Networking Arrangements

Financial institutions can provide their customers with a wide array of financial products and services through networking arrangements. This is where a financial institution enters into a contract with a registered broker-dealer for the provision of brokerage services to its customers. The sale of nondeposit investment products, such as mutual funds, stocks, bonds, variable annuities, municipal bonds, mortgage-backed securities, or limited partnership interests, to savings association customers through networking arrangements is growing. Savings associations offer these products and services to remain competitive by providing one-stop shopping and customer convenience. Offering these products and services also enables savings associations to retain customers and increase fee income. The use of networking arrangements can be an important element of a savings association's profitability and overall business strategy.

This Handbook Section includes the following information:

- Describes the two types of networking arrangements.
- Describes the securities business in general.
- Discusses the risks in networking arrangements.
- States what steps management needs to take to adequately identify, measure, monitor and control the risks associated with its networking arrangement.

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The risk-focused approach to examinations allows flexibility in setting the examination scope. The scope must be reasonable and prudent, yet sufficient to evaluate the extent to which the networking arrangement poses risk to the savings association. To determine the level of risk posed by a networking arrangement you must first review the sales program structure and management controls. This review should also alert you to any potentially unsafe and unsound practices.

In this Section we cover in detail the various safeguards and regulatory requirements associated with the conduct of a safe and sound networking arrangement. There are three main pieces of guidance, among others, that we discuss in this Handbook Section. Savings associations that establish networking arrangements should comply with the guidance found in these documents:

- Interagency Statement on the Sale of Nondeposit Investment Products (Interagency Statement) Thrift Bulletin (TB) 23-2. See the discussion of Interagency Statement later in this Handbook Section. (See Appendix A.)

- Joint Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products, TB 23-3. (See Appendix B.)

- The Chubb Letter. A no-action letter issued by the Securities and Exchange Commission (SEC) to Chubb Securities Corporation on November 24, 1993. (See Appendix C.) The Chubb Letter provides restrictions on networking arrangements. OTS, as a policy matter, is applying these restrictions to savings associations that choose to offer nondeposit investment products and services to its customers through networking arrangements. The Chubb Letter restrictions will continue to apply until the SEC issues final regulations regarding broker registration exceptions under the Gramm-Leach-Bliley Act (GLBA) and those regulations become effective.

We discuss these documents in more detail later in this Section.

New Developments

In the past, banks were exempted from broker- dealer registration requirements under the Securities Exchange Act of 1934. Savings associations did not have a similar exemption.

In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA). Section 201 of GLBA removed the blanket registration exemption for banks and substituted specific broker-dealer activities that did not require registration. The exception for broker activities, for example, permits banks to enter into networking arrangements with registered broker-dealers provided certain conditions are met.

To give banks time to conform their transactions to GLBA requirements and SEC time to issue regulations, the SEC provided banks with a temporary blanket broker exception from broker-dealer registration requirements (17 CFR § 140.15a-7 (2003)). The blanket exception is currently in effect and will remain until the SEC issues final regulations regarding the GLBA broker exceptions. The SEC temporary bank exception for dealer activities expired because SEC has issued an effective final regulation.

OTS requested SEC to extend the same treatment to savings associations as banks to maintain regulatory uniformity. SEC has issued an interim final rule excepting savings associations from broker-dealer registration requirements "on the same terms and under the same conditions" as banks (17 CFR § 240.15a-9 (2003)). As a result of these SEC actions, savings associations and banks currently have the same temporary blanket exception from registration requirements for broker activities.

Until SEC issues final regulations regarding the GLBA broker exceptions and those regulations become effective, savings associations should continue to abide by the provisions in the Interagency Statement and the Chubb Letter.

On July 11, 2003, OTS issued CEO Memorandum No.178 regarding networking arrangements conducted through a service corporation.

Consistent with previous OTS policy, some savings associations set up service corporations to contract with a broker-dealer to offer nondeposit investment products and services. In July 2003, the SEC informed OTS that it is issuing deficiency letters to broker-dealers that have a networking contract with

a service corporation of a savings association. The cause for the deficiency, under the Securities Exchange Act of 1934, is that the SEC considers a service corporation to be a broker itself when it contracts with a broker-dealer to offer nondeposit investment products and services to a savings association's customers. As previously mentioned, the exception under Rule 15a-9 is a blanket exception that would permit savings associations to directly contract with registered broker-dealers for networking arrangements without registering as a broker. This exception does not extend to service corporations, unless savings associations are required by law or regulation to conduct networking activities in a service corporation. Since OTS no longer requires the use of a service corporation to engage in networking arrangements with a broker-dealer, savings associations using a service corporation for networking arrangements should either:

- Replace the contract between the service corporation and the broker-dealer with a contract between the savings association and the broker-dealer; or

- Require the service corporation to register as a broker-dealer.

TYPES OF NETWORKING ARRANGEMENTS

There are several types of networking arrangements. The simplicity or complexity of the arrangement depends on the needs of the savings association. The arrangements range from a minimal commitment such as a referral service, to the formation of a service corporation that registers with the SEC as a broker-dealer.

The following two networking arrangements are the most common:

- Referral

- Standard

Referral Arrangement

This is an arrangement where the employees of the savings association simply refer customers that wish to discuss nondeposit investment products or services to a particular registered broker-dealer. They may provide customers with the broker-dealer's promotional materials, direct them to telephones for placing orders, or provide a toll free telephone number. The calls would connect the customer with a broker-dealer that has an agreement with the savings association. There is a written agreement between the savings association and the broker-dealer that stipulates the percentage of the gross commissions that the savings association will receive. Generally, with the referral arrangement, no sales occur on the premises of the savings association.

