, Internal Controls, for a detailed discussion of reviewing and evaluating the adequacy and effectiveness of internal controls.)

In providing on-premises securities brokerage services or customer referrals, internal policies and procedures should, at a minimum, incorporate the operating safeguards set forth in TB 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products. These general safeguards are described below and pertain to the following areas of the brokerage program review:

- Arrangements with third parties;
- Location of on-premises investment advisory and sales activities;

- Advertising and promotional materials;
- Disclosures;
- Sales practices and supervision of personnel;
- Compensation structures; and
- Systems for monitoring operations.

Since the OTS has traditionally only permitted securities brokerage activities through a service corporation, more specific requirements are set forth in 12 CFR § 545.74 and are also discussed in the latter part of this Section. Additionally, 12 CFR §§ 563.41 and 563.42 will apply when a thrift affiliate provides services to the brokerage program through a third party arrangement.

Third Party Arrangements

In light of the substantial costs associated with establishing a brokerage dealership and the extensive securities regulatory environment, the most common situation is for a service corporation to enter into an agreement with an established broker-dealer. The financial and managerial commitment of the service corporation and the level of profits that the entity retains will vary based on the brokerage program's structure, the services involved, and the terms of any written agreement with third parties.

Third parties can offer a full range of investment and administrative services to a securities brokerage subsidiary or a thrift. In providing these services, third parties (i.e., broker-dealers, marketing firms) may consider the thrift's brokerage operation as a conduit for sales, or primarily seek income by charging fees for administrative services.

There are a number of different ways in which a securities brokerage program may be structured. Marketing firms, depending on the needs of the service corporation, may establish and manage the operations or simply provide support functions. Broker-dealers can provide a broad scope of investment products including mutual funds, stocks, bonds, municipal bonds, mortgage-backed securities, annuities, or limited partnerships.

There are essentially two types of third parties that, for purposes of this Section, are referred to as "non-affiliates" and "affiliates." The term affiliate is defined in 12 CFR § 563.41(b)(1). There are general

areas of review for determining the risks associated with any third party arrangement. To the extent that a third party is a thrift affiliate, additional OTS regulatory restrictions and policy standards will apply.

Non-Affiliate Third Party Arrangements

Policies and procedures should contain standards for conducting an appropriate review of third parties that offer on-premises investment services and products. These controls should also ensure that the third party arrangements reflect the safeguards contained in TB 23-2 and comply with applicable OTS regulations and restrictions detailed in this Section. Additionally, any third party arrangements should be approved by the service corporation's board of directors.

Prior to establishing third party arrangements, service corporation management should thoroughly evaluate an entity and the quality of its services and investment products. The evaluation should be performed by personnel with appropriate knowledge, experience and analytical skills. The service corporation's files should document management's review of a third party's services and investment products and internal procedures in this area. For example, management should verify that: (1) the entity's business is approached with integrity; (2) consumer complaints, if any, are promptly addressed and are not indicative of poor overall operating practices; (3) there is a *history* of compliance with securities laws and regulations; (4) that disciplinary *histories are reviewed*; and (5) *all the products sold by the vendor meet the criteria set by the board of the thrift or the service corporation.*

An adequate review of investment underwriters or issuers and the quality of their products can prevent or limit the number of product liability lawsuits filed against the service corporation and, to the extent the corporate veil is pierced, the parent thrift. Service corporation management can also limit their risk exposure in this area by not offering highly speculative investment products such as commodity futures, real estate partnerships, or junk bonds. If such products are offered, however, appropriate safeguards (i.e., disclosures, customer/product suitability standards) should be employed to ensure the customer's awareness of the inherent financial risks of these types of investment products.

After an arrangement is established, the service corporation's board of directors and management should continue to review the third party's services and

investment products. Ongoing monitoring systems and periodic reporting procedures should ensure that the third party and its employees' activities comply with all contractual obligations, the thrift's internal policies and procedures, and applicable state and federal laws and regulations. Internal procedures should describe the types of reports that third parties must provide to service corporation management on a routine basis. Required reports might provide information on new account activity, findings revealed through internal compliance systems maintained by the senior securities principal, and sales activity exception reports that flag potential concerns regarding parameters that have been exceeded or unusual patterns or trends.

Affiliate Third Party Arrangements

While all third party arrangements should be thoroughly reviewed for compliance with regulations applicable to service corporation subsidiaries, arrangements with affiliates must also comply with the following OTS requirements and policy standards. (Refer to Section 400 of the Holding Companies Handbook for a detailed discussion of transactions with affiliates.)

Transactions with Affiliates

Sections 563.41 and 563.42 (Transactions with Affiliates) place quantitative and qualitative restrictions on loans and certain other transactions entered into by a thrift (or its related organization) and an affiliate. Section 563.42 contains specific restrictions on a thrift's purchases of securities from an affiliate when the thrift is acting as a fiduciary. In addition, § 563.41 prohibits a thrift, or its subsidiaries, from purchasing or investing in the securities of an affiliate.

Sales of Securities

Section 563.76 of the regulations generally prohibits on-premises sales of a thrift's or its affiliate's securities. A limited exception allows the sale of stock issued in connection with the conversion of a thrift from the mutual to stock form of ownership. TB 23a, Sales of Securities, clarifies this and other limited exceptions to the general prohibition in § 563.76.

Specifically, TB 23a provides that the OTS will not treat investment companies that are sponsored, advised, distributed, or administered by a thrift or its holding company, or a subsidiary of the holding company, as an "affiliate" for purposes of § 563.76.

TB 23a requires, however, that on-premises sales of an investment company's shares comply with safeguards that are comparable to those contained in § 563.76 and TB 23a. [Note: TB 23a provides that the investment company may be treated as a thrift affiliate under certain other regulations such as those that govern transactions with affiliates. Thus, the shares issued by the investment company would be shares of a thrift affiliate.]

Section 563.76 establishes certain requirements for thrifts that engage in on-premises sales of their (or an affiliate's) securities. One such requirement is that the thrift (or an affiliate) may not pay any commissions, bonuses, or comparable incentive compensation to its employees in connection with on-premises sales of its securities. Compensation consistent with industry norms, however, may be paid to securities personnel of registered broker-dealers.

Internal controls and policies should incorporate appropriate safeguards to ensure compliance with the above requirements and general policy standards contained in TB 23-2. Additionally, the OTS has, on a case-by-case basis, imposed additional restrictions on thrifts and their brokerage subsidiaries to address supervisory concerns that are specific to relationships with their securities affiliates.

Written Agreements with Third Parties

The service corporation's files should contain adequate documentation regarding its arrangements with third parties. Written agreements should sufficiently delineate all facets of the arrangement, and must be approved by the service corporation's board of directors. These agreements should, at a minimum, state the following:

- The functions or responsibilities of each party to the agreement;
- The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations and policy statements);
- Assurances of compliance with applicable laws, regulations and policies statements;
- The authority of the thrift or service corporation to conduct periodic reviews of the third party's activities to verify compliance with the terms of the agreement;

- Each party's right to participate in profits and obligations to share expenses;
- The types of third party services or investment products to be provided and related restrictions;
- Insurance requirements;
- Indemnification provisions; and
- Employee compensation programs and provisions for prior approval by the board of directors of any employment contracts.

A review of the agreements and records pertaining to third party arrangements provides an overview of the securities brokerage operations and reveals potential areas of risk that require further evaluation. Any contract between the service corporation and a third party should contain language that fully indemnifies the subsidiary and its parent thrift from liability attributable to the negligence, recklessness or intentional misconduct of the third party or its employees *as required by 12 CFR § 545.74(c)(4)(i)(C)*.

The thrift may not sign or otherwise be a party to its service corporation's agreement with a third party. This serves to insulate the thrift from the subsidiary's obligations and ensure that separate corporate identities are maintained. Thrifts may, however, enter into a written agreement to lease a portion of its office space to a nonsubsidiary broker-dealer or, to the extent that such arrangements may be authorized by the OTS, directly engage in securities brokerage activities. [Note: A thrift and its related organizations may not, absent prior OTS approval, engage in the lessee's operations. Also, these arrangements should be based on a bona fide lease and an equitable commission sharing arrangement or provide for the thrift to receive regular, fixed payments that reflect the fair market rental value of the property.]

Service corporation management must be able to demonstrate that internal controls are adequate to monitor a third party's compliance with written agreements. Adequate records pertaining to all brokerage activities should be maintained in a manner that facilitates a prompt review by management and regulators. In determining, for example, whether income is shared in an agreed upon manner, production reports that identify the number and types of sales for the service corporation and for the bro-

ker-dealer should be reviewed to determine whether they balance. This is particularly important if remuneration is based in any way on production.

Additionally, third party arrangements should be consistent with representations made to the OTS through the notification or application approval process. The service corporation's files should indicate whether there have been any changes involving third party arrangements since the last examination. A service corporation that terminates a contract with a broker-dealer to enter into a new contract with a second broker-dealer, must file a new notification or application with the OTS. If, however, a third party broker-dealer is acquired by another broker-dealer that assumes its existing contracts, the parent thrift may obtain a no-action letter from the OTS that permits the thrift to change broker-dealers without filing another notice or application.

The business plan of the thrift and its service corporation should also be reviewed to determine whether the third party arrangements are consistent with stated management strategies and objectives pertaining to the subsidiary's operations. Overall, the regulator's review of the brokerage program's agreements and internal controls should reveal whether established procedures, policies and prudent business practices are successfully implemented.

Location of Offices and Informational Materials

Internal controls should also ensure that the brokerage program is clearly distinguished from the thrift's traditional operations for minimizing potential customer confusion. It should be obvious to the casual observer that a brokerage dealership operating on the thrift's premises is a separate organization. For example, a service corporation generally should not conduct on-premises sales of investment products with a name similar to that of the parent thrift, except for conversion stock (see 12 CFR § 563.76), unless internal controls can adequately minimize the risk of customer confusion. As set forth in TB 23-2, investment products must not have a name that is identical to that of the thrift. Similar names are not permitted unless applicable requirements established by the SEC are observed and the sales program is designed to minimize the risk of customer confusion.

Specifically, the following practices should be implemented to ensure that the investment sales area is distinct and that sales literature and material does not convey any inaccurate or misleading impressions

about the nondeposit investment products offered.

- The area where nondeposit investment products are offered should be physically separated (i.e., walls, partitions, signs) from teller windows and desks where retail deposit-taking activities are offered;
- Literature and information on investment services should be clearly separate from material pertaining to traditional thrift products (i.e., rates for investment products should be posted separately from checking or certificate of deposit promotional literature, the thrift and brokerage program should have separate advertisements and pamphlets);
- Signs and literature should clearly state that investment products are not FDIC-insured;
- Statements provided to customers that contain deposit and securities brokerage account information should clearly separate the information and include the required minimum disclosures; and
- Under no circumstances should any employee, while located in routine deposit-taking areas (i.e., teller windows, new account desks), make general or specific recommendations regarding investment products or accept orders for such products.

Maintenance of Separate Corporate Identities

While the above safeguards are prudent business practices, they are also important to ensure compliance with regulatory requirements pertaining to the maintenance of separate corporate identities (§§ 571.21 and 563.37). These requirements are described in Handbook Section 610, and are an important aspect of the service corporation review. To comply with such standards, for example, leasing or rental contracts between a thrift and its subsidiary should be at terms that reflect the fair market value of the space being leased.

Additionally, § 571.21 provides that a thrift and its related organizations should operate without intermingling their respective business transactions, and keep separate accounts and records. It is common, however, for a thrift to provide customer information to its securities brokerage subsidiary. The OTS has not established a regulatory prohibition against

this practice, but has taken the position that the securities brokerage subsidiary should comply with the thrift's conditions regarding the use of the parent thrift's customer information. These procedures should comply with applicable state law. On the basis of legal or supervisory concerns, the OTS can, under § 545.74(b), limit access to or use of thrift customer information (i.e., if the information is used in a manner that increases the potential for customer confusion).

When separate corporate identities are not maintained, the parent thrift may be held liable for the contractual obligations of its subsidiary. A review of internal controls and any agreements between a service corporation and its parent thrift or a third party may assist in determining whether separate corporate identities are sufficiently maintained. (Refer to the discussion of "Maintaining Separate Corporate Identities" in Handbook Section 610.)