Standard Networking Arrangements

The most common arrangement is for a savings association to enter into a networking agreement with a registered broker-dealer, which may be:

- An unaffiliated third party.
- A service corporation.
- An affiliate of the savings association.

In a standard networking arrangement, broker-dealers offer a range of investment products and services to a saving association's customers on the saving association's premises.

In a networking arrangement, the degree of the savings association's financial and managerial commitment and its level of profits will vary based on the following considerations:

- The structure of the networking arrangement.
- The products or services offered.
- The terms of the written agreement.

In these arrangements, the savings association makes available to the broker-dealer's registered representatives, a working area on the premises, telephones, and desk space. In return, the broker-dealer pays the savings association a fee based on all securities transactions that occur at or are attributable to activities conducted on the savings association's premises. This arrangement typically does not involve substantial upfront fees.

The broker-dealer employs or contracts with the registered representatives (individuals licensed to sell securities) and is fully responsible for all securities sales occurring through them. The broker-dealer recruits, screens, trains, and manages the sales force. Under some networking arrangements, registered representatives are dual employees of the savings association and the broker-dealer. When the dual employee is providing investment products and services, the broker-dealer is responsible for monitoring the registered representative's compliance with applicable securities laws and regulations. When the dual employee is providing bank products or services, the savings association has the responsibility for monitoring the employee's performance. (Also, see Dual Employees in this Handbook Section.)

Brokerage Partners

A savings association may enter into a networking arrangement with a broker-dealer that is affiliated with the savings association such as a service corporation or an affiliate, or with a nonaffiliated broker-dealer. There are additional considerations when the broker-dealer is an affiliate or a service corporation.

For instance, if the association filed an application, OTS may have imposed certain restrictions on the savings association and their broker-dealer or insurance affiliates or service corporations. You should review the Director's Order or application approval letter – if there is one – for any operating restrictions OTS imposed as a condition of approval. For example, an application to establish a broker-

dealer subsidiary might have associated conditions. If there are conditions, you should review the savings association, the affiliate, or the service corporation's compliance with these conditions.

Broker-Dealer is an Affiliate

Typically, in this kind of arrangement a securities affiliate has a mutual fund that they sell through the savings association. This is a proprietary fund. Characteristically, the fund name and the institution name are similar to the name of the holding company. For example, a hypothetical association called First Savings with a holding company called First Holding Company might offer a First Savings Growth Fund or a First Savings Capital Appreciation Fund. Some institutions market only their proprietary funds, while others offer both their own funds and funds sponsored by others. (See the section on Common Names later in this Section.)

The transaction with affiliate regulation applies if the broker-dealer is an affiliate (12 CFR § 563.41).

This regulation places certain restrictions on transactions between affiliated entities. See Examination Handbook Section 380 for a detailed description of the transaction with affiliates rules.

If the broker-dealer is an affiliate of a depository institution, the functional regulation provisions of GLBA also apply. GLBA established a framework of procedural requirements and criteria for working with functionally related entities, which may be a subsidiary or sister corporation engaged in activities regulated by another regulatory agency, such as the SEC. OTS will work cooperatively with the primary regulator of the affiliated broker-dealer to request information and reports. In limited circumstances, if the regulator is unable or unwilling to obtain the information, OTS can request the information directly from the entity. If the information is insufficient, OTS can, in some instances, conduct an on-site examination of the entity if OTS can meet certain requirements showing OTS' need for the information.

Broker-Dealer is a Service Corporation

If the broker-dealer is a service corporation of the savings association, you should follow the examination procedures outlined in Section 730, "Related Organizations," of the Examination Handbook and observe the functional regulation requirements of GLBA.

Sale of Association or Affiliate's Stock Including Unsolicited Sales in a Networking Arrangement

OTS regulations at 12 CFR § 563.76 generally prohibit most on-premises offers or sales of a savings association's or its affiliate's securities. The prohibition applies to offers or sales made through a networking arrangement. See the definition of "affiliate" in 12 CFR § 561.4.

OTS issued TB 23a, "Sales of Securities" on June 23, 1993. TB 23a lists exceptions for the on-premises sales of a savings association's or its affiliate's equity securities, provided that the permitted offers and sales are conducted in a safe and sound manner.

TB 23a states that OTS will not treat as an affiliate, any investment company (mutual fund) that a savings association, its holding company, or a subsidiary of the holding company sponsors, advises, distributes, or administers. A common name for these mutual funds is proprietary mutual funds. TB 23a requires, however, that sales of these mutual fund shares must comply with the safeguards established in § 563.76 and TB 23a.

One of the safeguards established in § 563.76 and TB 23a is that only registered representatives subject to supervision by a registered broker-dealer may make sales unless certain SEC exceptions apply, such as the exception at 17 CFR § 240.3a4-1. Section 563.76 also requires that the savings association (or an affiliate) may not pay any commissions, bonuses, or comparable incentive compensation to its employees in connection with the on-premises sales of its securities. Registered broker-dealers, however, may pay registered representatives compensation consistent with industry norms. The regulation also requires that customers must certify in writing that they have received specific disclosures on the nature of the securities they are buying.

The Chubb Letter discusses the purchase or sale of the securities of financial institutions (which includes savings associations) in networking arrangements. The Chubb Letter only permits broker-dealers to execute a customer's unsolicited transaction in equity securities of the financial institution or its affiliates. The customer must sign 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, its affiliates, the FDIC, or any other state or federal deposit guarantee fund relating to financial institutions. Another term for unsolicited transactions is "order taking." The Chubb Letter does not permit broker-dealers to discuss the purchase or sale of debt securities of the financial institution or its affiliates, on an unsolicited basis or otherwise, on any part of the premises of the financial institution that is generally accessible to the public.