Content of Advertising and Promotional Materials

Advertising and other promotional materials should be clearly distinguished from that of the parent thrift's depository functions and must comply with the following standards:

- Advertising must not confuse transactions executed and investment advice provided through brokerage operations with federally insured deposits;
- Advertising must clearly state the name of the entity (i.e., service corporation, third party) that it is offering the nondeposit investment products;
- The broker-dealer must be identified in advertising:
 - The parent thrift's logo must not be used in the brokerage program's advertisements; and
 - Promotional material should not omit material facts or mislead customers regarding the characteristics of, and risks associated with, particular investment products.

Advertisements and promotional materials regarding brokerage services should be available to customers in those areas where securities brokerage functions are performed, and may also be placed at branch entrances. When the thrift includes the brokerage subsidiary's materials in mailings that contain thrift cus-

customer account statements, these practices should be carefully reviewed to ensure that disclosures are adequate to minimize potential customer confusion and contain the required disclosures as outlined in TB 23-2. For additional information regarding OTS regulations on advertising, refer to Compliance Activities Regulatory Handbook Section 425, Advertising.

Oral and Written Disclosures

Because prospective brokerage customers tend to associate the name and logo of a thrift with the federal insurance that protects their deposits against loss, it is essential that adequate disclosures be made. When the name of the brokerage program (or its investment products) is similar to that of the thrift or its services are offered on the thrift's premises, unsophisticated customers may assume that the investment products are federally insured. For this reason the SEC presumes that similar names promote customer confusion. In order to be permitted to use a similar name, this presumption must be rebutted. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names).

The potential for customer confusion also increases when references are made, through investment sales presentations or materials, to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state funds, or private companies). These references should be followed by a clear explanation of the distinctions between such insurance coverage and FDIC deposit insurance. Thrift and service corporation management should ensure that all employees having customer contact receive adequate training on relevant insurance coverages. Internal procedures should also require that written and oral explanations of such insurance coverages are provided to all customers in accordance with established disclosure practices.

Management must ensure that oral and written disclosures are clear, conspicuous, and effective in minimizing customer confusion by fully distinguishing: (1) uninsured products from insured thrift deposits, and (2) brokerage services from deposit-taking functions of the thrift. On-premises sellers of investment products should disclose, in all sales presentations, advertising, confirmation forms, and account statements, the characteristics of the products being offered or sold. Specifically, TB 23-2 establishes the following required "minimum" disclosures that must be provided to customers:

- The products are not insured by the FDIC;
- The products are not deposits or other obligations of the institution and are not guaranteed by the thrift; and
- The products are subject to investment risks, including possible loss of principal invested.

Additionally, internal controls should address standards for providing customers with prudent disclosures regarding any fees, penalties, or surrender charges associated with specific investment products. These controls should also indicate the content and form of customer disclosures pertaining to material relationships between the thrift, its service corporation, an affiliate or an investment company whose shares are sold by the brokerage program.

Internal policies should also ensure that required disclosures are conspicuously stated in all advertisements, sales presentations, or other information (i.e., brochures) pertaining to the features of investment products. Disclosures should generally be presented on the front of a brochure, in the top portion of any text regarding investment products and at the beginning of sales presentations, customer referrals or solicitations. In addition, effective internal procedures in this area would include highlighting the required disclosures in a box, in bold type or with bullet points.

In reviewing the adequacy of internal procedures, the following regulatory requirements and policy standards regarding the timing and form of disclosures should be addressed.

Sales of a Thrift or Thrift Affiliate's Securities

For on-premises sales, 12 CFR § 563.76 requires that purchasers of a thrift's or an affiliate's securities must certify in writing that they have received specific disclosures on the nature of the securities being sold.

Sales of Other Investment Products

The minimum disclosures should be provided to the customer in the following manner:

- orally during any sales presentation;
- orally when investment advice concerning nondeposit investment products is provided; and
- orally and in writing prior to or at the time an investment account is opened.

In addition, at the time an investment account is opened, the seller of investment products should obtain a signed certification from customers acknowledging that the customer received and understands such disclosures. (Refer to the sample certification form attached to "Retail Investment Sales Guidelines for Banks" issued through a joint effort by six financial institution trade associations, including the Savings and Community Bankers of America and the American Bankers Association.)

Customer Referrals by Nonregistered Thrift Employees

Management should adopt standards pertaining to customer referrals by a thrift's employees to the brokerage operation. ***Nonregistered thrift employees cannot give investment advice, make general or specific recommendations, qualify a customer as eligible to purchase nondeposit investment products or accept orders for such products, even if unsolicited.***

Appropriate Sales Practices

Liability to customers is a primary area of concern in assessing the level of risk presented to the thrift. A broker-dealer that charges excessive mark-ups or makes fraudulent representations of a general nature (i.e., implies that an investment is FDIC-insured when it is not) can be a source of liability to the service corporation and, when separate corporate identities are not maintained, to the thrift as well. The brokerage program must also be conducted in a manner that insulates the thrift from liability under the anti-fraud provisions of the federal securities laws.

Adequate controls should be implemented to ensure that sales practices are appropriate and that registered representatives comply with management's internal policies, applicable regulations and restrictions of the OTS and securities regulators. These controls are particularly important to contain risks associated with inappropriate sales practices involving misrepresentations or ineffective disclosures provided to customers.

TB 23-2 and applicable OTS regulations establish minimum standards pertaining to customer disclosures. Risks that are specific to a particular product, the program's sales techniques, a referral arrangement or relationships with affiliates may require additional disclosures. These disclosures must enable customers to make well-informed investment decisions that serve their own best interests.

There are three primary areas that should be addressed in policies pertaining to sales practices: (1) suitability standards; (2) training; and (3) monitoring systems. Management should ensure that the broker-dealer and sales representatives employ prudent practices in the following areas.

Suitability Standards

The brokerage operation has an obligation to provide customers with products suitable to their needs. Poor or inappropriate investment recommendations attributed to brokerage advisory services will not stand the thrift (or its service corporation) in good stead with the public.

The brokerage program's policies should document minimum standards that registered representatives must employ to determine whether to recommend a particular investment product to a customer. Such standards require that sales staff obtain sufficient customer information (i.e., age, education, financial and tax status, investment objectives, retirement/financial plans), for making such a determination. For example, an elderly couple that seeks investment products to provide a steady source of income and preservation of capital in the near future should not be advised to invest their life savings in a highly speculative mutual fund.

The brokerage program's internal controls should require that sellers of investment products comply with applicable "suitability" and "know your customer" standards or related customer protection practices established by securities laws, regulations or the rules of the self-regulating organizations (SROs), ***such as the NASD***. Such standards generally provide that sales representatives should have reasonable grounds for recommending that a certain investment product is suitable for a particular customer. Also, the sales representative must believe that the customer is reasonably capable of evaluating, and financially able to bear, the risks associated with an investment recommendation. Customer information that forms the basis for recommending particular transactions should be thoroughly documented in the brokerage dealership's files and updated periodically.

The broker-dealer should be required to periodically certify that it complies with any applicable suitability requirements and customer protection rules as required under 12 CFR § 545.74(c)(4)(i)(D). In addition, service corporation management should document procedures for monitoring the brokerage pro-

gram's success in complying with established policies pertaining to customer suitability standards. Such monitoring might include periodic reviews of any records on regulatory violations by the company and its sales representatives, customer complaints, or post-audit reviews of a representative sample of transactions. Management should be able to demonstrate that any concerns regarding customer suitability issues have been adequately investigated and resolved (i.e., through training or other actions).

When weaknesses in internal controls are revealed, the regulator should review management reports to identify patterns in order to evaluate concerns regarding appropriate sales practices (i.e., whether a significant number of mutual fund redemptions have occurred after fairly short holding periods). To select sales for review, the regulator should consider patterns related to, for example, specific marketing strategies (i.e., designed for retirees), new account activity, customer complaints, or the performance of representatives with low or high levels of sales activity.

Concerns pertaining to specific sales patterns may require further review beyond customer suitability issues. For example, based on a review of relevant reports maintained by the broker-dealer, a substantial number of "early" mutual fund redemptions may be attributed to improper practices by individual registered representatives, a problem with the investment product, or deficiencies in the employee training program.

Training

In addition to monitoring sales practices, service corporation management can minimize the thrift's exposure to loss by ensuring that employees are adequately trained. Internal policies should establish minimum qualifications and training procedures for the distinct types of brokerage personnel. Management controls should ensure that third party broker-dealers and their employees are appropriately registered with the SEC, NASD, and state securities regulators. In addition to qualifications and training required by securities regulators, brokerage personnel must obtain adequate knowledge in the following areas:

- products involved, including applicable legal restrictions;

- internal policies and procedures of the service corporation and its parent thrift; and
- OTS requirements and restrictions.

Limitations on an employee's authority, proper disclosure practices, and customer suitability standards should be set forth in training materials. Internal policies and records should clearly describe the responsibilities and specific authority assigned to each "type" of employee (i.e., clerical, registered sales representatives, supervisor). Documentation should also indicate the manager responsible for supervising specific employees or types of securities brokerage activities. At a minimum, training material and brokerage policies should address the following areas:

General Restrictions on Sales Representatives' Practices

Brokerage employees should not, without prior OTS approval, engage in the following activities:

- make recommendations regarding securities of issuers that have lending relationships with the thrift, its subsidiaries, or affiliates;
- solicit transactions in specific securities from customers; and
- condition the execution of securities transactions on a customer's use of the service corporation's or a third party's safekeeping services (i.e., holding or transferring actual securities on behalf of the customer).

Training materials should also ensure that sales representatives are thoroughly familiar with overall permissible brokerage activities that are preapproved or specifically authorized by the OTS or FDIC. Operating restrictions and standards imposed by the OTS or FDIC through supervisory letters, approval orders or policy statements should be reflected in internal policies and procedures. For example, standards pertaining to permissible conduct by registered securities brokerage employees should generally be limited to:

- soliciting interest in the program's overall investment products and advisory services;
- making recommendations in response to a request by a customer; and

- not recommending specific nondeposit investment products through “cold calls,” or other unrequested contacts with a potential customer. [Note: This is not a prudent practice since there can be no reasonable determination as to customer suitability concerns nor the individual’s ability to understand the product’s features and financially bear related investment risks.]

In addition, a broker-dealer may limit various classes of personnel (i.e., based on their qualifications and training) from offering their own assessment of the market or making recommendations based on their perception of the customer’s investment needs. When a customer raises a question or seeks advice on a matter beyond the knowledge or authority of the representative to answer, the employee should forward the customer’s request to registered securities principals (either on-premises or an off-site information center) with expertise in that area. Training programs must, therefore, ensure that employees understand the limits of their authority.

Registered Representatives that are Dual Employees

As mentioned, joint ventures and other arrangements between the service corporation and a third party broker-dealer may staff sales operations with individuals that are also employed by the parent thrift. These individuals are referred to as dual employees. The potential for customer confusion is greater when dual employees have customer contact on behalf of both the thrift and the brokerage subsidiary. Thus, additional safeguards may be appropriate to address such risk. Policies and employee training material should include activities restrictions and responsibilities that apply to brokerage employee functions. For example, dual employees should not, while located in routine deposit-taking areas (i.e., teller windows), make general or specific recommendations regarding investment products, or accept any orders for such products.

Nonregistered Employees

Employees that are not registered representatives may perform brokerage functions that are ministerial or clerical in nature. When the brokerage program is conducted through a service corporation subsidiary, prior OTS approval is required under 12 CFR § 545.74(c)(4)(ii)(G) for these employees to engage in additional responsibilities. For example, nonregistered employees may not, under § 545.74,

accept or deliver money or securities nor take orders to execute securities transactions. Thrift employees (sole or dual) may, in accordance with thrift policies, refer customers to individuals who are designated and trained to assist customers interested in securities brokerage services.

Thrift Employees

OTS allows tellers and other employees to refer customers to individuals who are specifically trained and designated to assist customers interested in the purchase of investment products. The thrift’s internal policies should clearly state that tellers may not sell nondeposit investment products nor offer investment advice to customers by making recommendations or discussing the features of such products. There are additional restrictions on their activities and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Use of the Thrift’s Customer Information

Employee training materials should describe the brokerage program’s procedures on the appropriate use of the thrift’s customer information and identify which employees are authorized to use the information. These materials should address specific steps for minimizing customer confusion when the information is used to contact thrift customers whose CDs are due to mature. Specifically, such contacts should be conducted in a manner that alerts customers to the features and risks associated with nondeposit investment products and that the products are not offered by the thrift nor FDIC-insured.

Monitoring Systems

As stated above, thrift or service corporation management should conduct an initial review of broker-dealers prior to entering into any written agreements. Once an agreement is established, systems should be implemented to review a broker-dealer’s activities. For example, a periodic review of consumer complaints can reveal deteriorating trends in a broker-dealer’s business practices (i.e., misrepresentations, poor disclosures) and the quality of investment-related products. Information on consumer complaints against the service corporation or a third party broker-dealer might be available from the Better Business Bureau and other consumer organizations. Also, the OTS Consumer Complaint System will indicate whether any complaints have been filed with the OTS.

Standards for reviewing the conduct of individual sales representatives and identifying sales patterns should be documented in the written policies and procedures adopted by the service corporation's board of directors. These standards should be established as part of a comprehensive monitoring system and might provide for:

- routine daily management and oversight of sales representatives by the broker-dealer;
- requirements relating to prior management approval for opening new accounts or executing transactions that exceed a certain dollar amount;
- exception reports that identify transactions that exceed established parameters;
- compliance with applicable rules and regulatory requirements of the OTS and securities regulators; and
- periodic comprehensive reviews of sales representatives' practices (i.e., sampling transactions for compliance with customer/product suitability standards, surveying customer satisfaction through questionnaires, evaluating the nature of any customer complaints or disciplinary actions initiated by securities regulators).

Management's controls with respect to the security brokerage process should ensure that the service corporation's business is conducted in accordance with applicable regulatory constraints and supervisory restrictions. Adequate oversight procedures for monitoring sales practices can reveal unethical and illegal practices such as the "churning" of customer accounts (i.e., causing the rapid turnover of a client's accounts for the sole purpose of earning commissions).

Compensation Structures

The structure of compensation programs should also minimize the potential for abusive practices. The incentive compensation structures adopted by service corporation management tend to be similar to those found throughout the securities industry. Compensation structures for each class of personnel should be established in written policies and procedures and be available for review by the regulator. The brokerage program's compensation structures should be clearly separate from those of the thrift.

Registered representatives may receive incentive compensation, such as commissions, bonuses, and awards provided their practices are prudent and comply with brokerage program's policies and procedures regarding, for example, customer suitability considerations and adequate disclosures.

Management should be able to demonstrate that compensation paid to dual employees is reasonable. Internal policies and procedures should identify whether commissions and bonuses are available to dual employees, and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Tellers and other thrift employees may receive fees for referring customers to the securities brokerage subsidiary, however, only a one-time nominal fee may be received for each referral. (See Appendix B.) Compensation and referral fees paid to dual and sole brokerage employees can be of concern insofar as these may bias employees to refer business to the securities products rather than those of the thrift. Such incentives may also result in aggressive sales practices. Management should monitor investment product sales activity for individual sales representatives and evaluate whether any patterns reveal improper practices (i.e., concentrations in the types of products sold that may indicate whether recommendations are driven by incentive compensation).

Internal controls throughout all aspects of securities brokerage activity are important to ensure that incentive compensation programs do not lead to improper sales techniques or unethical tactics in an attempt by sales representatives to reap greater financial rewards. Additionally, compliance and audit personnel should not receive any incentive compensation related to the brokerage program's operations. On the basis of supervisory or legal concerns, the OTS may, under § 545.74(a)(5), object to any element of a service corporation's compensation program.

Conflicts of Interest

Thrifts and their subsidiaries should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The policy should address those entities and individuals that are providing services through third party arrangements. Specifically, sales of investment products to trust accounts (or other fiduciary accounts in which the parent thrift exercises discretion) may result in conflicts of interest and are generally prohibited.

(Refer to the Trust Activities Handbook for guidelines on prudent practices pertaining to fiduciary accounts.)

Inventory Risk

The brokerage program faces inventory risk, or risk that the actual securities will be lost or stolen, if kept on the premises. While this is not often a major concern because the broker-dealer is acting for the customer, there are times when the broker-dealer will hold the securities until the customer picks them up. Systems should be in place to ensure that no inventory is maintained, and that safety measures are taken for the transportation of securities. Procedures should also be employed to prevent securities orders from being lost.

Assessment of Service Corporations' Securities Brokerage Operations

In addition to determining whether management has successfully implemented the safeguards detailed in TB 23-2, the service corporation's operations must be reviewed for compliance with 12 CFR § 545.74. To facilitate OTS examinations, as well as audits, 12 CFR § 563.170 requires that service corporations establish and maintain adequate records that provide an accurate and complete picture of all business that the entity transacts. Information pertaining to the service corporation's operations can, therefore, be obtained from the service corporation's files and interviews with the securities principal responsible for brokerage program oversight. A review of these files should provide an understanding of the risk assumed by a service corporation and a basis for evaluating the adequacy of management's risk containment measures.

Section 545.74(c)(4) sets forth the operating restrictions that apply specifically to a service corporation's securities brokerage activities. Additional regulatory requirements that generally apply to all service corporation activities (i.e., investment limitations, financial reporting standards, notification procedures) are detailed in Handbook Section 610.

Preapproved Securities Brokerage Activities

A service corporation may only engage in securities brokerage activities that are preapproved or have been authorized by the OTS or FDIC. Section 545.74(c)(4) lists preapproved securities brokerage activi-

ties and pertains solely to a federal thrift's authority to conduct such operations through a service corporation. State laws should be consulted to determine whether similar authority exists for state-chartered associations. As detailed in Handbook Section 610, a state savings association's authority to conduct activities through a service corporation generally may not, under 12 CFR § 303.13, exceed those permissible for a federal thrift unless prior FDIC approval is obtained. The scope of preapproved securities brokerage activities is limited to the following categories of services: (1) executing trades on an agency and riskless principal basis and (2) investment advisory services.

For securities brokerage activities to qualify as preapproved, the service corporation must, to the satisfaction of the regulator, comply with the following requirements established in § 545.74(c)(4)(i).

- Activities must be conducted in a physical area that is clearly identified and distinguished from the areas where the parent thrift's depository functions are performed. Areas may be physically defined in various ways including the use of partitions, plants, platforms and kiosks. Advertising must also distinguish a subsidiary's services from those of the parent.
- Third party broker-dealers must indemnify the service corporation and parent thrift for any liability arising from the negligence, recklessness or intentional conduct of the broker-dealer or its employees.
- The senior securities principal of the brokerage dealership must maintain adequate systems and controls that detect and prevent any violations of applicable securities laws or rules of the SROs. Annual certifications that such systems are maintained and that the brokerage program complies with applicable securities rules and regulations must be filed with the OTS.
- The service corporation or broker-dealer must not condition or tie the provision of brokerage services to a customer's use of its services or those of an affiliate of its parent thrift.

A brokerage subsidiary that limits its operations to preapproved activities can, nevertheless, present material risk to the parent thrift. This risk increases when management is negligent in implementing or maintaining adequate operating controls and monitoring procedures. The service corporation's manage-

ment should be able to demonstrate that the brokerage program operates within the scope of activities that are preapproved or specifically authorized.

Activities Not Authorized as Preapproved

A service corporation's parent thrift must file an application to seek prior OTS authority to engage in an activity that is not preapproved. (Refer to "Other Reasonably Related Activities" in Handbook Section 610.) The OTS has, for example, on a case-by-case basis allowed service corporations to engage in the underwriting and marketing of mutual fund shares or products of an investment company. Section 545.74(c)(4)(i) specifically states that the following activities are not authorized as preapproved:

- executing principal securities transactions, making markets in securities or underwriting securities;
- paying referral fees to the parent thrift's employees unless a "no-action" letter is obtained from the SEC and prior OTS notice is provided regarding the size and manner of referral fee payments. (The SEC no longer issues individual no-action letters. (See Appendix B.)) ;
- soliciting transactions in a particular security;
- indemnifying a broker-dealer to a greater extent than the service corporation is being indemnified;
- extending margin credit to investors; or
- allowing nonregistered representatives to engage in other than clerical and ministerial work.

Management must be able to demonstrate that all securities brokerage services are conducted in accordance with the stated purpose of the service corporation, any OTS approval order or representations made to the OTS through the notification process, and the applicable regulatory and policy standards discussed throughout this Section. The OTS Thrift Information Exchange Systems (TIES) is a source of information for obtaining nonstandard approval conditions for a specific service corporation application.

In addition to any OTS operating restrictions, a thrift subsidiary that operates as a broker-dealer

must also comply with SEC rules and regulations, including registration requirements. When the service corporation itself is not a broker-dealer, and establishes a referral fee program instead, it must comply with the SEC's policy on networking arrangements to legally receive referral fees and rely on the broker-dealer for all technical matters relating to securities. This policy pertains to whether depository institutions (including thrifts and their service corporations) themselves, or their nonregistered employees, are required to register as broker-dealers when brokerage services are offered on their premises.

Prior to establishing a service corporation referral fee program, under § 545.74(c), the parent thrift must obtain an SEC no-action letter. This letter ensures that enforcement action will not be initiated against the thrift, its subsidiary and nonregistered personnel for failing to register with the SEC. The SEC, however, no longer provides such letters and instead has issued a comprehensive no-action letter, in Re Chubb Securities Corporation, dated November 4, 1993. This letter represents the SEC's policy on networking arrangements and applies to all referral fee programs established by depository institutions and their subsidiaries. (See Appendix B, SEC Policy on Networking Arrangements.)

In light of the change in SEC policy, the OTS will not enforce the no-action letter requirement when the following criteria are met:

- the parent thrift must provide an opinion from counsel or the senior securities principal responsible for brokerage program oversight, with subsequent certification from the thrift's board of directors, that any referral fee arrangement complies with applicable SEC regulations and policies; and
- the regional office has no supervisory objections to the referral fee arrangement.

Under the SEC's policy, referral fees paid to nonregistered employees must (1) be nominal and unrelated to the volume of securities traded by the customer, (2) be limited to one fee per customer referred, and (3) not include other compensation such as trips, free meals, or monetary awards. The broker-dealer must also provide manuals on appropriate conduct to nonregistered employees that specify the limits on their permissible activities. Additionally, supervisory employees must not receive any fees for referrals made by their subordinates.

As can be seen, the risks presented to the parent thrift by its brokerage subsidiary can vary among the distinct types of brokerage programs. Thus, an understanding of the service corporation's approach to brokerage operations can assist the regulator in identifying potential areas of risk and establishing an appropriate scope of review. Since service corporation brokerage operations typically involve referral fee arrangements, the competence of third parties and the quality of their services/products are an important factor in determining the level of risk assumed by the service corporation.

Overall Risk Assessment

In determining the overall risk presented to the thrift by a securities brokerage program, the basic aspects of permissible securities brokerage activities and management controls for containing risk, as discussed in this Section, should alert the regulator to potential unsafe and unsound practices. Given the different types of brokerage programs and investment products that are offered to customers, the discussion has necessarily focused on general types of brokerage program structures and various risks that can increase the thrift's exposure to loss and lead to customer confusion.

While the procedures that follow relate primarily to the securities brokerage program, the regulator's review of service corporations should also address general business concerns and the areas of review detailed in Handbook Section 610, Overview. The extent to which procedures are performed will depend on a number of factors, including the types of securities brokerage activities, specific products offered, relationships with affiliates, third parties and the parent thrift, the size of the business, and those factors detailed in the Overview Section.

It should be kept in mind that it remains common for securities firms to be established in periods of high trading volumes, and to do well during those times. They may, however, suffer cutbacks or go out of business when volume declines. Therefore, it is appropriate to evaluate the service corporation's future prospects for weathering the storms of the markets, and any measures that have been taken to prepare for the next low point in the cycle. Management expertise and competence is an important factor in assessing the service corporation's long-range planning strategies.