Until the SEC issues final regulations on brokerage activities under GLBA and those regulations become effective, savings associations should continue to abide by the provisions in the Chubb Letter.

Description of Securities Brokerage Business

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 may be pertinent to your exam of the networking arrangement.

Securities Brokerage Regulators

The SEC regulates securities transactions at the federal level and states regulate securities transactions at the local level. State laws may vary in scope, but apply to activities and products transacted within their borders. Broker-dealers must register with the SEC generally and must comply with registration requirements of the states and the National Association of Securities Dealers (NASD). NASD requires registration for both the broker-dealer and the individuals associated with the firm.

National Association of Securities Dealers

The NASD is a self-regulated entity. It establishes member qualifications, tests, and licenses individuals. NASD maintains Rules of Fair Practice and enforces compliance with securities laws and its own rules (subject to SEC review). Under NASD Rule 1031, all persons associated with a member broker-dealer, who are engaged in the securities business for the member broker-dealer are designated as representatives that must be registered with the NASD. The term "associated person" includes securities professionals that are employees of the broker-dealer, independent contractors working with a broker-dealer, and dual employees of the broker-dealer and the savings association.

NASD Requirements

The registration application requires information about the individual's prior employment and disciplinary history. The NASD prescribes two levels of registration for individuals:

- Registered representatives, generally sales personnel.

- Principals, generally officers of the firm and other management personnel actively involved with the day-to-day operation of the firm's securities business.

A prerequisite for a broker-dealer to register with the NASD is for each individual associated with the broker-dealer to have successfully completed each required qualification examination. NASD determines which examinations to require based upon the individual's position within the broker-dealer. Only individuals that are sponsored by a current broker-dealer member may take a qualification examination to receive a license. When a person has previously passed a qualification exam and has registered with a member broker-dealer firm within the previous two years, NASD does not require additional qualification examinations to continue functioning in the same capacity.

The most common NASD licenses are:

- Series 24 – General Securities Principal. This license authorizes the individual to supervise all sales personnel.

- Series 11 – Assistant Representative. This license authorizes the individual to take and enter unsolicited orders, but they cannot determine suitability or provide investment recommendations.

- Series 7 – General Securities Representative. This license authorizes the individual to sell all securities except commodities.

- Series 6 – Investment Company Products and Variable Contracts Limited Representative. This license authorizes the individual to sell only mutual funds and variable annuities.

Securities and Exchange Commission

Congress created the SEC to protect investors, maintain fair and orderly securities markets, and enforce federal securities laws. The SEC requires that an issuer provide adequate, relevant information to enable a potential buyer to make an informed decision regarding the purchase. Additionally, state laws generally require that issuers register with, or gain approval from state authorities. Federal and state laws also include provisions that address manipulation of securities trading markets. These laws apply to, among other things, insider trading based on nonpublic information and actions and statements by management designed to deceive others.

SEC Requirements

Since broker-dealers maintain custody of the funds and securities of their clients, the SEC requires that they show evidence of financial responsibility. Broker-dealers must establish mechanisms for customers to recover funds should the broker-dealer become insolvent or otherwise unable to meet its responsibilities. Three principal mechanisms permit broker-dealers to show evidence of financial responsibility:

Net Capital Rules – These rules require broker-dealers to maintain certain levels of capital. These levels generally depend on the activities in which they engage. The broker-dealer must carry its assets at fair market value, which is determined every business day.

Handling of Customer Funds – Broker-dealers must comply with requirements for segregation of customer funds and securities. Thus, broker-dealers must implement adequate measures to separately maintain client and broker funds and securities.

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, but does not apply to losses that result from investment risk. Members maintain this fund through assessments. The SIPC may borrow funds from the United States Treasury if assessments are insufficient to cover its obligations.

Regulatory Coordination

OTS generally does not examine registered broker-dealers. The NASD, SEC, and state authorities regularly examine broker-dealers to determine if they comply with securities rules and regulations. The extent to which a brokerage operation complies with securities laws, rules, and regulations can materially affect the broker-dealer's viability and the public's overall perception of the savings association.

The oversight of brokerage firms by securities regulators provides important information in determining the appropriate examination scope of the networking arrangement. For this reason, OTS and the other banking agencies signed an information sharing agreement with the NASD on January 3, 1995. The agreement seeks to eliminate duplication of effort and regulatory overlap through the sharing of examination schedules and examination information. The agreement covers situations where the broker-dealer is an affiliate of the savings association and when the broker-dealer is not an affiliate.

When the broker-dealer is an affiliate, the agreement states that OTS and NASD will share examination schedules and where appropriate, coordinate both agencies' examinations. The two agencies have also agreed to share information and allow access to examination related work papers. Under the agreement, where the broker-dealer is not an affiliate, OTS may, in connection with an examination of a savings association, request from NASD information concerning the most recent examination results of the broker-dealer if OTS believes that such information may facilitate its supervision of the savings association. Each Regional office must contact the appropriate NASD offices and set up procedures to implement the information sharing agreement so that the agencies exchange appropriate examination information and can make referrals regarding any violations of securities laws or other supervisory concerns. See Appendix E, Agreement In Principle.

How Securities are Sold

Investors buy and sell securities in the United States in two primary markets: the over-the-counter (OTC) market and stock exchanges. The OTC 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 that engages in either activity. A principal is an officer or partner of a brokerage firm who is responsible for a certain functional area. Different authorities call sales persons employed by broker-dealers different names. A registered representative is the term at the federal level and an agent is the term at the state level. Representatives and agents must obtain licenses according to applicable federal and state laws.

Types of Brokerage Services

Brokers provide either discount or full brokerage services. A discount brokerage operation takes customer orders to buy or sell securities. It offers no investment advice and makes no margin loans (loans that permit securities trades on credit with a deposit maintained in a customer account). A full-service broker-dealer offers comprehensive services including investment advice and margin loans along with a full range of investment products.

The two major types of brokerage transactions are agency and principal. The most common type of transaction conducted on the premises of a savings association is an agency transaction in which the broker-dealer acts on behalf of the customer and receives commissions. A principal transaction occurs when the broker-dealer trades securities for its own account.

Broker-dealers may provide either individualized or standard investment advice. 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.

Risks Associated with Networking Arrangements

Networking arrangements present certain potential risks to savings associations. You should determine whether the savings association is appropriately identifying, measuring, monitoring, and controlling the risks associated with the networking arrangement.

The risks are as follows:

- Losses through customer litigation over actions of the broker-dealer.

  There is a risk that customers will not fully understand that the FDIC does not insure nondeposit investment products. There is also the risk that customers may think that nondeposit investment products are deposits or other obligations of the savings association. As a result, the savings association may be held liable in litigation due to failure of the registered broker-dealer to provide customer disclosures or if the broker-dealer engages in unsuitable sales practices. One way to mitigate the risk of customer confusion is for the broker-dealer to operate in a manner that insulates the savings association from potential liability under the anti-fraud provisions of the federal securities laws (Section 10(b) of the Securities Exchange Act and Rule 10b-5). The anti-fraud provisions prohibit materially misleading or inaccurate representations in connection with the sale of securities.

- Inventory risk.

  The risk that the securities will be stolen or lost. This is not a major concern as the majority of securities are traded electronically through the Depository Trust Company. There are very few actual paper securities left in circulation. Systems should be in place, however, to ensure that the broker-dealer takes appropriate safety measures for the safekeeping and the transportation of securities.

- Loss of deposits and costs associated with the networking arrangement.

  The savings association may minimize its overall exposure to this risk by monitoring the networking arrangement's income, expenses, and effect on deposits.

Your examination of the networking arrangement will focus on two main points:

- To determine the adequacy of the savings association's internal controls for identifying, measuring, monitoring, and controlling the risks presented to the savings association.

- To determine whether the networking arrangement does an effective job of minimizing potential customer confusion between FDIC-insured and non-FDIC insured investment products.

There are a number of ways that savings associations with networking arrangements can minimize their overall exposure to risk by observing certain safeguards:

- Conducting appropriate review of the broker-dealer before entering into an arrangement and on a periodic basis throughout the relationship.

- Taking appropriate measures to ensure that customers clearly understand the differences between insured deposits and nondeposit investment products and receive, at least, the minimum disclosures both orally during sales presentations (including telemarketing) and in writing. Also, see Disclosures in this Handbook Section.

- Acting appropriately to ensure that customers clearly understand that nondeposit investment products and services are subject to investment risks, including possible loss of the principal invested. Also, see Disclosures in this Handbook Section.

- Written agreements with the broker-dealer that require indemnification provisions and other protections. Also, see Written Agreements with broker-dealers in this Handbook Section.

- Contingency planning if the broker-dealer is unable to perform in accordance with the agreement.

- Oversight by management and the board of directors to ensure an operating environment that fosters consumer protection in all facets of the networking arrangement.

- Effective compliance and audit programs for the networking arrangement.

- Blanket bond coverage.

Risk Management for Networking Arrangements

Introduction

The following information covers the various safeguards and regulatory requirements associated with the conduct of a safe and sound networking arrangement. Much of this supervisory guidance is in the Interagency Statement jointly issued by the four federal regulatory agencies (OTS, OCC, FDIC and FRB) on February 15, 1994. This Interagency Statement applies to all third party brokerage arrangements. The banking agencies developed the Interagency Statement to offer financial institutions uniform guidance on how to operate nondeposit investment product programs in a safe and sound manner while reducing customer confusion.

Currently, savings associations must also comply with the SEC's policy on networking arrangements as set forth in the Chubb Letter. This is a comprehensive no-action letter, Re: Chubb Securities Corporation dated November 4, 1993. (See Appendix C.) OTS, as a policy matter, is applying these restrictions to savings associations that choose to offer nondeposit investment products and services to their customers.

The Interagency Statement applies to the sale of stocks, mutual funds, and variable rate annuities. The Interagency Statement also covers hybrid accounts, such as sweep accounts, retail purchase agreements, and stock-indexed CDs that combine attributes of both insured deposits and nondeposit investment products.

The Interagency Statement does not apply to the following types of sales or products:

- Sales of nondeposit investment products to nonretail customers, such as sales to institutional customers and fiduciary accounts administered by the savings association.
- Sales of government or municipal securities away from the lobby area.
- Insurance products that do not have an investment component such as credit life insurance.
- Traditional savings instruments such as savings bonds.

The Interagency Statement generally applies to sales using electronic media such as telephones and the Internet.

The Chubb letter contains restrictions regarding referral fee programs. Until the SEC issues final regulations on brokerage activities under GLBA and those regulations become effective, savings associations should continue to abide by the provisions in the Chubb Letter. Supervisory guidance is also in TB 82, Third Party Arrangements. This document provides general guidance on third party arrangements, whether they occur between affiliated or unaffiliated entities. OTS expects directors and management to effectively manage risks that arise from all third party arrangements, including networking arrangements with broker-dealers.

Internal Controls

Management and the board of directors must establish a system of internal controls to ensure that the networking arrangement complies with applicable regulatory requirements and restrictions, and is consistent with stated management strategies and objectives as well as the savings association's business plan.