Examination Objectives

To determine the level of risk that securities brokerage activities present to the thrift and to recommend corrective actions as necessary.

To determine whether the required disclosures are made to customers.

To determine the effectiveness of internal controls that distinguish the securities brokerage program from the thrift's traditional activities.

Examination Procedures

Pre-Examination Analysis

1. Review a copy of:

- The most recent NASD, SEC or state examination report(s) and any reports pertaining to customer complaints or disciplinary actions initiated by securities regulators against the broker-dealer or any of its employees;
- The NASD and state regulatory license for each state in which the securities brokerage program operates;
- The production and financial reports for the securities brokerage program and any associated third party;
- Reports pertaining to internal compliance reviews;
- The most recent public accounting report; and
- All written agreements and conditions of approval pertaining to the securities brokerage program.
- Thrift Financial Report Schedule CSI-Mutual Fund and Annuity Sales.

2. Determine the types of activities that the brokerage program engages in, its structure (i.e., lessee, joint venture, turnkey, referral) and the investment products offered (i.e., mutual funds, annuities, equity securities).

3. Verify that the association received OTS approval prior to engaging in securities brokerage activities and is in compliance with approval conditions.

Sales of Investment Products and Referral Activity*Level I*Internal Controls

4. Determine if internal policies and procedures have been approved by the appropriate board of directors (service corporation or thrift) and whether they are sufficiently detailed.
5. Verify that the senior securities principal maintains adequate systems to detect and prevent any violations of securities, laws, regulations or rules.

Third Party Arrangements

6. Verify that agreements with third parties exist, and determine that:
 - a. They were approved by the appropriate board of directors (service corporation or thrift);
 - b. They contain, at a minimum, provisions that address the following:
 - The functions and responsibilities of each party;
 - Compliance with applicable securities laws, rules and regulations;
 - The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations, policy statements, and management's internal controls);
 - Access to the third party's records;
 - Indemnification of the thrift (and its service corporation, if applicable) for potential liability resulting from the actions of its employees; and
 - Employment contracts offered to dual employees.
 - c. If the third party agreement is between the thrift's subsidiary and a third party, verify that the thrift is not a party to the agreement.
7. Determine whether the thrift (or its service corporation) has established adequate procedures for evaluating third parties and the quality of their services or investment products.
 - Is the evaluation performed by personnel with

appropriate knowledge, experience and analytical skills?

- Are the procedures sufficient to ensure that the third party is financially stable and approaches its business with integrity? (Are consumer complaints reviewed along with any examination reports of the appropriate regulator(s)?)
- Do records document periodic assessments by management of the quality standards and monitoring systems used by the senior securities principal for each type of investment product? (Is a nationally recognized rating system or a thorough analytical process used?)

Location of Offices and Investment Sales Activity

8. Determine whether prudent internal controls are employed to ensure that it is obvious to prospective customers that securities brokerage services are offered by a separate entity, not the thrift, and determine whether:
 - The area where nondeposit investment products are offered is physically separate from teller windows and other areas where retail deposit-taking activities are offered;
 - Literature and information on investment services are located in areas that are clearly separate from material on traditional thrift products (i.e., the brokerage program's signs and advertisements are not located at teller windows, rates for products are posted separately); and
 - Employees, while located in the routine deposit-taking areas (i.e., teller windows, desks where CDs can be purchased), are not permitted to make any recommendations regarding nondeposit investment products or engage in any activities related to offering or selling such products.

Content of Advertising and Promotional Material

9. Determine whether the brokerage program's advertisements and other promotional materials are clearly distinguished from that of the thrift's depository functions and are not misleading.
 - Do materials contain the thrift's logo or terms such as "guaranteed" or "no risk" or other misleading terms?

- Is the entity offering the nondeposit investment products identified as the seller as required?

Note: If a concurrent compliance examination is scheduled that includes Section 425, Advertising, simultaneous review should be considered as these examination procedures overlap.

Oral and Written Disclosures

10. Determine the adequacy of disclosure policies through a review of training manuals, internal policies and materials available to customers (i.e., advertisements, brochures, prospectuses, offering circulars). Any “No” answers violate OTS policy.

a. Do procedures ensure that the required minimum disclosures are provided to customers: (1) the products are not insured by the FDIC, (2) the products are not deposits or other obligations of the institution or guaranteed by the thrift, and (3) the products are subject to investment risks, including possible loss of principal invested?

b. Are the required minimum disclosures made:

- Orally during sales presentations or when advising customers on investment products?
- In writing prior to or at the time an investment account is opened?
- Conspicuously, such that disclosures are: (i) located on the front of materials, in the top portion of text or at the beginning of sales presentations, customer referrals or solicitations, or (ii) highlighted in a box, with bold print, or with bullet points?

c. Are all fees, penalties, or surrender charges listed?

d. Do disclosures accurately identify material relationships between the brokerage dealership and an affiliate or investment company whose shares are offered to customers?

e. Are prospective customers advised to review information such as offering circulars or prospectuses before purchasing an investment product, if required by law, rule or regulation?

f. Are any references to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state

funds or private companies) followed by a clear and accurate explanation of such coverage?

g. Are customers required to sign a certification form acknowledging the characteristics of, and disclosures received about, nondeposit investment products?

Similar Names

11. Determine whether thrift management can demonstrate that applicable SEC requirements are observed when the name of investment products is similar to that of the thrift. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names.)

Use of a Thrift's Customer Information

12. Determine the adequacy and appropriateness of internal procedures regarding the use of the thrift's customer information by the broker-dealer. “Yes” answers are appropriate.

- Does the policy comply with applicable state laws?
- Is it clear that only designated personnel may use the information?
- Are adequate measures taken to minimize potential customer confusion when, for example, the information is used to contact holders of CDs that mature in the near future?

Compensation

13. Confirm that the senior securities principal has established internal policies that describe the authority, responsibilities, and method of compensation for each class of personnel and that a supervisor has been designated for each area of the brokerage program's operations.

14. Determine whether internal controls serve to detect and prevent improper sales techniques or unethical practices attributable to incentive compensation programs.

- When bonuses are offered as additional incentives, assess whether qualifications for the bonus increase the potential for aggressive sales practices or unethical practices (i.e., churning of accounts, providing misleading information). (Are bonuses dependent upon the sale of specific investment product(s)?)

Referral Fees and Practices

15. When the thrift is not registered as a broker-dealer, determine whether thrift management can demonstrate that a referral fee arrangement complies with the SEC requirements. (Refer to Appendix B, SEC Policy on Networking Arrangements.)

16. Evaluate the adequacy of the thrift's internal policies regarding customer referral practices.

- Do procedures provide for other than a one-time, nominal fee for each referral?
- Do fees depend on whether a transaction occurs?
- Are referrals made in a manner that effectively distinguishes investment products from FDIC-insured accounts?
- Is it clear that tellers are trained in acceptable referral practices and are prohibited from discussing the features of investment products, soliciting sales, or offering investment advice?

Dual Employees

17. When dual employees are registered representatives:

a. Determine the adequacy of safeguards for avoiding customer confusion. Any "No" answers indicate a violation of OTS policy.

- Are brokerage services performed in areas segregated from retail deposit-taking areas, as required?
- Do sales staff comply with the requirement that they identify the company that they represent?
- Are tellers dual employees? Are their teller functions conducted totally separate from securities brokerage activity?

b. Determine that compensation arrangements do not provide for inappropriate incentives.

Nonregistered Employees

18. Verify that internal controls ensure that the functions performed by nonregistered brokerage personnel are limited to those of a clerical or ministerial nature and consider whether nonregistered person-

nel are prohibited from assisting customers in completing forms for brokerage services and providing general investment advice, even if unsolicited.

Training and Qualifications

19. Evaluate whether the thrift's policies and procedures are sufficient to ensure that brokerage personnel are professionally qualified and adequately trained. "Yes" answers are appropriate.

- Has the broker-dealer established the qualifications and training requirements for each class of brokerage personnel?
- Is adequate training provided for each type of investment product that is sold or recommended?
- Do standards exist to monitor sales personnel such as sampling transactions, or requiring supervisor approval for new accounts and transactions that exceed established parameters?

Suitability Standards

20. Determine the adequacy of the broker-dealer's monitoring systems for ensuring that investment recommendations are "suitable" for a particular customer and determine whether:

- Recommendations are based on a reasonable assessment of the customer's financial position, objectives, tax status, age, and ability to understand and bear the investment risks;
- Standards are used to recommend products in amounts, and with terms and features, that are consistent with the customer's financial position and goals;
- Supporting documentation is maintained in customer files, updated periodically, and sufficient to provide a prudent analysis;
- Post-audit reviews of a representative sample of transactions are routinely performed; and
- Broker-dealers periodically certify that they comply with applicable rules of the SEC, SROs and states.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions

derived from performance of Level I procedures.

Level II

Third Party Arrangements

22. Evaluate whether internal controls are effective in monitoring a third party's compliance with the terms of a written agreement. (Do records indicate that commission income is being split in an agreed upon manner? Does the third party pay its own expenses?)

23. Verify the financial soundness of third parties that provide services or investment products on the thrift's premises or through an arrangement with a thrift subsidiary.

Internal Controls

24. Confirm that internal controls and procedures have been established to ensure compliance with board approved policies and procedures and determine whether:

- The compliance program is independent of the brokerage program's sales function;
- Post transaction quality controls have been implemented (i.e., exception reporting systems, reviews of customer satisfaction, and internal and external audits); and
- The compliance program, at a minimum, includes a system to monitor customer complaints, investment sales activity and customer accounts to detect and prevent improper practices.

25. Determine whether adequate procedures are established for handling any customer complaints or disciplinary actions initiated by securities regulators.

26. Determine the adequacy of internal controls in preventing situations that could potentially lead to a conflict of interest. (Is the conflict of interest policy revised periodically? Is it clear that representatives should not recommend securities issued by entities that borrow from the thrift?)

27. Determine whether systems are in place to ensure that no inventory of securities are maintained on the brokerage program's premises. (Do adequate

security measures exist for the transportation of securities? Are procedures followed that prevent orders from being lost?)

Evaluation of Business Plan Projections

28. Determine whether the brokerage program's operating results are consistent with business plan projections and that management periodically addresses long range strategic planning.

29. Evaluate the securities brokerage program's operating results and the volume of business against business plan estimates for overall operations and specific types of investment products. (Thrift management should be able to explain material variances.)

30. Determine whether management routinely reviews reports on customer mix and market surveys or other appropriate analyses and that the brokerage program's operating projections are supported by adequate documentation.

31. Determine whether reports provided to management on nondeposit investment sales activity are sufficient to determine trends or patterns that may require further review (i.e., a substantial number of mutual fund redemptions after fairly short holding periods, concentrations pertaining to specific investment products or types of customers).

32. Evaluate the thrift's procedures to implement corrective action in response to internal weaknesses or violations of applicable laws or regulations identified through monitoring systems, internal audits, and examinations by the OTS or securities regulators.

Service Corporations' Securities Brokerage Program

33. Perform the appropriate procedures in Handbook Section 610, Overview.

34. When reviewing compliance with regulatory requirements specifically applicable to securities brokerage operations conducted through service corporations (12 CFR § 545.74(c)(4)), management should, unless prior OTS approval is obtained, be able to demonstrate that:

- Securities brokerage activities do not involve executing principal securities transactions, making markets in securities or underwriting securities;

- Referral fees are not paid to the parent thrift unless the brokerage program complies with OTS restrictions and the SEC's policy on networking arrangements (refer to Appendix B, SEC Policy on Networking Arrangements);
- The broker-dealer does not solicit transactions in a particular security;
- The broker-dealer is not indemnified to a greater extent than the service corporation and parent thrift are being indemnified; and
- The service corporation and parent thrift are not extending margin credit to investors.

35. When the service corporation is not registered as a broker-dealer, verify that an opinion of counsel, or of the senior securities principal, states that any referral fee arrangement complies with the SEC's policy on networking arrangements as detailed in Appendix B. The opinion should be certified by the thrift's board of directors. (See Appendix B.)

Thrifts' Third Party Lease Arrangements

36. When a third party leases space directly from the thrift, confirm that there is a bona fide lease agreement that provides for fair market rent or an equitable commission sharing arrangement. Ensure that the thrift (or its subsidiary) does not engage in the lessee's operations.

Third Party Arrangements with Affiliates

37. When third party arrangements involve thrift affiliates, determine whether management can demonstrate that established internal controls are adequate to ensure that the thrift, or its subsidiary, complies with the restrictions detailed in §§ 563.41 and 563.42 of the OTS regulations.

38. Determine whether on-premises sales of a thrift's securities, or those of an affiliate, comply with the restrictions in 12 CFR § 563.76 and are performed in a manner that is consistent with the safeguards listed in TB 23a, Sales of Securities.

39. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Proprietary Funds

40. Review proprietary fund sales programs to determine that:

- oral and written disclosures are made, prior to the purchase of shares, of all relationships between the thrift, or its affiliates, and the fund; and
- proprietary funds do not have names identical or similar to the thrift.

41. Review compensation arrangements for proprietary funds. Determine the effect of any difference in compensation structure. Review suitability documentation to ensure that compensation is not a factor in determining suitability.

42. Determine whether a contingency plan has been established for handling adverse events, such as a sudden market downturn or periods of heavy redemptions.

43. Review the association's earnings and evaluate:

- profitability of activities including any investment advisory fees the association may receive; and
- income and expense from proprietary fund sales, investment advisory and proprietary fund management activities, as a percentage of noninterest income and expense.

44. Review investment history of proprietary funds to determine that:

- fund investments are in line with disclosures given in prospectus; and
- fund investments are appropriate given board investment policies.

45. Review proprietary fund investment portfolios for any structured securities holdings. (Most structured securities are unsuitable for money market funds, such as inverse floaters, cost of funds index floaters, constant-maturity Treasury floaters, dual-index floaters, and range floaters.)

- **Check documentation for compliance with investment policy, results of sensitivity analysis (stress testing), evaluation of pricing, and liquidity and credit risk prior to purchase.**

46. Review current ratings from rating agencies such as Standard and Poors (S&P is a rating agency of many money market funds). Try to determine if the rating agency has any plans to change (especially downgrade) the current rating.

References

United States Code (12 USC)

Home Owners' Loan Act

- § 1464(c) Loans and Investments
- § 1464(q) Tying Arrangements
- § 1468(a) Affiliate Transactions
- § 1468a Advertising
- § 1468b Powers of Examiners

Federal Deposit Insurance Act

- § 1828(m) Activities of Thrift Subsidiaries
- § 1831e Activities of Savings Associations

Code of Federal Regulations (12 CFR)

FDIC Rules and Regulations

- § 303.13(f) Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary
- § 303.13(g) Notice by Federal Associations Conducting Grandfathered Activities

OTS Rules and Regulations

Subchapter C: Regulations for Federal Savings Associations

- § 545.74 Service Corporations
- § 545.74(c)(4) Securities Brokerage Services
- § 545.77 Real Estate for Office and Related Facilities
- § 545.78 Leasing

Subchapter D: Regulations Applicable to All Savings Associations

- § 561.4 Affiliate
- § 561.45 Definition of a Service Corporation
- § 561.46 Definition of a Service Corporation Affiliate
- Part 563g Securities Offerings
- § 563.33 Selection of Directors and Officers
- § 563.37 General; Operation of a Service Corporation Liability of Savings Associations for Debt of Service Corporations
- § 563.41 Loans and Other Transactions with Affiliates and Subsidiaries
- § 563.42 Additional Standards Applicable to Transactions with Affiliates (Section 23B)
- § 563.76 Offers and Sales of Securities at an Office of a Savings Association
- § 563.132 Securities Issued Through Subsidiaries
- §563.170 Examinations and Audits; Appraisals, Establishment and Maintenance of Records
- § 563.171 Compensation
- § 571.7 Conflicts of Interest
- § 571.21 Separate Corporate Existence of a Service Corporation

Other Reference

Retail Investment Sales Guidelines for Banks, issued jointly by the six National bank trade associations (January 1994)

Office of Thrift Supervision Bulletins

- TB 23a Sales of Securities
- TB 23-2 Interagency Statement on Retail Sales of Nondeposit Investment Products
- TB 23-3 *Joint Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products***
- TB 31-2 Application of Securities Offering Rule to Material for Offerings of Debt

United States
Securities and Exchange Commission
Washington, D.C. 20549

RB 32-4 Appendices rescinded 1/7/04 by RB 32-34. Click [HERE](#) to link to RB 32-34.

May 7, 1993

The Honorable John Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

RESCINDED

Dear Chairman Dingell:

In response to your request of March 9, 1993, I asked the Division of Investment Management to prepare the enclosed memorandum on Commission and staff actions regarding mutual funds that have the same names as, or names similar to, banks that advise the funds or sell the funds' shares. As you can see, the Commission's staff is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, and are not insured or otherwise protected by the federal government.

I hope this memorandum satisfactorily responds to your questions. If you have any further questions regarding the issues raised in your letter, please contact me, Barbara J. Green, Deputy Director, or Thomas S. Harman, Associate Director, Division of Investment Management.

Sincerely,

/s/Richard C. Breeden
Chairman

Enclosure

MEMORANDUM

May 6, 1993

To: Chairman Breeden

From: Barbara Green, Deputy Director
Thomas S. Harman, Associate Director
Division of Investment Management

Subject: Bank Mutual Fund Names

This memorandum responds to Chairman Dingell's letter of March 9, 1993 in which he asks several questions about what, if any, action the Commission has taken or intends to take to ensure that investors in bank advised or bank sold mutual funds are not misled into believing that their investments are guaranteed or insured in the same manner as bank deposits. In particular, Chairman Dingell expresses concern regarding mutual funds that have names that are the same as, or similar to, banks that advise the funds or sell the funds' shares ("common name funds"). Chairman Dingell's questions and our responses are set forth below.

Question 1. What prohibitions or restrictions do current Commission rules and regulations contain with respect to common or shared bank and mutual fund names, and under what authorities? Please explain the rationale for said provisions or the lack thereof.

Section 35(d) of the Investment Company Act of 1940 ("1940 Act") provides the Commission with the authority to issue an order declaring that any word or words that a mutual fund uses in its name are deceptive or misleading. The staff has taken the position under the authority of Section 35(d) that a mutual fund should not use in its name certain generic terms that may mislead investors into believing that the fund's shares are federally insured. ^{1/} The staff also does not permit mutual funds that invest in U.S. government securities to use terms in their names or advertising that imply that the securities issued by the funds are guaranteed or insured by the U.S. government. ^{2/}

The Commission previously has not adopted any rules or regulations prohibiting or restricting mutual funds' use of common names. However, after carefully reviewing the risk that mutual funds sold on bank premises could be misconstrued as having the benefit of either federal deposit insurance or the liquidity protections of the discount window of the Federal Reserve, the Division is of the view, under the authority of Section 35(d), that common names between federally insured institutions and funds sold or marketed by or through such institutions are presumptively misleading. A common name fund can rebut this presumption through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of, or guaranteed

^{1/} See, e.g., CNA Management Corporation (pub. avail. Nov. 29, 1974) (staff letter objecting to use of "Mutual Savings Fund"); Wright Investors' Service (pub. avail. March 14, 1974) (staff letter objecting to use of "Savings"); National Securities & Research Corporation (pub. avail. Jan. 21, 1974) (staff letter objecting to use of "Savest"); Ben Franklin Thrift Shares, Incorporated (pub. avail. Sept. 1, 1973) (staff letter objecting to use of "Thrift").

^{2/} See Letter from William R. McClucas, Director, Division of Enforcement, and Gene A. Gohlke, Acting Director, Division of Investment Management, to Registrants, October 25, 1990.

or endorsed by, the bank, and that the shares are not federally insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency.

As noted in response to question 4, the Commission has not taken a formal position regarding whether Section 35 should be amended to restrict or prohibit the use of common names. There is a risk that, no matter how prominent the disclosure, some customers will not appreciate that their investment in a mutual fund sold by or through a bank, especially if marketed in the lobby of the bank, could potentially fall precipitously in value in response to changes in the value of portfolio securities. The staff expects to continue to review the question of whether common names should be barred notwithstanding the level of disclosure, but the staff has not reached any such conclusion at this time.

Question 2. What disclosures are required to prospective customers, and under what authorities? Please explain the rationale for these requirements.

The Division will require disclosure in three situations. First, the staff will require any common name fund to disclose prominently on the cover page of its prospectus that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency. The staff considers a disclosure to be prominent if it appears in some typographically distinct manner (e.g., boldface, italics, red letters, etc.). Second, the staff already requires any mutual fund whose shares are sold exclusively by or through a bank to provide essentially the same disclosure on the cover page of its prospectus. ^{3/} Finally, the staff will require any bank sold mutual fund to make the same disclosure, even where that fund's shares are not sold exclusively through banks and the fund is not a common name fund.

As stated above, the Division is of the view that common names are presumptively misleading. The authority for requiring these disclosures is the Commission's broad authority to require that a prospectus contain the necessary material information to make the statements contained in the prospectus not misleading. ^{4/} The policies underlying Section 35(d) provide additional authority to require disclosure with respect to common name funds. In addition, as discussed more fully below in response to question 5, broker-dealers and thrift employees, though not bank employees, are subject to certain disclosure requirements in connection with the sale of mutual fund shares to bank and thrift customers.

Question 3. What action has the Commission taken or intends to take in response to the recent adoption by mutual funds of names similar to the banking organizations that advise them? Please explain the rationale.

^{3/} See Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Registrants (Feb. 22, 1993).

^{4/} See Rule 8b-20 under the 1940 Act, 17 C.F.R. 8b-20 (investment company registration statement or report required to include material information in addition to that expressly required if necessary to make the required statements not misleading); Rule 408 under the Securities Act of 1933 ("1933 Act"), 17 C.F.R. 230.408 (any registration statement required to include material information in addition to that expressly required if necessary to make the required statements not misleading); see also Section 10(c) of the 1933 Act, 15 U.S.C. 77j(c) (Commission authorized to adopt rules requiring any prospectus to provide such additional information as necessary or appropriate in the public interest or for protection of investors).

As noted above, the Division is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, that the shares are not guaranteed or endorsed by the bank, and that the shares are not insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other federal agency. The Division has reviewed a significant number of common name fund prospectuses and found that a large number already have rebutted the presumption through disclosure. The Division will require that all other common name funds amend their prospectuses in the future so that they will similarly rebut the presumption through disclosure. The Division also is considering whether the rules governing mutual fund advertising should be amended to address issues raised by common name funds. ^{5/}

Question 4. What steps, if any, does the Commission believe are warranted to achieve consistent protection in this area?

As noted above, the Division is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, that the shares are not guaranteed or endorsed by the bank, and that the shares are not insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other federal agency. Of course, the Division will apply this policy consistently to all registered funds advised by or sold through banks, thrifts or any insured depository institution. ^{6/} The Commission currently does not have a position regarding whether Section 35(d) or other federal securities laws should be amended to restrict expressly or to prohibit mutual funds from using common names. The Division will continue to monitor this issue with a view towards making any needed recommendations.

Question 5. To the knowledge of the Commission, are tellers and other personnel on bank and thrift premises complying with the applicable requirements? What resources have been committed to ensuring compliance in this area?

Because banks are expressly excluded from the broker-dealer provisions of the Securities Exchange Act of 1934 ("Exchange Act"), ^{7/} the Commission does not have the oversight authority or the ability to allocate the resources necessary to determine if bank tellers and other bank personnel are complying with the federal securities laws. The Commission's regulatory and oversight authority with respect to personnel that sell securities on the premises of a bank is limited to the employees of registered broker-dealers, which includes bank subsidiaries and affiliates because the subsidiaries and affiliates are not covered by the bank exclusion. The Commission also has authority over the securities activities of personnel of thrift institutions (and other institutions not covered

^{5/} See, e.g., Rule 134 under the 1933 Act, 17 C.F.R. 230.134 ("tombstone" advertisements); Rule 482 under the 1933 Act, 17 C.F.R. 482 ("omitting prospectus" advertising); Rule 34b-1 under the 1940 Act, 17 C.F.R. 270.34b-1 (investment company sales literature).