Management must be able to demonstrate to OTS examiners that internal controls are adequate to monitor and assess the broker-dealer's compliance with written agreements, applicable law, and OTS supervisory guidance.

After the savings association enters into a networking arrangement, the board of directors and management should periodically review the arrangement.

The savings association's internal controls should describe the types of reports that the broker-dealer must provide to management on a routine basis.

Required reports should include the following information:

- New account activity for each registered representative;
- Customer complaints;
- Findings contained in the broker-dealer's internal audit, external audit, or compliance report; and
- Sales activity exception reports that flag potential concerns regarding limits exceeded or unusual patterns or trends.

Weblinking

The OTS, along with the FDIC, OCC, and the NCUA, on April 23, 2003, issued Interagency Guidance on Weblinking: Identifying Risks and Risk Management Techniques. (See Thrift Bulletin 83.)

While weblinks are a convenient and accepted tool in website design, their use can present certain risks. Generally, the primary risk posed by weblinking is that viewers can become confused about whose website they are viewing and who is responsible for the information, products, and services available through that website.

The purpose of the Weblinking guidance is to assist financial institutions in identifying risks posed by the use of weblinks on their websites and to suggest a variety of risk management techniques institutions should consider using to mitigate these risks. The guidance applies to institutions that develop and maintain their own websites, as well as institutions that use third-party service providers for this function.

Written Statement

Management of the savings association should adopt a written statement that addresses the risks associated with the arrangement and that contains a summary of policies and procedures instituted to address these risks. The statement should address the scope of the broker-dealer activities and the association's compliance program to monitor these activities. The savings association's board of directors should adopt and periodically review the written statement.

Policies and Procedures

The savings association's policies and procedures, at a minimum, should incorporate the safeguards in the Interagency Statement. The level of detail necessary in a saving association's policies and procedures will depend on the structure and complexity of the networking arrangement. Savings associations' policies and procedures should address the following areas:

- Compliance procedures.
- Supervision of personnel involved in sales.
- Types of products sold.
- Permissible use of customer information.
- Designation of employees to sell investment products.
- Disclosures and advertising.
- Setting and circumstances of sales activity.
- Qualifications and training.
- Compensation.

Review of the Broker-Dealer

The savings association should, before entering into an arrangement, conduct an appropriate review of the broker-dealer. The review should include an assessment of the broker-dealer's financial status, management experience, reputation, and ability to fulfill its contractual obligations to the savings association, including compliance with all applicable OTS regulations and policies.

Personnel with appropriate knowledge, experience, and analytical skills should perform the evaluation. The files should document management's review of the broker-dealer. Documentation of the broker-dealer review should include:

- A description of the services and investment products offered;
- The broker-dealer's competence and experience;
- The broker-dealer's financial condition through its most recently audited financial statement and annual report;
- The broker-dealer's business reputation, complaints, and litigation past and pending;
- Qualifications and training of the broker-dealer's staff members;
- The broker-dealer's internal and external audit and compliance reports;
- The broker-dealer's information and reporting system including its ability and willingness to deliver reports to the savings association regarding the networking arrangement;

- The broker-dealer's contingency and recovery plan; and

- The broker-dealer's insurance coverage, which should include fidelity bond coverage for losses attributable to dishonest acts and liability coverage for losses attributable to negligent acts.

Management of the savings association must make reasonable efforts to ensure that the broker-dealer continues to be an appropriate partner in the networking arrangement. Such efforts should include ongoing review of information regarding the broker-dealer, such as the following:

- NASD and SEC regulatory reports or deficiency letters.

- Industry ratings.

- Financial statements

- Third-party audit reports.

- Other appropriate material such as customer complaints, and customer satisfaction surveys.

In addition, management should monitor the broker-dealer's personnel changes. High turnover of employees may indicate problems. Management must address and resolve any material problems uncovered through a periodic review of the broker-dealer.

Written Agreements with Broker-Dealers

The savings association's files should contain adequate documentation regarding the arrangement with the broker-dealer. A review of the agreements and records pertaining to the networking arrangement should provide an overview of the networking arrangement and reveal potential areas of risk that require further evaluation. Written agreements should sufficiently delineate all facets of the arrangement. The board of directors should approve the agreement. The savings association's senior management should periodically monitor compliance with the agreement. Any agreement should contain language that fully indemnifies the savings association from liability attributable to the negligence, recklessness, or intentional misconduct of the broker-dealer or its employees (independent contractors). If the arrangement includes dual employees, the agreement must provide for written employment contracts that specify the duties of such employees and their compensation arrangements.

The agreement between the broker-dealer and the savings association should include the following:

- The duties and responsibilities of each party to the agreement including the provision of regular reports from the broker-dealer to the savings association regarding, for each registered representative involved in the networking arrangement, account openings, transactions, disciplinary history, and customer complaints.

- A description of permissible activities by the broker-dealer on the premises of the savings association.

- A description of the broker-dealer's internal controls that will ensure compliance with applicable laws, regulations, and OTS policy statements with a particular focus on ensuring that registered representatives are complying with customer suitability standards. (See previous discussion on review of internal controls in this Handbook Section.)

- The defined terms of the broker-dealer's use of the savings association's space, personnel, and equipment.

- The types of investment products and services to be provided and related restrictions.

- Insurance requirements.

- An assurance that the broker-dealer will not disclose or use the savings association customer's personal information for any purpose other than to offer investment products or services to those customers.

- The broker-dealer's authorization of the savings association and OTS to have access to its premises, personnel, and records as are necessary or appropriate to evaluate compliance with the terms of the agreement. These records should include SEC and NASD examination reports, sales-practice reviews, and any correspondence provided to the broker-dealer by its regulatory authorities.

- A description of the compensation arrangements of the registered representatives involved in the networking arrangement.