^{6/} The Division recently compiled the attached list of bank-related investment companies with names similar to the bank.

^{7/} Sections 3(a)(4) and 3(a)(5) of the Exchange Act exclude banks, as defined in Section 3(a)(6), from the definitions of "broker" and "dealer." See Sections 3(a)(4), 3(a)(5), and 3(a)(6) of the Exchange Act, 15 U.S.C. 78c(a)(4) - 78c(a)(6) (defining "broker," "dealer," and "bank").

by the bank exclusion) that enter into "networking" or "kiosk" arrangements with broker-dealers. 8/ These persons are subject to specific restrictions on their activities, as set forth in a series of no-action letters, which are described in detail in a staff memorandum forwarded to you by Chairman Breeden on February 19, 1993 ("Memorandum"). 9/ Dual employees of broker-dealers and thrift institutions that enter into networking arrangements, for example, are required to disclose material information to investors about the risks of investing in mutual funds, including the fact that they are not federally insured or guaranteed by the institution. In addition, unregistered personnel of the institution are expressly prohibited from engaging in any sales activities. These important protections for customers are not available to the customers of banks, whose employees are exempt by current law from any similar requirements.

As noted in the Memorandum, to ensure compliance with these no-action letters, during the last fiscal year the Commission staff conducted examinations of several thrift institution networking arrangements, focusing on the broker-dealer's branch office review procedures, supervision of registered and unregistered employees, advertising, and sales practices. These examinations revealed substantial compliance with the provisions of the Exchange Act and the terms of the individual no-action letters, and isolated compliance problems were effectively addressed. The Commission, however, intends to continue to use its examination authority to monitor the sales practices and supervisory procedures of broker-dealers that sell mutual funds.

In addition, self-regulatory organizations ("SROs"), with Commission support, have taken steps to ensure that broker-dealers and their personnel that sell securities on bank or thrift premises are fully aware of and in compliance with their disclosure obligations under the federal securities laws. 10/ Although the Commission to date has not received a significant number of investor complaints about bank mutual funds, 11/ to supplement the efforts of the SROs, the Commission staff is currently developing educational materials discussing the risks of investing in bank mutual funds and other uninsured products, for future distribution to investors.

Question 6. What are the risks to the insured depository institution in terms of customer backlash and litigation liability if common-name or common-logo funds suffer losses? What steps can be taken or are being taken to eliminate or manage these risks?

We do not know whether and to what extent an insured depository institution would experience "customer backlash" or be subject to litigation if a common-name or common-logo mutual

8/ In a "networking" or "kiosk" arrangement, a broker-dealer agrees to provide securities services to the customers of a financial institution on the premises of that institution in exchange for a percentage of the commissions earned.

9/ Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (February 19, 1993) (enclosing memorandum from the Commission's Division of Market Regulation regarding reinvestment of proceeds of certificates of deposit in securities products).

10/ The SROs, for example, recently announced a plan to develop a single continuing education program for all securities industry registered representatives and principals. See 7 *NASD Regulatory & Compliance Alert*, No. 1 (March, 1993). The National Association of Securities Dealers, Inc. also has implemented initiatives designed to alert broker-dealers to their disclosure obligations when recommending that investors reinvest the proceeds of certificates of deposit in securities, such as bond funds and collateralized mortgage obligations. See, e.g., *NASD Notice to Members*, No. 91-4 (November, 1991).

11/ The staff has reviewed its files and has not found any investor complaints alleging confusion between mutual fund investments and insured bank deposits.

fund suffers losses. We believe that these questions, as well as the question regarding what steps have been or are being taken to address any risks, would be more appropriately directed to the banking regulators.

A bank or thrift would not be liable under the federal securities laws solely because a common-name or common-logo fund whose name is not otherwise misleading suffers losses. The bank or thrift may be liable under the federal securities laws, however, if it commits fraud in connection with the purchase or sale of securities. ^{12/} In addition, a bank or thrift that sells a security by means of a prospectus or oral communication that contains an untrue statement of a material fact or omits to state a material fact may be liable to shareholders for rescission or damages. ^{13/} Further, a bank or thrift may be liable if it commits a breach of fiduciary duty in connection with its receipt of compensation from an investment company that it advises. ^{14/}

^{12/} See Rule 10b-5 under the Exchange Act, 17 C.F.R. 240.10b-5 (general antifraud provision in connection with purchase or sale of securities).

^{13/} See Section 12(2) of the 1933 Act, 15 U.S.C. 771(2) (liability for use of misleading prospectus or oral communication in connection with sale of a security).

^{14/} See Section 36(b) of the 1940 Act, 15 U.S.C. 80a-35(b) (breach of fiduciary duty by investment adviser to investment company in connection with compensation received by adviser).

Office of Thrift Supervision
Department of the Treasury

TO: REGIONAL DIRECTORS

FROM: Carolyn Lieberman
Acting Chief Counsel

SUBJECT: New SEC Policy Re: Referral Fee Program "No-action" Letters

DATE: January 7, 1994

Introduction

The purpose of this memo is to 1) alert you to the Securities and Exchange Commission's (SEC) new policy to no longer issue individual "no-action" letters to federal associations regarding securities brokerage referral fee programs in service corporation networking arrangements, and 2) in light of the SEC's policy change, provide interim guidance as to how federal associations may otherwise effect compliance with current OTS requirements to obtain a SEC no-action letter in order to conduct referral fee programs.

Discussion

Current OTS requirements

The OTS service corporation regulations provide, in pertinent part, that a federal association may acquire or establish a service corporation to engage in certain preapproved securities brokerage activities, provided certain conditions are met.

One of these conditions prohibits payment to any employee of the association of a referral fee, bonus or incentive compensation, in cash or in kind, for referring any thrift customer to the service corporation except as may be consistent with a "no-action" letter received by the association from the SEC, stating that the SEC will not recommend enforcement action if association employees receive the planned referral fee but do not register as a broker dealer under the securities laws. See 12 C.F.R. §45.74(c)(4) (ii)(B). As a matter of policy, a similar requirement has been imposed on non-preapproved service corporation brokerage activities. See Service Corporation Guidelines, Section 710.10, OTS Applications Processing Handbook.

SEC policy change

To date, federal associations have complied with the above described requirement by individually requesting "no-action" letters from the SEC.

The SEC, however, generally will no longer issue no-action letters in this area. In this regard, the SEC's Division of Market Regulation recently issued a comprehensive no-action letter, *In Re Chubb Securities Corporation*, dated November 24, 1993 ("Chubb letter")(attached) which sets forth the SEC's policy regarding networking arrangements between broker-dealers and depository institutions. In connection with issuing the Chubb letter, the SEC staff advised OTS that 1) it will no longer respond to individual requests for no-action relief regarding such arrangements, unless a request presents novel or unusual issues, and 2) broker-dealers and depository institutions, including federal associations and their service corporations, may rely on the Chubb letter if they structure their networking arrangements in accordance with the terms and conditions set forth in the letter.

Interim guidance

In light of the new SEC policy, OTS will be considering appropriate regulatory and policy changes in this area in the near future. In the interim, OTS will not enforce the no-action letter requirement, provided the following two conditions are met:

1. The applicant provides an initial opinion of counsel or an opinion from the senior securities principal responsible for overseeing the subject brokerage program, with subsequent certification from the applicant's board of directors, that any referral fee arrangement is in compliance with the Chubb letter, and any related SEC regulations and policies. The opinion on this issue may be included in the initial opinion required by OTS from federal associations that propose to establish service corporation brokerage programs (re: that the program has been established pursuant to procedures designed to ensure conformity with applicable securities laws and regulations).¹

2. The Regional Director has no other supervisory objections to the proposed referral fee arrangement.

If you have any questions regarding the foregoing, please contact Dean Shahinian, Corporate and Securities Division at (202) 906-7289.

¹ See 12 C.F.R. 545.74(c)(4)(i)(D); OTS *Applications Processing Handbook* at Section 710.10.

United States
Securities and Exchange Commission
Washington, D.C. 20549

November 24, 1993

Carolyn Lieberman, Esq.
Acting Chief Counsel
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Dear Ms. Lieberman:

Enclosed is a no-action letter issued by this office on November 24, 1993, to Chubb Securities Corporation ("CSC"), a registered broker-dealer. In that letter, CSC proposed to enter into networking arrangements with various depository institutions, including federal savings associations and their service corporations, to provide brokerage services on the premises of such institutions, without such institutions or their unregistered employees registering as broker-dealers.

The enclosed letter to CSC sets forth our policy with regard to networking arrangements between broker-dealers and depository institutions. In the future, we will no longer respond to requests for no-action relief regarding such arrangements, unless a request presents novel or unusual issues. Broker-dealers and depository institutions, including federal savings associations and their service corporations, may rely on the letter to CSC if they structure their networking arrangements in accordance with the terms and conditions set forth in that letter.

Sincerely,

/s/Catherine McGuire
Chief Counsel

Enclosure

**United States
Securities and Exchange Commission
Washington, D.C. 20549**

November 24, 1993

Ian E. Celecia, Esq.
Chubb Securities Corporation
One Granite Place
P. O. Box 2005
Concord, New Hampshire 03302

Re: Chubb Securities Corporation

Dear Mr. Celecia:

In your letter of September 1, 1993, on behalf of Chubb Securities Corporation ("CSC"), as supplemented by telephone conversations with the staff, you request assurance that the staff would not recommend enforcement action to the Commission under Section 15(a) (1) of the Securities Exchange Act of 1934 ("Exchange Act") if CSC enters into networking arrangements with certain federal and state chartered banks, savings and loan associations, savings banks, and credit unions (collectively, "Financial Institutions") and, where required by law, their service corporation subsidiaries, to provide securities brokerage services on the premises of such Financial Institutions, as described in your letter, without the Financial Institutions, the required service corporations, or their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act.

We understand the facts to be as follows:

CSC, a wholly-owned subsidiary of Chubb Life Insurance Company of America, is a registered broker-dealer and member of the National Association of Securities Dealers, Inc. ("NASD"). CSC proposes to enter into networking arrangements with Financial Institutions to provide securities brokerage services to customers of such Financial Institutions and the general public, on the premises of the Financial Institutions. Where required by the laws or regulations governing a Financial Institution, the Financial Institution will enter into the networking arrangement with CSC through a service corporation subsidiary of the Financial Institution.

CSC will provide brokerage services on the premises of each Financial Institution in an area that is physically separate from the Financial Institution's regular business activities, in such a way as to clearly segregate and distinguish CSC from the Financial Institution. The area in which CSC provides brokerage services will clearly display CSC's name and an indication that CSC is a member of the NASD, and will be registered with the NASD as a branch office of CSC. Under the networking arrangements, CSC will provide brokerage services only on the premises of the Financial Institutions themselves, and not in areas where a service corporation has a location independent of the Financial Institution.

The networking arrangement between CSC and each Financial Institution (including its required service corporation) will be governed by a Customer Access Agreement, which will set

forth the responsibilities of the parties, the conditions of the arrangement, and the compensation to be received by the Financial Institution (including its required service corporation). As a registered broker-dealer, CSC will comply with all statutory and regulatory requirements applicable to broker-dealers, including applicable rules of self-regulatory organizations ("SROs"). CSC will exclusively control, supervise, and be responsible for all securities business conducted in its locations at the Financial Institutions. Under the networking arrangements, transactions in securities may be effected only by registered representatives of CSC, some of whom also may be employees of the Financial Institution, including its required service corporation ("Dual Employees"). CSC will control, properly supervise, and be responsible for all its registered representatives, including any Dual Employees acting in their capacity as CSC registered representatives.

Any materials used by CSC or the Financial Institutions (including required service corporations) to advertise or promote the availability of brokerage services under the networking arrangements will be approved by CSC for compliance with the federal securities laws prior to distribution. All such materials will be deemed to be CSC's materials, and will indicate clearly that the brokerage services are being provided by CSC and not the Financial Institution or its required service corporation; that neither the Financial Institution nor its required service corporation is a registered broker or dealer; that the customer will be dealing solely with CSC with respect to the brokerage services; and that CSC is not affiliated with the Financial Institution or its required service corporation. References to a Financial Institution in advertising or promotional materials will be for the purpose of identifying the location where brokerage services are available only, and will not appear prominently in such materials.

All confirmations, account statements, and other customer communications regarding securities transactions under the networking arrangements will be sent directly to the customer by CSC or by the issuer, transfer agent, or principal underwriter of the security. All documentation sent by CSC directly to a customer, including confirmations and account statements, will indicate clearly that the brokerage services are provided by CSC and not by the Financial Institution or its required service corporation. If any documentation regarding securities transactions is sent directly to a customer of CSC by an issuer, transfer agent, or principal underwriter, CSC will be responsible for ensuring that such materials comply with the federal securities laws; and the name of the Financial Institution or its required service corporation will not appear on such materials.

Each Financial Institution (including required service corporations) will allow supervisory personnel of CSC and representatives of the Commission, the NASD and other SROs of which CSC is a member, as well as other applicable federal and state governmental authorities, to inspect the Financial Institution's premises where CSC conducts brokerage activities and any books and records maintained by CSC with respect to brokerage activities. Each Financial Institution (including required service corporations) will be deemed to be an associated person of CSC within the meaning of Section 3(a)(18) of the Exchange Act.

Employees of the Financial Institutions (including required service corporations) who are not registered representatives of CSC will not engage in any securities or investment-related activities on behalf of CSC. Unregistered employees will be prohibited from recommending any security or giving any other form of investment advice, describing investment vehicles such as mutual funds, discussing the merits of any security or type of security with a customer, or handling any question that might require familiarity with the securities industry or the exercise of judgment regarding securities and investment alternatives. Unregistered employees will refer all securities-related questions to registered representatives of CSC. All telephone inquiries related to CSC will be answered solely by registered representatives of CSC. Unregistered employees will be prohibited from accept-

ing or transmitting orders, handling customer funds or securities (except that unregistered employees may effect electronic funds transfers to CSC from an account at the Financial Institution or required service corporation at a customer's request) or having any involvement in securities transactions other than providing clerical and ministerial assistance.

Unregistered employees of the Financial Institutions (including required service corporations) will not receive any compensation based on transactions in securities or the provision of securities advice. Unregistered employees may, however, be paid a nominal fee for referring Financial Institution customers to CSC. The amount of any such fees, which will be unrelated to the volume of securities traded by the customer, will be determined and paid by the Financial Institution (or required service corporation). Unregistered employees will be paid no more than one fee per customer referred. Other than this one-time, nominal fee, unregistered employees will not receive any other compensation, such as trips, free meals, or monetary awards, as the result of a referral or the number of referrals made. Supervisory employees will not receive any fees for referrals made by their subordinates.

CSC will provide conduct manuals to unregistered employees of the Financial Institutions (and required service corporations) that specify the limits on their permissible activities, as set forth above. Each Financial Institution (including required service corporations) will monitor the activities of its unregistered employees, and ensure their compliance with the limits on their permissible activities as set forth in the conduct manual. Furthermore, CSC will conduct periodic reviews to assure that the Financial Institutions (including required service corporations) and their unregistered employees comply with the limits on their activities set forth in the conduct manual. CSC also will provide each of its registered representatives with a copy of CSC's compliance manual. Registered representatives will adhere to the policies and procedures contained in CSC's compliance manual. CSC will monitor its registered representatives' compliance in this regard.

All brokerage services provided at the Financial Institutions (including required service corporations) will be provided by registered representatives of CSC, either Dual Employees or otherwise, all of whom will be registered and qualified as necessary with the Commission, the NASD, and any appropriate state regulatory authorities, and all of whom will be associated persons of CSC within the meaning of Section 3(a)(18) of the Exchange Act. Each Financial Institution (including required service corporations) will agree that any Dual Employee whom the Commission, the NASD, or CSC bars or suspends from association with CSC or any other broker-dealer will be terminated or suspended, accordingly, from all securities activities by the Financial Institution (and its required service corporation). The securities activities of each Dual Employee will be supervised by the supervisory personnel of CSC, who are registered securities principals. The amount of any transaction-related compensation paid to CSC's registered representatives, including Dual Employees, under the networking arrangement, will be determined solely by CSC. For convenience with respect to tax and social security withholding, health, retirement, and other benefits, transaction-related compensation may be paid to Dual Employees by the employer Financial Institution (including required service corporations), provided that it is clear that such payments are made on behalf of CSC from funds allocated by CSC for payment of Dual Employees.

Registered representatives are required to inform all securities customers, and obtain a written acknowledgment from such customers, that the brokerage services are being provided by CSC and not by the Financial Institution (or its required service corporation), and that the offered securities are not guaranteed by the Financial Institution (or its required service corporation) or insured by the Federal Deposit Insurance Corporation ("FDIC") or any other federal or state deposit guarantee fund relating to financial institutions.

CSC will not solicit customers of a Financial Institution in connection with the purchase or sale of the securities of that institution or any of its affiliates (including required service corporations). CSC may execute unsolicited transactions in the equity securities of the Financial Institution or its affiliates (including required service corporations) on behalf of a Financial Institution customer, provided that the customer signs an affidavit affirming that the transaction was effected on an unsolicited basis and that the customer has been informed that the securities are not insured by the Financial Institution or any of its affiliates (including required service corporations), the FDIC, or any other state or federal deposit guarantee fund relating to financial institutions. No debt securities of the Financial Institution or its affiliates (including its required service corporations) will be sold, on an unsolicited basis or otherwise, on any part of the premises of the Financial Institution that is generally accessible to the public.

CSC will pay a fee to the Financial Institution (including required service corporations) based on all securities transactions that occur at or are attributable to activities conducted on that Financial Institution's premises. CSC will provide a copy of this letter to each Financial Institution (including required service corporations) and will ensure that each Financial Institution (including required service corporations) understands its obligations under the networking arrangement.

Response:

On the basis of your representations and the facts presented, and strict adherence thereto by CSC, the Financial Institutions (including required service corporations) and their unregistered employees, and particularly in view of the fact that CSC is a registered broker-dealer and all personnel engaged in securities activities under the networking arrangements will be fully subject to the regulatory requirements of the federal securities laws and the applicable rules of SROs, the staff would not recommend enforcement action to the Commission under Section 15(a)(1) of the Exchange Act if CSC offers brokerage services under the networking arrangements described above without the Financial Institutions (including required service corporations) and their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act. This staff position is based in part on CSC's representation that it will control, properly supervise, and be responsible for all registered representatives participating in the networking arrangements. Consequently, any designation of such registered representatives as "independent contractors" will have no effect on CSC's responsibilities under the federal securities laws, including without limitation Sections 15(b) and 20(a) of the Exchange Act.¹

This position concerns enforcement action only and does not represent a legal conclusion regarding the applicability of the statutory or regulatory provisions of the federal securities laws. Moreover, this position is based solely on the representations that you have made; any different facts or conditions may require a different response.

Sincerely,

/s/Catherine McGuire
Chief Counsel

¹ See *Hollinger v. Titan Capital Corp.*, 914 F. 2d 1564, 1572-78 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991).

Scope

- Q. Does the Interagency Statement (TB 23-2) apply to the retail sale of repurchase agreements?**
- A. Yes, the guidelines apply to the retail sale of all nondeposit investments, including repurchase agreements, to thrift customers. Nothing in the guidelines would apply to non-retail sales, such as institutional sales.**
- Q. If an institution offers discount brokerage services, do the guidelines apply?**
- A. The guidelines apply to the thrift's¹ discount brokerage services; however, certain provisions such as suitability determinations may not apply if no investment advice is given or recommendations are made.**
- Q. If the thrift directs retail sales of nondeposit investment obligations through its trust department, do the guidelines apply?**
- A. Possibly. That determination is made on a case-by-case basis. The guidelines do not apply to fiduciary activities and the exception was designed to cover traditional trust activities. However, some thrifts may direct their retail sales of nondeposit products through the trust department. Therefore, the guidelines would apply to individual accounts administered in an agency capacity by the thrift which were set up solely to facilitate the purchase of nondeposit investment products. In addition, sales made through the trust department that are directed by the customer, such as self-directed IRAs or asset allocation accounts, are also considered "retail" and are covered under the Interagency Statement.**

Oversight

- Q. Should the broker/dealer Compliance Officer report to the broker/dealer Principal and not the thrift's board of directors?**
- A. Under the National Association of Securities Dealer's (NASD) guidelines, the compliance officer must report to the Registered Principal. However, it is very important that the affiliated broker/dealer's and the thrift's Board of Directors are fully informed of compliance issues affecting the nondeposit investment sales program within thrift offices. Both boards should receive regular compliance reports, descriptions of significant complaints, etc. The thrift's internal audit department should review the nondeposit investment sales program for compliance with the Interagency Statement.**

¹Throughout this document, "thrift" means thrift or service corporation, as appropriate.

Q. If the thrift has officers that are directors of the broker/dealer does the thrift's board have to also be involved in oversight/approval activities?

A. Yes. The thrift board has the ultimate responsibility to set policy for the nondeposit investment sales program and oversee it to ensure management is following such policy. While the common officers/directors are helpful in keeping affiliated organizations informed about each others activities, formal oversight/reporting should be in place to ensure that the thrift board can fulfill its oversight responsibilities.

Q. The thrift provides registered representatives² with full access to thrift customer information for purpose of soliciting sales, any problem?

A. The sharing of customer information is governed by state law and thrift policy. The thrift should be able to demonstrate that it is in compliance with state law in this area. Many thrifts require the customer to authorize such access by any outside parties, and to preserve customer financial confidentiality, or may choose to give certain information, such as name and address, but not other information, such as account balances, CD maturity date or customer age.

Q. Is it adequate if only the broker/dealer's management evaluates mutual fund companies annually to ensure they are of acceptable quality before keeping them on the approved product list?

A. No. Thrift management should not rely on the broker/dealer to decide which product/product types are offered for sale within a thrift's offices. The thrift should have sufficient oversight over the nondeposit investment sales program to ensure that the thrift is not exposed to undue risk and customer confusion is minimized. As such, the thrift should review the evaluation process and criteria the broker/dealer uses to ensure products are the type that the thrift wants its customers exposed to and its offices associated with. However, broker/dealers are responsible for knowing on a daily basis the attributes of all mutual funds they recommend.

Q. Is reliance on A M Best rating sufficient for an evaluation of annuity products?

A. No. A documented review of the issuer of the annuity products that are sold in thrift offices should generally include a review of financial performance and current information about the company, which can include information provided by rating services such as A M Best.

Q. May registered representatives offer products beyond those approved?

A. It depends on the thrift's policy. Most thrifts restrict registered representatives to an approved product list to ensure that riskier products are not sold from within their branches. Other

²Throughout this document, the term "licensed registered representative or "registered representative" is used for the sake of clarity and simplification. However, NASD registered representatives are limited to sales of securities (limitations vary by NASD designation). NASD registered representatives cannot sell fixed-rate annuities (an insurance product) unless authorized under separate licensing arrangements established by state law. For purposes of this document, registered representative will refer to both NASD registered representatives and appropriately licensed state insurance sales representatives, unless otherwise indicated.

thrifts permit "unsolicited" orders for products not on the approved product list. Allowing a registered representative to sell any product he/she determines is suitable exposes the thrift to increased risk and should be discouraged if not accompanied with enhanced safeguards.

- Q. Is it required that a thrift keep a log of oral complaints and written complaints?**
- A.** The NASD requires each broker/dealer to keep a written log of all written customer complaints. Thrifts should be encouraged to track oral complaints and periodically review the broker/dealer's complaint file and the actions taken to address the complaint. Doing so may help identify training, procedural, and disclosure weaknesses. In addition, this review aids management in identifying unsuitable sales practices.