Supervision of Personnel Involved in Sales

The savings association's policies and procedures should designate, by title or name, the individuals responsible for supervising referral activities initiated by savings association employees not authorized to sell investment products. They also should include standards pertaining to such customer referrals. OTS, under the Chubb letter, allows tellers and other employees to refer customers to registered representatives employed by the broker-dealer.

Designated supervisory personnel should also be responsible for monitoring compliance with the agreement between the savings association and the broker-dealer, as well as compliance with the Interagency Statement and any other applicable laws or guidelines. Supervisory duties should also include surveying customer satisfaction through questionnaires, evaluating the nature of any customer complaints, and reviewing any disciplinary actions initiated by the NASD or the SEC.

Dual Employees

Networking arrangements between the savings association and a broker-dealer may include dual employees. The savings association and the broker-dealer both employ these individuals. In some cases, instead of being an employee, the individual may be an independent contractor associated with the broker-dealer. They are registered representatives so they may sell nondeposit investment products on

behalf of the broker-dealer. The broker-dealer must control, properly supervise, and be responsible for dual employees when they are acting in their registered representative capacity. The potential for customer confusion increases when dual employees have customer contact on behalf of both the savings association and the broker-dealer. Thus, additional safeguards are appropriate to address such risk.

Types of Products Sold

The savings association's board should carefully evaluate and decide on the types of investment products that the association should offer through the networking arrangement. An association can limit risk exposure by not offering highly speculative investment products such as limited partnerships, real estate partnerships, high-yield/low rated bonds. If the association offers high-risk products, it must ensure that the broker-dealer employs appropriate safeguards to ensure that customers are aware of the financial risks of these types of investments. The safeguards include oral and written disclosures, and product suitability standards.

Sharing of Customer Information

The savings association's employee training materials should describe the networking arrangement's procedures on the appropriate use of customer information. In addition, the written agreement between the broker-dealer and the savings association should specifically identify which employees may use the information. These materials should address specific steps for minimizing customer confusion when registered representatives use the information to contact savings association customers.

The extent to which a savings association may make its customer information available to the broker-dealer depends on whether the recipient of the information is affiliated or nonaffiliated. The answer will define the limits of what information the association can and cannot share and the ability of the individual customer to allow the sharing or to "opt out."

Sharing with Nonaffiliates

Title V of GLBA, captioned "Privacy" and Subtitle A, "Disclosure of Nonpublic Personal Information," establishes the first comprehensive legislative effort to limit a financial institution's use of consumers' personal information. In brief, Title V prohibits a financial institution from disclosing "nonpublic personal information" about a consumer to nonaffiliated third parties, subject to certain exceptions, unless the institution satisfies various notice and opt-out requirements, and if the consumer has not elected to opt out of the disclosure. OTS has issued regulations at 12 CFR Part 573 to implement the statutory provisions for its institutions. You should refer to OTS' Examination Handbook Section 1375 for additional guidance.

When a savings association enters into a contract with a broker-dealer that is not an affiliate, it must be careful to abide by the privacy requirements of GLBA and OTS' implementing regulations. Under the privacy provisions, the savings association must provide its customers with a "clear and conspicuous" notice that describes the types and sources of information collected and shared, among other elements. Additionally, the institution must provide the customer with a reasonable means and opportunity to opt

out or disallow any disclosure of their nonpublic personal information to the nonaffiliated broker-dealer, unless an exception applies. (See 12 CFR §§ 573.13, 573.14 and 573.15.)

Section 573.13 is likely to be of particular relevance for savings associations seeking a business relationship with a nonaffiliated broker-dealer. This section allows an exception to the opt out right (but *not* to the notice requirement) for service provider relationships and for joint marketing agreements. This section specifically permits a savings association to disclose nonpublic personal information about its customers to the nonaffiliated broker-dealer without providing the customer an opportunity to opt out if the association meets three requirements:

- The broker-dealer must market financial products or services offered under a joint agreement between the savings association and the broker-dealer. The joint agreement must be a written agreement under which the savings association and the broker-dealer "jointly offer, endorse, or sponsor" a financial product or service. For example, an agreement that allows the broker-dealer to offer investment products and services on the premises of the savings association would demonstrate a joint offering, endorsement, or sponsorship.

- The savings association must have provided its customers with an initial privacy notice that includes a description of the joint marketing arrangement.

- The written agreement between the savings association and the broker-dealer must restrict the broker-dealer from disclosing or using the savings association customer's personal information for any purpose other than to offer investment products or services to those customers.

Sharing Information with Affiliates

There is no exact parallel to the GLBA Privacy Regulation for affiliate sharing. However, the Fair Credit Reporting Act (FCRA) addresses affiliate sharing for certain types of customer information and mandates a notice and opt out opportunity, much like that in GLBA. In addition, the recently adopted Fair and Accurate Credit Transactions Act of 2003 (FACTA) limits the use of customer information permissibly shared under FCRA among affiliates.

The FCRA provides the framework under which savings associations are permitted to share consumer information among their affiliates without incurring the obligations of consumer reporting agencies. Specifically, these provisions authorize savings associations to communicate to and among their affiliates (i) information as to their "transactions or experiences" with the consumer and (ii) "other" information (i.e. information covered by the FCRA but not transaction or experience information), provided that the association has given notice to the consumer that the "other" information may be communicated and has furnished the consumer with an opportunity to "opt out," and the consumer has not opted out.

The term "transaction and experience" information includes firsthand information gleaned from the account relationship with the customer over time. Examples might include a history of late payments, exceeding credit limits, the number and amount of deposits and withdrawals, the average monthly balance, and many others. For transaction and experience information, a financial institution is not

required to provide notice or to seek the customer's consent; this information can flow freely to affiliates – although its use for marketing purposes has been restricted by FACTA as explained below.

The term "other" information refers to information that is covered by the FCRA and that does not relate to transaction or experiences between the consumer and the person making the communication. In the case of "other" information, the savings association must provide a notice to the customer and must allow the individual an opportunity to opt out prior to commencement of this sharing. The types of information covered by this category include credit reports, applications, and outside sources, such as verifications of employment history.

Using Affiliate Information for Solicitation

Even if affiliates share information according to the requirements described above, new regulatory limitations will apply to the use of that information in accordance with the FACTA. This limitation will apply whether the information derives from transactions and experience or other sources. Generally, the new limitation prevents the affiliate receiving the information from using that information to make a solicitation for marketing purposes to the consumer about the receiving affiliate's products or services, unless the consumer is first given notice and a simple means of opting out of such a marketing solicitation. Exceptions to this limitation are contained in the statute and will be part of implementing rules to be promulgated in the second half of 2004. For instance, under FACTA, the solicitation use limit does not apply to a person who uses affiliate information to solicit consumers with whom it has an existing business relationship.

Designation of Employees to Sell Investment Products

Management must provide a description of the responsibilities of those personnel authorized to sell nondeposit investment products as well as other personnel who may have contact with retail customers.

The savings association's policies and procedures, as well as employee training materials, should carefully detail the activities restrictions and responsibilities that apply to dual employees. For example, dual employees should not, while located in routine deposit-taking areas (specifically teller windows), make general or specific recommendations regarding investment products, or accept any orders for such products.

Nonregistered Employees

Employees of the savings association that are not dual employees may not engage in any securities or investment related activities other than providing clerical and ministerial assistance unless an SEC exception, such as the exception at 17 CFR § 240.3a4-1 is met. This means nonregistered employees may not perform any of the following tasks:

- Accept or deliver money or securities.
- Recommend any security or give any form of investment advice.

- Describe investment vehicles such as mutual funds.
- Discuss the merits of any security or type of security with a customer.
- Handle any question that might require familiarity with the securities industry or the exercise of judgment regarding securities and investment alternatives.
- Take orders to execute securities transactions.

Savings association employees may, in accordance with the savings association's policies, refer customers to registered representatives who may assist customers interested in securities sales.

Disclosures and Advertising

The savings association's management must ensure that oral and written disclosures to customers purchasing nondeposit investment products are clear, conspicuous, and effective in minimizing customer confusion. Such disclosures must fully distinguish between the following:

- Uninsured investment products from insured savings association deposits.
- Brokerage services from deposit-taking functions of the savings association.
- Investment product or service is subject to investment risks, including possible loss of the principal amount invested.

Content and Form of Disclosure

Registered representatives, when selling or recommending investment products must provide to customers the following minimum disclosures:

- The FDIC does not insure investment products.
- Investment products are not deposits or other obligations of the association and are not guaranteed by the savings association.
- Investment products are subject to risks, including possible loss of the principal amount invested.

Placement of Disclosures

Policies and procedures should ensure that required disclosures are conspicuous in all advertisements, sales presentations, or other information such as brochures pertaining to the features of investment products. Disclosures should generally be 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. The disclosures must be conspicuous (highlighted through bolding, boxes, or a larger typeface) and presented in a clear and concise manner.

Timing of Disclosure

The savings association should ensure that the broker-dealer's registered representatives provide the minimum disclosures to all customers in the following form at the following times:

- Orally during any sales presentation.
- Orally when the registered representative provides investment advice concerning nondeposit investment products.
- Orally and in writing before or at the time the customer opens an investment account.
- In advertisements and other promotional materials, as described below.

Signed Certification

- When a customer opens an investment account, the registered representative should obtain a signed certification in which the customer acknowledges receipt and understanding of the required disclosures.
- The association may make the minimum disclosures on a customer account agreement or on a separate disclosure form. Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block. If the savings association and the broker-dealer send joint customer account statements, the information concerning the nondeposit investment products must be clearly separate from the information regarding deposit account activity and should be introduced with the required minimum disclosures as stated above. In addition, the identity of the broker-dealer must be included.

Advertisements and Other Promotional Material

Advertising and other promotional materials must clearly distinguish the savings association's depository functions from nondeposit investment products and must comply with the following standards:

- Includes the minimum disclosures.
- Does not confuse transactions executed and investment advice provided through the networking arrangement with federally insured deposits.
- Clearly states the name of the broker-dealer that is involved in the networking arrangement.

- Does not omit material facts or mislead customers regarding the characteristics of, and risks associated with, particular investment products.

For additional information regarding OTS regulations on advertising, see Examination Handbook Section 1425, Advertising.

Logo Disclosures

In accordance with TB 23-3, savings associations may use shorter, logo form disclosures in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and in written advertisements and promotional materials such as brochures. Savings associations may not use logo disclosures in the written acknowledgment forms that customers sign. The text of an acceptable logo format disclosure must include the following statements:

- Not FDIC insured
- No Bank Guarantee
- May Lose Value

Savings associations must display logo format disclosures conspicuously, in a box, and set them in bold face type.

Where No Disclosures Are Required

TB 23-3 does not require minimum disclosures under the following circumstances:

- Radio broadcasts of 30 seconds or less.
- Electronic signs (does not include TV, Internet, or ATMs).
- Signs, such as banners and posters, when used only as location indicators.

Displays of promotional sales material related to the networking arrangement in the savings association's retail area should be separate from material related to insured products. Associations may place sales material in the securities sales area or at branch entrances.