Personnel

- Q. May non-registered thrift employees tell a customer about the features and benefits of an institution's annuity and security products when making referrals?**
- A.** No. Only appropriately licensed registered representatives should discuss the merits of nondeposit investment products. Thrift employees can, however, make referrals to registered representatives. A thrift employee that tells a customer about the benefits or features of a nondeposit investment product is providing investment advice which is prohibited. In no case should any non-registered person or any registered person while located in the routine deposit taking area, such as a teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited.
- Q. May non-registered thrift employees provide a customer with a prospectus on the nondeposit investment product when making a customer referral to ensure that the customer has a written disclosure of relevant information about the product or when a registered representative is unavailable or out of the office?**
- A.** No. Only Registered Representatives should provide a prospectus. Other product literature may be provided in making the referral, but extreme care should be exercised to avoid a non-registered thrift employee from providing investment advice or fostering a perception that the products are thrift products, recommended by the thrift, or FDIC insured.
- Q. Is it permissible for a third-party non-affiliated broker/dealer to contract with thrift employees to become registered representatives for the broker/dealer during certain times.**
- A.** Yes, such registered representatives become dual employees. To become NASD registered representatives, they must be sponsored by a registered broker/dealer (in this case, the non-affiliated, third-party broker/dealer), but they may also be thrift employees and paid by the thrift for that portion of the time they work for the thrift.

Advertising

- Q. May a radio advertisement by a thrift for nondeposit investment products be aired without all the required disclosures?**
- A.** It is not practical to make all or, in some cases any of the disclosures on certain types of advertising. The federal banking and thrift regulatory agencies issued joint interpretations of the Interagency Statement on September 12, 1995. These joint interpretations clarify the Interagency Statement, and provide a disclosure alternative. OTS issued the Joint Interpretations of the Interagency Statement as Thrift Bulletin 23-3. In all cases, the advertisement should be clear as to the nature of the products offered and the broker/dealer making the sale.
- Q. May nondeposit investment product literature be displayed anywhere in the branch?**
- A.** No. Nondeposit investment product literature should generally be located in the separate non-deposit sales area. It is acceptable to have such sales brochures/advertisements at the entrance and exit to the branch or sales area. Nondeposit investment product literature should not be placed next to teller stations or where new deposit accounts are opened as such literature may contribute to potential customer confusion. In addition, nondeposit investment products should not be advertised on the same rate boards for deposit accounts.
- Q. May nondeposit investment product literature be located on ATMs?**
- A.** Yes. ATMs are not considered "routine deposit-taking areas." An ATM is simply a communication device that facilitates many different kinds of transactions. Such literature, of course, must contain the disclosures required in the Interagency Statement (TB 23-2).
- Q. If the NASD clears an advertisement of the broker/dealer, may the thrift consider such advertisement acceptable?**
- A.** No. The NASD review will concentrate on all applicable securities regulations. The thrift should not assume that the advertisement complies with all requirements of the Interagency Statement.
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Suitability

- Q. Which of the following is necessary to ensure suitability?**
- a. Knowledge of the customer's tax status.
 - b. Knowledge of the customer's financial position.
 - c. Knowledge of the customer's risk tolerance.
 - d. Knowledge of the customer's time horizon for investing.
 - e. Knowledge of the customer's investment goals.
 - f. Knowledge of the customer's age, health, personal obligations.

- A. All of the above are key factors that should be considered in determining whether any recommend nondeposit investment is suitable for a particular customer. The registered representative should document all suitability information, which is generally contained on the initial application form.
- Q. Is the registered representative required to describe a product to a customer, even though the customer has requested the product, to make sure the customer is aware of what he/she is buying?
- A. Suitability determinations are necessary only when the thrift is offering investment advice. The scenario described is an unsolicited sale. If the customer specifically requests a particular investment product, the thrift may sell that product without elaboration based on that customer's request. However, it is always a prudent sales procedure for a sales person to make sure the customer understands what kind of product he or she is buying and a suitability determination would be necessary if the registered representative believes the customer does not understand.

Disclosure

- Q. The disclosure says the investment "involves investment risk" and that "the investment can fluctuate in value." In addition, it discloses that the investment is not FDIC insured, not an obligation of, or guaranteed by the thrift, and is not a deposit. Is this disclosure sufficient even though it does not say "involves investment risk including the possible loss of principal"?
- A. The disclosures contained in the guidelines are the minimum information to be given. Disclosures that contain other information are acceptable, as long as that information does not distract from the core disclosures. Wording of the disclosures may vary in order to more accurately reflect a particular product, so long as the basic intent of the disclosures is not changed.
- Q. Do the same disclosures have to be made in an oral presentation as in the written customer acknowledgment/disclosure?
- A. Generally yes. The required minimum disclosures must be provided orally during any sales presentation, orally when investment advice is provided, and orally and in writing prior to or at time an investment account is opened to purchase nondeposit investment products. The additional disclosures (advisory relationships, fees, penalties, etc.) may be made in writing (providing a prospectus containing such information to the customer for example) prior to or at the same time an investment account is opened to purchase such products.
- Q. Does a registered representative have to disclose that certain products are proprietary?
- A. Yes. All advisory or other material relationships between the thrift or an affiliate of the thrift and an investment company whose shares are sold by the thrift and any material relationship between the institution and an affiliate involved in providing nondeposit investment products must be disclosed. Such disclosure may be in the prospectus.

- Q. Do the required minimum disclosures have to be on the front cover or the top of any text advertising brochure?**
- A. Generally yes. The required minimum disclosures may also be highlighted or contained within a box on the front cover or in a prominent location next to the first discussion of nondeposit investment products. The disclosures, no matter how highlighted or boxed, do not meet the conspicuous standard of the Interagency Statement if they are located on the back page of the sales brochure or advertisement and should be in type at least as large as the predominant type.**
- Q. Does a registered representative have to disclose that they receive more commission for selling certain nondeposit investment products (e.g., receive more for selling an annuity than a mutual fund)?**
- A. No. However, all sales must be suitable and advisory relationships must be disclosed.**
- Q. Does a registered representative have to disclose fees, penalties and surrender charges?**
- A. Yes. The Interagency Statement requires that fees, penalties and surrender charges be disclosed prior to or at the time an investment account is opened. This disclosure may be provided in the prospectus.**
- Q. The prospectus contains an application that does not include the thrift's standard disclosures since it is a generic product put out by the mutual fund company. The thrift opens new accounts in its offices with an application that contains appropriate suitability and disclosure information. Any potential concern?**
- A. Yes. A problem exists if the application in the prospectus could be used to open a new nondeposit investment product account in the thrift's offices or when the thrift refers the customer. Nondeposit investment product sales within a thrift or as a result of a referral of retail customers by the institution when the institution receives a benefit for the referral must comply with the Interagency Statement. However, if the generic application in the prospectus is used only to open accounts via mail directly with the broker/dealer or mutual fund, the disclosures required by the Interagency Statement are not required.**
- Q. The thrift uses a combined savings/checking and nondeposit investment product statement that presents the customers deposit and nondeposit account activity. Any potential concern?**
- A. Yes. Although combined statements may be used, if a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the required minimum disclosures and the identity of the entity conducting the nondeposit transaction.**

Annuities

- Q. May fixed rate annuity sales be made from a new deposit account desk?**
- A. No.** Fixed rate annuities are nondeposit investment products for purposes of the Interagency Statement and a new deposit account desk is considered a "place where deposits are routinely taken." Nondeposit investment products should not be sold from locations within the thrift where deposits are routinely taken.
- Q. May a NASD Series 6 Registered Representative sell fixed rate annuities?**
- A. Yes,** provided that a separate insurance license is held if required by state law. Fixed rate annuities are insurance products for NASD and state insurance licensing purposes.
- Q. May literature use phrases such as "guaranteed" and "insured" in reference to an annuity product?**
- A. No,** not in isolation. The use of such phrases in an insured institution could potentially confuse thrift customers. Any reference to a guarantee or insurance feature that does not also provide, in the same or the following sentence, the identity of the entity that provides the guarantee or insurance, is misleading. Such references should also disclose the aspect of the investment that is "guaranteed."
- Q. May documents relating to annuity products use language customarily associated with insured deposits or that refer to annuities as similar to deposits?**
- A. No.** The use of such language in a thrift sales program could potentially confuse thrift customers.

Referral Fees

- Q. May the broker/dealer pay a referral fee of \$20? \$50? \$100?**
- A. The referral fee should be nominal in amount, one time, and not dependent on a sale being made.** Most institutions tend to pay from \$1 to \$10. A \$20 fee would be near the top end of "nominal." The NASD currently has a proposal out for comment to their members that would prohibit a broker/dealer from paying referral fees. However, the proposal would not prohibit the payment of referral fees by the savings association.
- Q. May the thrift pay the registered representative more for selling proprietary products such as an affiliated mutual fund?**
- A. Yes,** and such additional payment for selling one's own products is common. The compensation, however, cannot be structured to encourage or result in unsuitable recommendations/

sales. The existence of a higher pay scale for proprietary funds warrants a more thorough review of suitability determinations.

- Q. In order to receive a one time, nominal referral fee, the thrift employee must qualify the customer by making sure they have at least \$5,000 to invest and intend to make an investment within the next 30 days. Any problem?**
- A. No, so long as the employee is not making general or specific investment advice/recommendations, accepting orders for such nondeposit investment products, or qualifying a customer as eligible to purchase such products (determining suitability).**

Securities Investor Protection Corporation (SIPC) Insurance

- Q. Does SIPC insurance protect investors from a decline in the market value of securities and the physical loss of securities if the broker/dealer holding the securities for the customer fails?**
- A. No. SIPC does not protect investors from declines in value such as those that may result from changes in market conditions. SIPC protects investors' securities or funds if the brokerage firm fails.**
- Q. May a SIPC sticker be placed next to a FDIC sticker at the thrift?**
- A. The SIPC sticker should, as required by the NASD, be placed at the separate location within a thrift where nondeposit investment product sales are made. It should not be placed on a teller window, or on the door next to a FDIC insurance sticker. SIPC insurance should be explained and disclosed as not being similar or equivalent to FDIC insurance if it is mentioned in brochures.**
- Q. If SIPC insurance is mentioned what other information should be given?**
- A. Incomplete or potentially confusing references to SIPC insurance is a problem. A complete explanation regarding the nature and extent of SIPC coverage should be given to customers. The following is a good example of disclosure relating to SIPC insurance: Accounts are protected by the Securities Investor Protection Corporation (SIPC) which protects investor's securities or funds if the brokerage firms fails. SIPC insurance does not protect your account against declines in value such as those that may result from changes in market conditions.**

Affiliates

- Q. An affiliated broker/dealer pays the thrift market rates for the space it occupies in each thrift office, any FRB 23B problem?**
- A. While the 23B test of "terms equivalent to those available to non-affiliated parties" is at first glance met by paying a market rent for the space occupied, it does not compensate the thrift for**

access to its customer base and/or customer information. Additional compensation is therefore required in addition to a market rent per square foot. No standards apparently exist within the industry for this compensation. Non-affiliated, third-party broker/dealers generally pay a percentage of total commission generated from sales within thrift offices (40 percent to 90 percent) instead of a fixed rent per square foot for the right to sell nondeposit investment products within thrift offices. The difference in percentages paid reflects the differing levels of assistance provided by the broker/dealer such as whether the broker/dealer pays the Registered Representatives. The compensation of access to customers may be in the form of a percentage of commissions earned or a fixed amount. The institution should be required to demonstrate that the payment meets the 23B test.

- Q. When the broker/dealer is a holding company subsidiary selling nondeposit investment products in the thrift, does the thrift need a written agreement on such sales? Written lease for space?**
- A. Yes to both questions. The affiliated broker/dealer is considered a third party for purposes of the Interagency Statement. Written third-party agreement and leases should meet all regulatory requirements including the requirements within the Interagency Statement and the OTS legal opinion dated February 7, 1985.**
- Q. May a Series 7 registered representative of an affiliate broker/dealer located within a thrift accept unsolicited orders for the thrift holding company stock and bonds?**
- A. Yes. Generally, such sales are not permitted pursuant to 12 C.F.R. 563.76. The only written exceptions are the sale of conversion stock and the exceptions listed in TB 23a which include unsolicited matching buy and sell orders of thinly traded stock; however, unsolicited orders may be filled as a customer courtesy.**