Additional Disclosures

Savings associations should ensure that registered representatives are providing customers with written disclosures regarding any fees, penalties, or surrender charges associated with investment products. Associations should also ensure that customers receive written disclosures, in a prospectus or otherwise, regarding the existence of an advisory or other material relationship between the savings association and its affiliates. Examples of relationships that need to be disclosed are when the savings association, or an affiliate, is the investment advisor for mutual funds that are being sold by the broker-

dealer (proprietary mutual funds) or when the broker-dealer in the networking arrangement is an affiliate of the savings association. The registered representative should make these disclosures before a customer opens an investment account, or at the time a customer opens an investment account.

The potential for customer confusion also increases when registered representatives, through investment sales presentations or materials, reference insurance coverage provided by an entity other than the FDIC. Most commonly, this will be the SIPC, state funds, or private companies. Such references must include a clear explanation of the distinctions between such insurance coverage and FDIC deposit insurance. Savings associations should ensure that all employees having customer contact receive adequate training on relevant insurance coverage.

Common Names and SEC Policy

Prospective nondeposit investment customers tend to associate the name and logo of a savings association with the federal insurance that protects their deposits against loss. When the name of any nondeposit investment product (such as a mutual fund) is similar to that of the savings association, unsophisticated customers may assume that the investment products are federally insured. For this reason the SEC presumes that similar names promote customer confusion. If one of the products offered to savings association's customers is a mutual fund that has in common the name of the savings association, there must be a prominent disclosure. This disclosure must be on the cover page of the prospectus of the mutual fund stating the shares are not federally insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other banking agency. (See Appendix D, SEC Policy on Bank and Mutual Fund Names.)

Setting and Circumstances

Savings associations must ensure that the networking arrangement can be clearly distinguished from the savings association's banking operations to minimize any potential customer confusion. It should be obvious to the casual observer that the broker-dealer, not the savings association, is offering the nondeposit investment products and services.

The following practices will ensure that the investment sales area is distinct and that sales literature and materials do not convey any inaccurate or misleading impressions about the networking arrangement. Savings associations should implement these practices:

- The area where the broker-dealer offers nondeposit investment products should be physically separate from teller windows and desks where retail deposit-taking activities take place.
- Information on investment products or services should be separate from material pertaining to banking products.
- Signs and literature should clearly state that investment products are not FDIC-insured.
- Statements provided to customers that contain deposit and securities information should clearly separate the information and include the required minimum disclosures.

- Under no circumstances should any employee, while located in routine deposit-taking areas such as teller windows, make general or specific recommendations regarding investment products or accept orders for such products.

Qualifications and Training

In addition to monitoring the networking arrangement, savings association management can minimize exposure to loss by adequately training its own employees. The savings association's policies and procedures should establish training programs for nonregistered savings association employees on how to make proper referrals and for dual employees on how to determine when the employee is acting on behalf of the savings association and when on behalf of the broker-dealer. Savings association management should also ensure that registered representatives meet the qualifications and training required by securities regulators and that they have obtained adequate training in the following areas:

- Products in the networking arrangement.
- Internal policies and procedures of the savings association.
- OTS requirements and restrictions.

The training materials for registered representatives should set forth limitations on their authority, OTS required disclosures, and customer suitability standards.

Suitability and Sales Practices

The broker-dealer must comply with suitability standards and other related customer protection practices established by SEC and NASD regulations and guidelines. These standards provide that sales representatives should have reasonable grounds for recommending that a certain investment product is suitable for a particular customer. In addition, the sales representative must believe that the customer is reasonably able to evaluate the financial risks associated with an investment recommendation. Registered representatives should document the customer's information such as income, tax status, age, and investment objectives that form the basis for recommending particular investments in the broker-dealer's files, and update them periodically.

Unsolicited Transactions

Unsolicited transactions occur when customers direct the registered representative to initiate securities transactions that the registered representative did not recommend or suggest. Suitability standards are less stringent for unsolicited transactions and discount brokerage operations. Regardless, the customer must acknowledge receipt of the minimum disclosures. In addition, the broker-dealer should retain documentation that shows the registered representative did not solicit the sale, that the customer requested the transaction, and that the customer did not rely on a registered representative's recommendation.

Compensation

The structure of the broker-dealer's compensation program (which typically includes incentive compensation such as commissions) for registered representatives, including dual employees, should be structured to minimize the potential for abusive practices, unsuitable recommendations, improper sales, or unnecessary transactions. Incentive compensation may result in aggressive sales practices. Savings association management should monitor, via reports from the broker-dealer, the sales activity for each registered representative to determine any patterns. For example, concentrations in the types of products sold may indicate that sales representatives are making recommendations based on incentive compensation.

Savings associations should review the broker-dealer's compensation program and employment contracts for dual employees involved in the networking arrangement. 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 savings association, provided it is clear that such payments are made on behalf of the broker-dealer from funds allocated by the broker-dealer for payment of dual employees.

Tellers and other savings association employees that are not registered representatives may receive fees for referring customers to the securities sales force; however, savings associations can only pay a one-time nominal fee for each referral. Payment of the fee cannot be dependent on whether or not a sale results.

REFERENCES

United States Code (12 USC)

§1464(c)(4)(B)	Service Corporations
§1468(a)	Affiliate Transactions
§1468a	Advertising
§1831e	Activities of Savings Associations

OTS Rules and Regulations

§561.4	Affiliate
§563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§563.76	Offers and Sales of Securities at an Office of a Savings Association
§573	Privacy of Consumer Financial Information

OTS Bulletins and Memoranda

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 82	Third Party Arrangements
TB 83	Interagency Guidance on Weblinking: Identifying Risks and Risk Management Techniques
CEO Memo 178	Networking Arrangements (July 11, 2003)